

Chapter 3 — Contract Costs

3.1 Costs of Obtaining a Contract

ASC 340-40 provides the following guidance on recognizing the incremental costs of obtaining a contract with a customer:

ASC 340-40

25-1 An entity shall recognize as an asset the incremental costs of obtaining a contract with a customer if the entity expects to recover those costs.

25-2 The incremental costs of obtaining a contract are those costs that an entity incurs to obtain a contract with a customer that it would not have incurred if the contract had not been obtained (for example, a sales commission).

25-3 Costs to obtain a contract that would have been incurred regardless of whether the contract was obtained shall be recognized as an expense when incurred, unless those costs are explicitly chargeable to the customer regardless of whether the contract is obtained.

3.1.1 Considerations for Identifying Incremental Costs of Obtaining a Contract With a Customer

ASC 340-40-25-2 states that the “incremental costs of obtaining a contract are those costs that an entity incurs to obtain a contract with a customer that it would not have incurred if the contract had not been obtained (for example, a sales commission).” Application of this guidance requires an entity to identify those costs that are incurred (i.e., accrued) as a direct result of obtaining a contract with a customer. An entity should apply existing guidance outside of the revenue standard to determine whether a liability should be recognized as a result of obtaining a contract with a customer. Upon determining that a liability needs to be recorded, the entity should determine whether the related costs were incurred because, and only because, a contract with a customer was obtained.

In many circumstances, it may be clear whether particular costs are costs that an entity incurs to obtain a contract. For example, if an entity incurs a commission liability solely as a result of obtaining a contract with a customer, the commission would be an incremental cost incurred to obtain a contract with a customer. However, in other circumstances, an entity may need to exercise judgment and consider existing accounting policies for liability accruals when determining whether a cost is incurred in connection with obtaining a contract with a customer. If the determination of whether a cost has been incurred is affected by other factors (i.e., factors in addition to obtaining a contract with a customer), an entity will need to take additional considerations into account when assessing whether a cost is an incremental cost associated with obtaining a contract with a customer.

The FASB staff noted the following:

- An entity should consider whether costs would have been incurred if the customer (or the entity) decided that it would not enter into the contract just as the parties were about to sign the contract. If the costs (e.g., the legal costs of drafting the contract) would have been incurred even though the contract was not executed, the costs would not be incremental costs of obtaining a contract.
- When an entity is identifying incremental costs incurred to obtain a contract, it may be important for the entity to first consider guidance outside of the revenue standard on determining whether and, if so, when a liability has been incurred. That is, other guidance will generally determine when a cost has been incurred, while ASC 340-40 provides guidance on determining whether costs should be capitalized or expensed.
- When sales commissions are paid to different levels of employees, the revenue standard does not differentiate among the commissions on the basis of the employees' respective functions or titles. For example, if an entity's commission policy on new contracts was to pay 10 percent sales commission to the sales employee, 5 percent to the sales manager, and 3 percent to the regional sales manager, all of the commissions are viewed as incremental because the commissions would not have been incurred if the contract had not been obtained.

Entities should continue to refer to existing U.S. GAAP on liability recognition to determine whether and, if so, when a liability needs to be recorded in connection with a contract with a customer. Therefore, an entity should initially apply the specific guidance on determining the recognition and measurement of the liability (e.g., commissions, payroll taxes, 401(k) match). If the entity recognizes a liability, only then should the entity determine whether to record the related debit as an asset or as an expense.

3.1.2 Sales Commissions and Compensation Structures

Commissions are often cited as an example of an incremental cost incurred to obtain a contract. The table below outlines the views related to whether commissions should be capitalized as detailed in [TRG Agenda Paper 57](#) and broadly summarized in [Implementation Q&A 78](#). Quoted text is from TRG Agenda Paper 57.

Topic	Example/Question	Views Discussed	View Selected by FASB Staff
Fixed employee salaries	Example 1: An entity pays an employee an annual salary of \$100,000. The employee's salary is based upon the employee's prior-year signed contracts and the employee's projected signed contracts for the current year. The employee's salary will not change based on the current year's actual signed contracts; however, salary in future years likely will be impacted by the current year's actual signed contracts. What amount, if any, should the entity record as an asset for incremental costs to obtain a contract during the year?"	<p>View A: "Determine what portion of the employee's salary is related to sales projections and allocate that portion of the salary as an incremental cost to obtain a contract."</p> <p>View B: "Do not capitalize any portion of the employee's salary as an incremental cost to obtain a contract. The costs are not incremental costs to any contract because the costs would have been incurred regardless of the employee's signed contracts in the current year."</p>	<p>View B. "[N]one of the employee's salary should be capitalized as an incremental cost to obtain a contract. . . . Whether the employee sells 100 contracts, 10 contracts, or no contracts, the employee is still only entitled to a fixed salary."</p> <p>"[T]he objective of the requirements in [ASC] 340-40-25-1 is not to allocate costs that are associated in some manner with an entity's marketing and sales activity. The objective is to identify the incremental costs that an entity would not have incurred if the contract had not been obtained."</p>

(Table continued)

Topic	Example/Question	Views Discussed	View Selected by FASB Staff
Some, but not all, costs are incremental	<p>Example 2: An entity pays a 5% sales commission to its employees when they obtain a contract with a customer. An employee begins negotiating a contract with a prospective customer and the entity incurs \$5,000 of legal and travel costs in the process of trying to obtain the contract. The customer ultimately enters into a \$500,000 contract and, as a result, the employee receives a \$25,000 sales commission. What amount should the entity capitalize as an incremental cost to obtain the contract?"</p>	<p>View A: "The entity should capitalize only \$25,000 for the sales commission. Those costs are the only costs that are incremental costs to obtain the contract because the entity would not have incurred the costs if the contract had not been obtained."</p> <p>View B: "The entity should capitalize \$30,000, which includes the sales commission, legal expenses, and travel expenses. The entity would not have been able to obtain the contract without incurring those expenses."</p>	<p>View A. "[T]he sales commission is the only cost that the entity would not have incurred if the contract had not been obtained. While the entity incurs other costs that are necessary to facilitate a sale (such as legal, travel and many others), those costs would have been incurred even if the customer decided at the last moment not to execute the contract."</p> <p>Consider a similar situation in which an entity "incurs the same type of legal and travel expenses to negotiate a contract, but the customer decides not to enter into the contract right before the contract was to be signed by both parties. [T]he travel and legal expenses would still have been incurred even though the contract was not obtained. However, the commission would not have been incurred."</p>

(Table continued)

Topic	Example/Question	Views Discussed	View Selected by FASB Staff
Timing of commission payments	<p>Example 3: An entity pays an employee a 4% sales commission on all of the employee's signed contracts with customers. For cash flow management, the entity pays the employee half of the commission (2% of the total contract value) upon completion of the sale, and the remaining half of the commission (2% of the total contract value) in six months. The employee is entitled to the unpaid commission, even if the employee is no longer employed by the entity when payment is due. An employee makes a sale of \$50,000 at the beginning of year one. What amount should the entity capitalize as an incremental cost to obtain the contract?"</p>	<p>View A: "Capitalize half of the commission (\$1,000) and expense the other half of the commission (\$1,000)."</p> <p>View B: "Capitalize the entire commission (\$2,000)."</p>	<p>View B. "The commission is an incremental cost that relates specifically to the signed contract and the employee is entitled to the unpaid commission.</p> <p>[T]he timing of payment does not impact whether the costs would have been incurred if the contract had not been obtained."</p> <p>"In this fact pattern, only the passage of time needs to occur for the entity to pay the second half of the commission. However, . . . there could be other fact patterns in which additional factors might impact the payment of a commission to an employee." For example, an entity could make the second half of the commission contingent upon the employee's selling additional services to the customer or upon the customer's "completing a favorable satisfaction survey about its first six months of working with the entity." Therefore, an "entity will need to assess its specific compensation plans to determine the appropriate accounting for incremental costs of obtaining a contract."</p>

(Table continued)

Topic	Example/Question	Views Discussed	View Selected by FASB Staff
Commissions paid to different levels of employees	<p>Example 4: An entity's salesperson receives a 10% sales commission on each contract that he or she obtains. In addition, the following employees of the entity receive sales commissions on each signed contract negotiated by the salesperson: 5% to the manager and 3% to the regional manager. Which commissions are incremental costs of obtaining a contract?"</p>	<p>View A: "Only the commission paid to the salesperson is considered incremental because the salesperson obtained the contract."</p> <p>View B: "Only the commissions paid to the salesperson and the manager are considered incremental because the other employee likely would have had no direct contact with the customer."</p> <p>View C: "All of the commissions are incremental because the commissions would not have been incurred if the contract had not been obtained."</p>	<p>View C. "The new revenue standard does not make a differentiation based on the function or title of the employee that receives the commission. It is the entity that decides which employee(s) are entitled to a commission directly as a result of entering into a contract."</p> <p>"[I]t is possible that several commissions payments are incremental costs of obtaining the same contract. However, [stakeholders are encouraged] to ensure that each of the commissions are incremental costs of obtaining a contract with a customer, rather than variable compensation (for example, a bonus)" that would not be incremental because it also relies on factors other than sales.</p>
Commission payments subject to a threshold	<p>Example 5: An entity has a commission program that increases the amount of commission a salesperson receives based on how many contracts the salesperson has obtained during an annual period. The breakdown is as follows:</p> <ul style="list-style-type: none"> • 0-9 contracts . . . 0% commission • 10-19 contracts . . . 2% of value of contracts 1-19 • 20+ contracts . . . 5% of value of contracts 1-20+ <p>Which commissions are incremental costs of obtaining a contract?"</p>	<p>View A: "No amounts should be capitalized because the commission is not directly attributable to a specific contract."</p> <p>View B: "The costs are incremental costs of obtaining a contract with a customer and, therefore, the costs should be capitalized."</p>	<p>View B. Both the 2 percent commission and the 5 percent commission are incremental costs of obtaining a contract. "The entity would apply other GAAP to determine whether a liability for the commission payments should be recognized. When a liability is recognized, the entity would recognize a corresponding asset for the commissions. This is because the commissions are incremental costs of obtaining a contract with a customer. The entity has an obligation to pay commissions as a direct result of entering into contracts with customers. The fact that the entity's program is based on a pool of contracts (versus a program in which the entity pays 3% for all contracts) does not change the fact that the commissions would not have been incurred if the entity did not obtain the contracts with those customers."</p>

Some commission plans include substantive service conditions that need to be met before a commission associated with a contract (or group of contracts) is actually earned by the salesperson. In such cases, some or all of the sales commission may not be incremental costs incurred to obtain a contract with the customer since the costs were not actually incurred solely as a result of obtaining a contract with a customer. Rather, the costs were incurred as a result of obtaining a contract with a customer *and* the salesperson's providing ongoing services to the entity for a substantive period.

A commission structure could have a service condition that is determined to be nonsubstantive. In such a case, the commission is likely to be an incremental cost incurred to obtain a contract with a customer if no other conditions need to be met for the salesperson to earn the commission. In other cases, a commission plan could include a service condition, but the reporting entity determines on the basis of the amount and structure of the commission payments that part of the entity's commission obligation is an incremental cost incurred to obtain a contract with a customer (because it is *not* tied to a substantive service condition) while the rest of the commission is associated with ongoing services provided by the salesperson (because it is tied to a substantive service condition).

Sometimes, there may be other factors that affect the commission obligation, but the ultimate costs are still incremental costs incurred to obtain the contract. For example, a commission may be payable to a salesperson if a customer's total purchases exceed a certain threshold regardless of whether the salesperson is employed when the threshold is met (i.e., there is no service condition). In these cases, although no liability may be recorded when the contract with the customer is obtained (because of the entity's assessment of the customer's likely purchases), if the customer's purchases ultimately exceed the threshold and the commission is paid, the commission is an incremental cost of obtaining the contract. That is, the commission is a cost that the entity would not have incurred if the contract had not been obtained. This situation is economically similar to one involving a paid commission that is subject to clawback if the customer does not purchase a minimum quantity of goods or services.

Entities will need to carefully evaluate the facts and circumstances when factors other than just obtaining a contract with a customer affect the amount of a commission or other incurred costs. Entities should consider their existing policies on accruing costs when determining which costs are incremental costs incurred to obtain a contract with a customer.

Example 3-1

Entity A's internal salespeople earn a commission based on a fixed percentage (4 percent) of sales invoiced to a customer. Half of the commission is paid when a contract with a customer is signed; the other half is paid after 12 months, but only if the salesperson is still employed by A. Entity A concludes that there is a substantive service period associated with the second commission payment, and A's accounting policy is to accrue the remaining commission obligation ratably as the salesperson provides ongoing services to A.

Entity A enters into a three-year noncancelable service contract with a customer on January 1, 20X7. The total transaction price of \$3 million is invoiced on January 1, 20X7. The salesperson receives a commission payment of 2 percent of the invoice amount (\$60,000) when the contract is signed; the other 2 percent commission payment will be made after 12 months if the salesperson continues to be employed by A at that time. That is, if the salesperson is not employed by A on January 1, 20X8, the second commission payment will not be made. Entity A records a commission liability of \$60,000 on January 1, 20X7, and accrues the second \$60,000 commission obligation ratably over the 12-month period from January 1, 20X7, through December 31, 20X7.

Example 3-1 (continued)

Entity A concludes that only the first \$60,000 is an incremental cost incurred to obtain a contract with a customer and would be capitalized in accordance with ASC 340-40-25-1. Because there is a substantive service condition associated with the second \$60,000 commission, A concludes that the additional cost is a compensation cost incurred in connection with the salesperson's ongoing service to A. That is, the second \$60,000 commission obligation was not incurred solely to obtain a contract with a customer but was incurred in connection with ongoing services provided by the salesperson.

If the salesperson would be paid the commission even if no longer employed, or if A otherwise concluded that the service condition was not substantive, the entire \$120,000 would be an incremental cost incurred to obtain a contract and would be capitalized in accordance with ASC 340-40-25-1. Entities will need to exercise professional judgment when determining whether a service condition is substantive.

Because commission and compensation structures can vary significantly between entities, an entity should evaluate its specific facts and circumstances when determining which costs are incremental costs incurred to obtain a contract with a customer. Since many entities pay sales commissions to obtain contracts with customers, questions have arisen regarding how to apply the revenue standard's cost guidance to such commissions, including:

- Whether certain commissions (e.g., commissions on contract renewals or modifications, commission payments that are contingent on future events, and commission payments that are subject to clawback or thresholds) qualify as assets.
- The types of costs to capitalize (e.g., whether and, if so, how an entity should consider fringe benefits such as payroll taxes, pension, or 401(k) match) in determining the amount of commissions to record as incremental costs.
- The pattern of amortization for assets related to multiple performance obligations (e.g., for contract cost assets related to multiple performance obligations that are satisfied over disparate points or periods of time).

Entities should continue to first refer to existing U.S. GAAP on liability recognition to determine whether and, if so, when a liability from a contract with a customer needs to be recorded. For example, an entity would apply the specific U.S. GAAP on liability recognition (e.g., commissions, payroll taxes, 401(k) match) and then determine whether to record the related debit as an asset or expense.

In addition, the revenue standard is clear that (1) an entity should amortize the asset on a systematic basis and (2) the method should reflect the pattern of transfer of goods or services to a customer to which the asset is related. That is, the asset should be amortized in a manner that reflects the benefit (i.e., revenue) generated from the asset.

3.1.2.1 Tiered Commissions

Commission plans for a specific employee that involve initial contracts and contract renewals might be established in such a way that (1) the commission is subject to a cumulative contract threshold and (2) commission rates change depending on the number (or cumulative value) of contracts signed. For instance, fixed or percentage commissions may commence or change once a specified threshold is achieved for the cumulative number or value of contracts. The examples below, which are adapted from examples considered by the FASB staff in [TRG Agenda Paper 23](#), illustrate various cumulative threshold scenarios.

Example 3-2

Once a cumulative threshold **number** of contracts is reached, the entity pays commissions on individual contracts as a percentage of the value of **each** contract in the manner shown in the table below.

Number of Contracts Signed	Commission Rate
1–5	0% commission
6–10	3% of each individual contract price
11 or more	5% of each individual contract price

Example 3-3

Once a cumulative threshold **value** of contracts is reached, the entity pays commissions on individual contracts as a percentage of the value of **each** contract in the manner shown in the table below.

Value of Contracts Signed	Commission Rate
First \$1 million	0% commission
Next \$4 million	3% of each individual contract price
More than \$5 million	5% of each individual contract price

Example 3-4

Once a cumulative threshold number of contracts is reached, the entity pays commissions on the last contract as a percentage of the **cumulative value of that contract and the preceding contracts** in the manner shown in the table below, taking into account any commission already paid.

Number of Contracts Signed	Commission Rate
1–5	0% commission
6	3% of the total contract price of contracts 1–6
7–10	0% commission
11 or more	5% of the total contract price of all contracts (including commission already paid on contracts 1–6)

Example 3-5

As shown in the table below, the entity pays the first commission when the first contract is signed. Subsequently, once a cumulative threshold number of contracts is reached, the entity pays a commission on the threshold contract that is greater than the commission paid on the initial contract and takes into account any commissions previously paid. In this example, it is assumed that the entity has no history of its sales employees' closing more than 15 new contracts in a period.

Number of Contracts Signed	Commission Amount	
1	\$	3,000
10	\$	5,000 cumulative commission (including \$3,000 already paid)
15	\$	10,000 cumulative commission (including \$5,000 already paid)

Assume that the commissions in all of the examples above are incremental costs incurred to obtain a contract that should be capitalized in accordance with ASC 340-40-25-1.

There are at least two acceptable approaches to determining which commissions are incremental to obtaining a contract in the scenarios described above. One approach ("Approach A") would be to specifically attribute the incremental costs of each contract to that contract. For example, if no commission is paid until the fifth contract is signed, the commission would be attributed to only the fifth contract. Another approach ("Approach B") would be to accrue commission for each contract on the basis of the average commission rate expected to be paid under the commission plan. For example, although a commission is paid only once the fifth contract is signed, the commission is earned, and would be accrued, as contracts 1 through 5 are signed. Entities should consider their historical policies for recording commission liabilities when determining which approach to apply.

Under the two alternative approaches, the entity in each of the illustrative examples above should account for the tiered commissions as follows:

- **Example 3-2:**
 - *Approach A* — When the 6th contract is signed, the entity should capitalize 3 percent of the price of that contract and successive contracts as an incremental cost of obtaining a contract until the 11th contract is signed, at which point the entity should capitalize 5 percent of the price of that contract and successive contracts.
 - *Approach B* — The entity should estimate the total amount of commission to be earned for the period and capitalize a ratable amount of commission costs upon the signing of each contract. For example, if the entity estimates that seven contracts, each valued at \$10,000, will be signed and therefore the total estimated price of the 6th and 7th contract is \$20,000, it estimates the total commission to be capitalized as \$600 (\$20,000 × 3% commission). Upon the signing of each \$10,000 contract, the entity may capitalize \$86 of commission (\$600 total estimated commission ÷ the 7 expected contracts signed = \$86 estimated commission per contract).

- **Example 3-3:**

- *Approach A* — Upon the signing of the specific contract that results in the aggregate value of over \$1 million in contract value, the entity should capitalize 3 percent of the price of that contract and successive contracts as an incremental cost of obtaining a contract until the \$5 million aggregate value is reached, at which point the entity should capitalize 5 percent of the price of that contract and successive contracts.
- *Approach B* — The entity should estimate the total amount of commission to be earned for the period and capitalize a ratable amount of commission costs upon the signing of each contract. For example, if the entity estimates that three contracts will be signed with an aggregate of \$4 million in contract value (contract 1 is \$1 million, contract 2 is \$1 million, and contract 3 is \$2 million), the entity will estimate \$90,000 in commissions to be capitalized, or $(\$4 \text{ million} - \$1 \text{ million}) \times 3\%$ commission. The entity may capitalize the relative value for each contract:
 - Contract 1: $(\$1 \text{ million} \div \$4 \text{ million}) \times \$90,000 = \$22,500$.
 - Contract 2: $(\$1 \text{ million} \div \$4 \text{ million}) \times \$90,000 = \$22,500$.
 - Contract 3: $(\$2 \text{ million} \div \$4 \text{ million}) \times \$90,000 = \$45,000$.

- **Example 3-4:**

- *Approach A* — When the 6th contract is signed, the entity should capitalize 3 percent of the cumulative prices of contracts 1 through 6 as an incremental cost of obtaining the 6th contract. Similarly, when the 11th contract is signed, the entity should capitalize 5 percent of the cumulative prices of contracts 1 through 11 (less the 3 percent previously paid on contracts 1 through 6) as an incremental cost of obtaining the 11th contract. Further, the entity should capitalize 5 percent of the price of each successive contract (beyond the 11th contract) as an incremental cost of obtaining a contract.
- *Approach B* — The entity should estimate the total amount of commission to be earned for the period and capitalize a ratable amount of commission costs upon the signing of each contract. For example, if the entity estimates that eight contracts will be signed and the estimated cumulative prices of contracts 1 through 6 will be \$32,000, it will estimate \$960 in commissions to be capitalized $(\$32,000 \times 3\% \text{ commission} = \$960)$. If the price of each contract is the same, the entity may capitalize \$120 upon the signing of each contract $(\$960 \text{ total estimated commission} \div \text{the 8 expected contracts signed} = \$120 \text{ estimated commission per contract})$.

- **Example 3-5:**

- *Approach A* — Once the initial contract is signed, the entity should capitalize \$3,000 as an incremental cost of obtaining that contract. The entity would not capitalize any additional amounts when contracts 2 through 9 are signed because the next commission “tier” has not been met. Once the 10th contract is signed, the entity should capitalize an additional \$2,000. Similarly, the entity would not capitalize any additional amounts when contracts 11 through 14 are signed and should capitalize an additional \$5,000 once the 15th contract is signed.
- *Approach B* — The entity should estimate the total amount of commission to be earned for the period and capitalize a ratable amount of commission costs upon the signing of each contract. For example, if the entity estimates that 11 contracts will be signed and the price of each contract is the same, it may capitalize \$455 when each contract is signed $(\$5,000 \div \text{the 11 expected contracts signed} = \$455 \text{ to be capitalized as the commission amount per contract})$.

3.1.2.2 *Fringe Benefits*

The example below illustrates the determination of whether fringe benefits such as 401(k) match contributions associated with sales commissions should be capitalized as incremental costs of obtaining contracts with customers.

Example 3-6

Entity C has a policy to match 401(k) contributions based on salaries paid to sales representatives, including sales commissions. These sales commissions are determined to meet the definition of incremental costs of obtaining contracts with customers in ASC 340-40-25-2 and are therefore capitalized in accordance with ASC 340-40-25-1.

When 401(k) match contributions (along with other fringe benefits) are attributed directly to sales commissions that are determined to be incremental costs of obtaining contracts with customers, the 401(k) match contributions also qualify as incremental costs of obtaining the contracts since such costs would not have been incurred if the contracts had not been obtained. However, incremental costs of obtaining contracts with customers would not include fringe benefits constituting an allocation of costs that would have been incurred regardless of whether a contract with a customer had been obtained.

3.1.3 Practical Expedient in ASC 340-40-25-4 for Expensing Contract Acquisition Costs

If an entity elects the practical expedient of expensing incremental costs of obtaining a contract when incurred because the amortization period of the asset would have been one year or less, the entity is also required, under ASC 606-10-50-22, to disclose such election. In addition, the practical expedient should be applied consistently to contracts with similar characteristics and in similar circumstances.

The identification of contracts with similar characteristics and the evaluation of similar circumstances should be performed as an entity-wide assessment. An entity with multiple subsidiaries or business units that operate in multiple jurisdictions might determine that different subsidiaries or business units have contracts with dissimilar characteristics or circumstances.

However, it is not permitted to apply the practical expedient selectively on a contract-by-contract basis. Further, an entity is not permitted to apply the practical expedient in ASC 340-40-25-4 to some costs attributable to performance obligations in a contract but not others. The incremental costs of obtaining a contract, which are required to be capitalized in accordance with ASC 340-40-25-1, are related to the contract as a whole. These capitalized costs of obtaining a contract form a single asset regardless of whether the contract contains more than one performance obligation. The practical expedient is available only if the amortization period of the entire asset that the entity otherwise would have recognized is one year or less.

Example 3-7 below illustrates a situation in which the practical expedient in ASC 340-40-25-4 would not be available.

Example 3-7

Entity B enters into a contract with a customer to provide the following:

- Product X delivered at a point in time.
- Maintenance of Product X for one year.
- An extended warranty on Product X that covers years 2 and 3 (Product X comes with a one-year statutory warranty).

Each of the elements is determined to be a separate performance obligation.

A sales commission of \$200 is earned by the salesperson. This represents \$120 for the sale of Product X (payable irrespective of whether the customer purchases the maintenance or extended warranty) and an additional \$40 each for the sale of the maintenance contract and the sale of the extended warranty (\$80 commission for the sale of both).

The commission is determined to meet the definition of an incremental cost of obtaining the contract in ASC 340-40-25-2 and is therefore capitalized in accordance with ASC 340-40-25-1.

In this fact pattern, the entity cannot elect the practical expedient in ASC 340-40-25-4 to expense costs as incurred because the amortization period of the asset that the entity would recognize is more than one year (i.e., the extended warranty performance obligation included in the contract is for years 2 and 3). The entity may, however, determine that it is appropriate to attribute the asset created by the commission to the individual performance obligations and record amortization of the asset in an amount that corresponds to the revenue recognized as each good or service is transferred to the customer.

As previously noted, an entity is precluded from using the practical expedient in ASC 340-40-25-4 if the amortization period of the asset that the entity otherwise would have recognized is greater than one year. This restriction applies even if the amortization period is only slightly greater than one year.

Example 3-8

Entity A enters into a noncancelable contract with a customer to provide marketing services for 13 months. A commission of \$100 is earned by the salesperson in connection with A's entering into the contract with the customer. The commission is determined to meet the definition of an incremental cost of obtaining the contract in ASC 340-30-25-2 and is therefore capitalized in accordance with ASC 340-40-25-1. Entity A concludes that the asset is related to the entire contract to provide 13 months of marketing services.

In this fact pattern, the entity cannot elect the practical expedient in ASC 340-40-25-4 to expense costs as incurred since the amortization period of the asset that the entity would otherwise recognize is more than one year (i.e., the 13 months in which marketing services are being performed).

3.1.4 Using the Portfolio Approach When Accounting for Contract Costs

ASC 340-40-05-1 expressly indicates that ASC 340-40 is aligned with ASC 606, stating that "[t]his Subtopic provides accounting guidance for the following costs related to a contract with a customer within the scope of Topic 606 on revenue from contracts with customers." ASC 606 is applied at the individual contract level (or to a combination of contracts accounted for under ASC 606-10-25-9). In addition, ASC 606-10-10-4 allows an entity to apply, as a practical expedient, the revenue recognition guidance to a portfolio of contracts rather than an individual contract. The practical expedient can only be used "if the entity reasonably expects that the effects on the financial statements of applying [the revenue recognition guidance] to the portfolio would not differ materially from applying [the revenue recognition guidance] to the individual contracts (or performance obligations) within that portfolio." In addition, ASC 606-10-10-3 states that an "entity shall apply this guidance, including the use of any practical expedients, consistently to contracts with similar characteristics and in similar circumstances."

If an entity reasonably expects that contract costs recorded under a portfolio approach would not differ materially from contract costs that would be recorded individually, it may apply a portfolio approach to account for the costs. The entity would use judgment in determining the characteristics of the portfolio in a manner similar to its assessment of whether a portfolio satisfies the requirements in ASC 606-10-10-4.

In applying the portfolio approach, an entity should consider paragraph BC69 of [ASU 2014-09](#), which states that the FASB and IASB “did not intend for an entity to quantitatively evaluate each outcome and, instead, the entity should be able to take a reasonable approach to determine the portfolios that would be appropriate for its types of contracts.” In determining the characteristics and composition of the portfolio, an entity should consider the nature and timing of costs incurred and the pattern of transferring control of the related good or service to the customer (e.g., amortization of the capitalized costs).

3.1.5 Determining When to Recognize and How to Measure Incremental Costs

Arrangements for the payment of some incremental costs of obtaining a contract may be complex. For example, payment of a sales commission may be (1) contingent on a future event, (2) subject to clawback, or (3) based on achieving cumulative targets.

The revenue standard does not address when to initially recognize the incremental costs of obtaining a contract. Rather, ASC 340-40 only addresses which costs to capitalize and subsequent recognition of amortization or impairment expense. Therefore, other Codification topics (e.g., ASC 275, ASC 710, ASC 712, ASC 715, and ASC 718) specify when a liability for costs should be recognized and how that liability should be measured.

If an entity concludes that a liability for incremental costs of obtaining a contract should be recognized under the relevant Codification topic, the guidance in ASC 340-40-25-1 should be applied to determine whether those recognized costs should be capitalized as an asset or recognized immediately as an expense.

3.2 Costs of Fulfilling a Contract

ASC 340-40 provides the following guidance on recognizing the costs incurred in fulfilling a contract with a customer:

ASC 340-40

15-3 The guidance in this Subtopic applies to the costs incurred in fulfilling a contract with a customer within the scope of Topic 606 on revenue from contracts with customers, unless the costs are within the scope of another Topic or Subtopic, including, but not limited to, any of the following:

- a. Topic 330 on inventory
- b. Paragraphs 340-10-25-1 through 25-4 on preproduction costs related to long-term supply arrangements
- c. Subtopic 350-40 on internal-use software
- d. Topic 360 on property, plant, and equipment
- e. Subtopic 985-20 on costs of software to be sold, leased, or otherwise marketed.

ASC 340-40 (continued)

25-5 An entity shall recognize an asset from the costs incurred to fulfill a contract only if those costs meet all of the following criteria:

- a. The costs relate directly to a contract or to an anticipated contract that the entity can specifically identify (for example, costs relating to services to be provided under renewal of an existing contract or costs of designing an asset to be transferred under a specific contract that has not yet been approved).
- b. The costs generate or enhance resources of the entity that will be used in satisfying (or in continuing to satisfy) performance obligations in the future.
- c. The costs are expected to be recovered.

25-6 For costs incurred in fulfilling a contract with a customer that are within the scope of another Topic (for example, Topic 330 on inventory; paragraphs 340-10-25-1 through 25-4 on preproduction costs related to long-term supply arrangements; Subtopic 350-40 on internal-use software; Topic 360 on property, plant, and equipment; or Subtopic 985-20 on costs of software to be sold, leased, or otherwise marketed), an entity shall account for those costs in accordance with those other Topics or Subtopics.

25-7 Costs that relate directly to a contract (or a specific anticipated contract) include any of the following:

- a. Direct labor (for example, salaries and wages of employees who provide the promised services directly to the customer)
- b. Direct materials (for example, supplies used in providing the promised services to a customer)
- c. Allocations of costs that relate directly to the contract or to contract activities (for example, costs of contract management and supervision, insurance, and depreciation of tools and equipment used in fulfilling the contract)
- d. Costs that are explicitly chargeable to the customer under the contract
- e. Other costs that are incurred only because an entity entered into the contract (for example, payments to subcontractors).

25-8 An entity shall recognize the following costs as expenses when incurred:

- a. General and administrative costs (unless those costs are explicitly chargeable to the customer under the contract, in which case an entity shall evaluate those costs in accordance with paragraph 340-40-25-7)
- b. Costs of wasted materials, labor, or other resources to fulfill the contract that were not reflected in the price of the contract
- c. Costs that relate to satisfied performance obligations (or partially satisfied performance obligations) in the contract (that is, costs that relate to past performance)
- d. Costs for which an entity cannot distinguish whether the costs relate to unsatisfied performance obligations or to satisfied performance obligations (or partially satisfied performance obligations).

Because the FASB and IASB did not intend to reconsider cost guidance altogether, the revenue standard focuses on costs of fulfilling a contract that is not within the scope of another standard. Accordingly, if costs are within the scope of another standard and that standard requires them to be expensed, it is not possible to argue that they should be capitalized in accordance with ASC 340-40. In addition, only costs directly related to a contract or anticipated contract with a customer are within the scope of ASC 340-40. Costs not directly related to a contract or anticipated (specified) contract should not be evaluated for capitalization under ASC 340-40. Further, when determining whether fulfillment costs are within the scope of ASC 340-40, the reporting entity should also consider its relationship with the other entity in the arrangement. That is, if the reporting entity incurs costs and transfers consideration to

another entity, and that other entity also transfers consideration to the reporting entity in exchange for goods or services, the reporting entity should consider whether the consideration exchanged between the two parties should be accounted for as (1) consideration payable to a customer under ASC 606 or (2) consideration received from a vendor under ASC 705-20.



Connecting the Dots

Stakeholders have questioned whether costs incurred for an anticipated contract (e.g., costs for design and development or nonrecurring engineering) (1) would be within the scope of ASC 340 and therefore could be capitalized or (2) should be expensed in accordance with ASC 730. The costs incurred for an anticipated contract would pertain to a contract that is not yet obtained and whose terms might not yet be known. Factors for an entity to consider in determining whether the costs should be capitalized include, but are not limited to, (1) the likelihood or certainty that the entity will obtain the contract, (2) the likelihood that the costs will be recovered under the specific anticipated contract, (3) whether the costs create or enhance an asset that will be transferred to the customer once the entity obtains the contract (such costs could be capitalizable under other guidance), and (4) whether the costs are considered to be costs associated with research and development (R&D) and would therefore be within the scope of ASC 730 and expensed as incurred. An entity will need to carefully consider the facts and circumstances of the arrangement in determining the appropriate treatment of costs incurred before a contract is obtained.

Example 2 in ASC 340-40 illustrates how to account for costs of fulfilling a contract.

ASC 340-40

Example 2 — Costs That Give Rise to an Asset

55-5 An entity enters into a service contract to manage a customer's information technology data center for five years. The contract is renewable for subsequent one-year periods. The average customer term is seven years. The entity pays an employee a \$10,000 sales commission upon the customer signing the contract. Before providing the services, the entity designs and builds a technology platform for the entity's internal use that interfaces with the customer's systems. That platform is not transferred to the customer but will be used to deliver services to the customer.

Costs to Fulfill a Contract

55-7 The initial costs incurred to set up the technology platform are as follows:

Design services	\$ 40,000
Hardware	120,000
Software	90,000
Migration and testing of data center	<u>100,000</u>
Total costs	<u>\$ 350,000</u>

ASC 340-40

55-8 The initial setup costs relate primarily to activities to fulfill the contract but do not transfer goods or services to the customer. The entity accounts for the initial setup costs as follows:

- a. Hardware costs — accounted for in accordance with Topic 360 on property, plant, and equipment
- b. Software costs — accounted for in accordance with Subtopic 350-40 on internal-use software
- c. Costs of the design, migration, and testing of the data center — assessed in accordance with paragraph 340-40-25-5 to determine whether an asset can be recognized for the costs to fulfill the contract. Any resulting asset would be amortized on a systematic basis over the seven-year period (that is, the five-year contract term and two anticipated one-year renewal periods) that the entity expects to provide services related to the data center.

55-9 In addition to the initial costs to set up the technology platform, the entity also assigns two employees who are primarily responsible for providing the service to the customer. Although the costs for these two employees are incurred as part of providing the service to the customer, the entity concludes that the costs do not generate or enhance resources of the entity (see paragraph 340-40-25-5(b)). Therefore, the costs do not meet the criteria in paragraph 340-40-25-5 and cannot be recognized as an asset using this Topic. In accordance with paragraph 340-40-25-8, the entity recognizes the payroll expense for these two employees when incurred.

3.2.1 Variable Consideration and Uncertain Transaction Price

As noted above, an entity would need to be able to demonstrate whether any capitalized costs are recoverable. That is, the entity's contract with a customer needs to generate sufficient profit to recover any capitalized costs. Otherwise, no asset should be recorded or a recorded asset would be impaired. Determining whether capitalized costs are recoverable may be challenging when the contract contains variable consideration rather than fixed consideration.

When an entity enters into a contract with a customer to provide goods or services for variable consideration and the transaction price is fully or partially constrained at the time the customer obtains control of the goods or services, the entity may incur an up-front loss until the uncertainty associated with the variable consideration is resolved. That is, the amount of the asset(s) derecognized or fulfillment costs recognized exceeds the amount of revenue to be recognized on the date the entity satisfies its performance obligation(s) because of the application of the constraint on variable consideration.

An entity should not defer costs associated with transferred goods or services in a contract when variable consideration is fully or partially constrained. Rather, an entity should expense costs that are not eligible for capitalization under other authoritative literature (e.g., ASC 330 on inventory; ASC 360 on property, plant, and equipment; or ASC 985-20 on costs of software to be sold, leased, or otherwise marketed) unless (1) such costs meet the criteria to be capitalized in accordance with ASC 340-40¹ or (2) the resolution of uncertainty giving rise to the constraint on variable consideration will result in the entity's recovery of an asset (e.g., a sales return).

¹ ASC 340-40-25-6 indicates that when costs incurred to fulfill a contract with a customer are within the scope of any other Codification topics or subtopics, such costs should be accounted for in accordance with those other topics or subtopics.

Example 3-9

Entity A, a manufacturer, sells hardware and related components to Customer B, a distributor, for resale to B's customers. The manufacturer is required to recognize revenue when, after consideration of the indicators of control in ASC 606-10-25-30, it determines that control of hardware and related components has been transferred to the distributor.

Entity A enters into a contract with B to sell hardware and related components with a cost basis of \$180,000 for consideration of \$200,000. However, the hardware and related components have a high risk of obsolescence, which may cause A to provide rebates or price concessions to B in the future (i.e., the transaction price is variable). The contract does not include a provision for product returns, and A does not expect to accept any return of obsolete goods.

Entity A adjusts (i.e., constrains) the transaction price and concludes that it is probable that \$170,000 of the consideration will not result in a significant revenue reversal. When control of the hardware and related components is transferred to B, A recognizes revenue of \$170,000 (the constrained transaction price) and costs of \$180,000.² As a result, A incurs a loss of \$10,000.

3.2.2 Initial Losses and Expected Future Profits

Questions arise about whether losses incurred on an initially satisfied performance obligation can be capitalized when an entity is expected to generate profits on the sale of optional goods or services to a customer. This scenario is illustrated in the example below.

Example 3-10

Entity E's business model includes the sale of (1) hardware and (2) parts needed to operate that hardware. It is possible for customers to source parts from other suppliers, but customers will almost always choose to purchase parts from E (the OEM). The parts are needed for the hardware to properly function for its expected economic life.

Entity E's business model is to sell the hardware at a significantly discounted price (less than the cost to manufacture the hardware) when E believes that doing so is likely to secure a profitable stream of parts sales. This initial contract is only for the hardware; it does not give E any contractual right to require that customers subsequently purchase any parts. However, E's historical experience indicates that (1) customers will virtually always subsequently purchase parts and (2) the profits on the parts sales will more than compensate for the discount given on the hardware.

The hardware has a cost of \$200 and would usually be sold for a profit. However, the equipment is sold at a discounted price of \$150 if subsequent parts sales are expected.

When the hardware is sold for \$150, E is *not* permitted to defer an element of the cost of \$200 to reflect its expectation that this sale will generate further, profitable sales in the future.

In accordance with ASC 340-40-25-6, when the costs of fulfilling a contract are within the scope of another standard, they should be accounted for in accordance with that standard. In the circumstances described, the cost of \$200 is within the scope of ASC 330 and must be expensed when the hardware is sold. Further, ASC 340-40-25-8(c) requires "[c]osts that relate to satisfied performance obligations (or partially satisfied performance obligations) in the contract (that is, costs that relate to past performance)" to be expensed when incurred.

Although E expects customers to purchase additional parts that will give rise to future profits, those additional purchases are at the customer's option and are not part of the contract to sell the hardware. Since E has satisfied its obligation to deliver the hardware, it is required to recognize revenue of \$150 and the \$200 cost in full.

Consequently, a loss of \$50 arises on the initial sale of the hardware.

² The entity may need to consider applying the impairment guidance in ASC 330 to similar hardware and related components held in inventory.

3.2.3 Contracts Satisfied Over Time

ASC 340-40-25-8(c) requires fulfillment costs attributed to satisfied (or partially satisfied) performance obligations to be expensed as incurred. In addition, the revenue standard requires fulfillment costs to be evaluated for expense or deferral independently of the recording of the associated revenue.

3.2.3.1 *Recognition of Fulfillment Costs Incurred Before the Transfer of Goods or Services When Revenue Is Recognized Over Time*

ASC 340-40-25-7 provides various examples of contract fulfillment costs, including direct labor, direct materials, and allocations of costs that are directly related to the contract (e.g., insurance, depreciation of tools and equipment used). In some contracts, fulfillment costs (e.g., implementation or other set-up costs) may be incurred before an entity begins satisfying its performance obligation. Further, in some cases, the costs incurred will enhance a resource of the entity that the entity will use in satisfying its performance obligation(s) to the customer.

An entity may need to exercise significant professional judgment when determining whether fulfillment costs incurred enhance a resource of the entity that the entity will use in satisfying its performance obligation(s) to the customer. To evaluate whether fulfillment costs meet the criterion in ASC 340-40-25-5(b) for capitalization, an entity should consider whether the costs (1) generate or enhance a resource (i.e., an asset, including a service) that will be transferred to the customer or (2) will be used by the entity in connection with transferring goods or services to the customer. The following considerations may be helpful in the evaluation:

- Is the customer's ability to benefit from the fulfillment activities limited to the use of the entity's service? If the customer cannot benefit from the entity's fulfillment activities other than from the use of the entity's service, the fulfillment costs may be enhancing the entity's resources.
- Do the fulfillment activities expand the entity's service capabilities? If the fulfillment activities are required before the entity can begin transferring services to the customer and they expand the entity's service capacity, the related fulfillment costs would most likely enhance a resource of the entity that the entity will use in satisfying its performance obligation(s) to the customer.

We do not believe that an entity needs to have physical custody of an enhanced resource for fulfillment costs to qualify for capitalization under ASC 340-40-25-5(b). For example, the criterion in ASC 340-40-25-5(b) could be met if the enhancements are made at the customer's location but will be used by the entity in connection with satisfying the performance obligation(s).

If the costs generate or enhance a resource that will be transferred to the customer, they may not enhance a resource *of the entity* that the entity will use in satisfying its performance obligation(s) to the customer. Such costs may still initially meet the criteria for capitalization (under either ASC 340-40 or other U.S. GAAP), but such costs would typically be recognized as an expense once the related asset is transferred to the customer.

Example 3-11

Entity P enters into a four-year contract with a customer to provide hosted software services. Before the hosted software services can begin, P is required to perform implementation services, which create interfaces between the customer's infrastructure and P's hosted software. The implementation services will not transfer to the customer a good or service that is distinct because the customer can only benefit from the interface connection through the use of the hosted software services. For the implementation services, P charges the customer \$600, which is included in the overall transaction price that is allocated to the performance obligation to provide hosted software services. Entity P incurs fulfillment costs of \$500 to perform the implementation services.

Because the implementation services do not transfer a distinct good or service to the customer, the fulfillment costs of \$500 do not enhance a resource that will be controlled by the customer. Rather, the fulfillment costs enhance a resource that P will use to satisfy its performance obligation. Therefore, the fulfillment costs of \$500 meet the criterion in ASC 340-40-25-5(b) for capitalization.

3.2.3.2 Costs Incurred to Fulfill a Combined Performance Obligation Satisfied Over Time

ASC 340-40-25-8(c) indicates that an entity should not capitalize costs related to completely or partially satisfied performance obligations. Further, ASC 340-40-25-8(d) requires an entity to expense costs when incurred if the entity cannot determine whether the costs are related to past performance or to future performance. Accordingly, if an entity incurs costs related to past performance or cannot determine whether the costs are related to past performance or to future performance, the entity should expense the costs when incurred rather than capitalize them.

In some arrangements, costs (other than set-up costs) are incurred at or around the time an entity begins to satisfy a performance obligation. For example, an entity may physically deliver hardware used as part of a combined performance obligation to provide services (e.g., an integrated security monitoring solution) to a customer over time. That is, the hardware is not distinct; rather, it forms part of a combined performance obligation that is satisfied over time. The hardware may be recorded by the entity as inventory before it is physically transferred to the customer and would typically be derecognized by the entity once it is physically delivered to the customer since it would most likely be a fulfillment cost.

Depending on the facts and circumstances, it may or may not be acceptable under ASC 340-40 for an entity to capitalize initial fulfillment costs incurred when the costs are related to part of a combined performance obligation that will be satisfied over time. Generally, before delivery, the asset to which the fulfillment costs are related (e.g., hardware) is held in the entity's inventory and is therefore within the scope of the inventory accounting guidance of ASC 330. However, once the asset is physically transferred to the customer, the asset may no longer be within the scope of ASC 330.

We observe that when the guidance in ASC 330 is applicable, ASC 330-10-10-1 and ASC 330-10-35-2 are particularly relevant to the determination of when to recognize the cost (i.e., expense) of the asset. ASC 330-10-10-1 states:

A major objective of accounting for inventories is the proper determination of income through the process of matching appropriate costs against revenues.

ASC 330-10-35-2 states, in part:

The cost basis of recording inventory ordinarily achieves the objective of a proper matching of costs and revenues.

Because the cost should be recognized with the related revenue, we believe that it may sometimes be acceptable to defer the cost.

In addition, we believe that in some cases, the asset may no longer be within the scope of ASC 330 once it is deployed in a specific customer contract (i.e., once it is shipped to a customer). At this point, the costs related to the asset could be evaluated as contract fulfillment costs in accordance with ASC 340-40.

If ASC 340-40 is applicable, an entity should consider the three criteria in ASC 340-40-25-5 to determine whether capitalization of the costs is appropriate. Generally, the asset to which the costs are related is physically delivered to the customer as part of a specific contract with that customer; therefore, criterion (a) is met. Further, if the entity expects to recover the costs of the delivered asset through the transaction price, the entity would conclude that criterion (c) is met.

Unlike the evaluations of criteria (a) and (c), respectively, which are relatively straightforward, the evaluation of whether criterion (b) is met (i.e., whether the costs generate or enhance a resource of the entity that the entity will use to satisfy its performance obligation in the future) generally requires more judgment. An entity should consider the following factors to determine whether the asset delivered to the customer generates or enhances a resource of the entity that the entity will use to satisfy its performance obligation in the future (e.g., to provide the ongoing service):

- Is the customer's ability to benefit from the fulfillment activities limited to the use of the entity's service? If the customer cannot benefit from the entity's fulfillment activities other than from the use of the entity's service, the fulfillment costs may be enhancing the entity's resources.
- Do the fulfillment activities expand the entity's service capabilities? If the fulfillment activities are required before the entity can begin transferring services to the customer and they expand the entity's service capacity, the related fulfillment costs would most likely enhance a resource of the entity that the entity will use in satisfying its performance obligation(s) to the customer.

We also believe that the following additional factors are relevant to the determination of whether capitalization of the fulfillment costs is appropriate:

- Does the activity that results in the delivery of the asset to the customer factor into the entity's measure of progress toward complete satisfaction of the performance obligation? For example, the entity may demonstrate that the fulfillment costs enhance a resource that will be used to satisfy the entity's performance obligation in the future if the entity does not begin satisfying its performance obligation until the asset is delivered to the customer.
- Does the entity still have some level of control or influence over the asset once the asset is physically delivered to the customer? Although the asset is physically delivered to the customer, the entity may be providing a service that requires the entity to integrate the asset and the service to deliver a combined output (e.g., because the asset and service are highly interdependent or highly interrelated). The entity may conclude that by transferring a combined service to the customer (e.g., a service that the entity delivers by using both hardware and the service), it continues to maintain some level of control or influence over the asset that is being used as an input to deliver a combined output. That is, the entity's service continues to dictate how the customer uses the asset even if the customer has physical possession. This analysis is consistent with the evaluation of whether an entity controls a good or service before the good or service is transferred to an end customer and therefore is a principal, as discussed in ASC 606-10-55-37A(c).

On the basis of the above factors, an entity should evaluate whether the fulfillment costs enhance the entity's resources that the entity will use to satisfy (or continue to satisfy) its performance obligation in the future. If the entity determines that capitalization of the related costs is appropriate in accordance with ASC 340-40-25-5, it should subsequently amortize the costs related to the asset as it transfers the related services.

Because of the level of judgment necessary to evaluate whether capitalization is appropriate — specifically, whether the asset generates or enhances a resource of the entity that the entity will use to satisfy its remaining performance obligation — we would encourage entities with similar types of arrangements to consult with their accounting advisers. Further, it may be appropriate in some cases to evaluate whether the arrangement contains a lease when the performance of the contract relies on a specified asset; see Deloitte's Roadmap [Leases](#) for more information on determining whether a contract is or contains a lease.

3.2.3.3 Labor Costs Incurred to Fulfill a Contract for Goods or Services When Revenue Is Recognized Over Time

ASC 340-40-25-7 provides guidance on the types of costs that constitute fulfillment costs within the scope of ASC 340-40 if they are outside the scope of other Codification topics. Costs incurred to produce goods for which revenue is recognized at a point in time would typically be treated as inventory costs within the scope of ASC 330. However, costs incurred to provide goods or services for which revenue is recognized over time would typically not be within the scope of ASC 330 since control over those goods or services is transferred to the customer as the entity performs.

Questions have arisen regarding the amounts to be included in fulfillment costs related to labor.

While “salaries and wages of employees who provide the promised services directly to the customer” are the only examples of direct labor costs that are cited in ASC 340-40-25-7(a), direct labor costs also include fringe benefits and other labor-related costs incurred in compensating an employee whose primary employment efforts are directly related to a contract with a customer. In addition, ASC 340-40-25-7(c) indicates that fulfillment costs include certain allocated labor costs (i.e., indirect labor costs) related to overhead, such as those incurred for contract management and supervision.

We believe that costs that would have been capitalizable as inventory had they been within the scope of ASC 330 would typically also represent fulfillment costs directly related to a contract in accordance with ASC 340-40. ASC 330-10-30-1 provides the following guidance on determining the amounts to be included in inventory:

As applied to inventories, cost means in principle the sum of the applicable expenditures and charges directly or indirectly incurred in bringing an article to its existing condition and location. It is understood to mean acquisition and production cost, and its determination involves many considerations.

In authoritative literature, specific references to the composition of labor costs are limited. However, the ASC master glossary's definition of direct loan origination costs includes a reference to ASC 310-20-55, which includes examples of forms of employee compensation that would be considered direct labor costs associated with originating a loan. Although the concepts discussed in the examples are specifically related to direct costs incurred in connection with loan origination activities, we believe that it is appropriate for an entity to consider the implementation guidance in ASC 310-20 by analogy to identify forms of employee compensation that should be included in the composition of labor costs.

The example in ASC 310-20-55-12 states:

Payroll-related fringe benefits include any costs incurred for employees as part of the total compensation and benefits program. Examples of such benefits include all of the following:

- a. Payroll taxes
- b. Dental and medical insurance
- c. Group life insurance
- d. Retirement plans
- e. 401(k) plans
- f. Stock compensation plans, such as stock options and stock appreciation rights
- g. Overtime meal allowances.

Further, ASC 310-20-25-6 states, in part:

Bonuses are part of an employee's total compensation. The portion of the employee's total compensation that may be deferred as direct loan origination costs is the portion that is directly related to time spent on the activities contemplated in the definition of that term and results in the origination of a loan.

We believe that in a manner consistent with the above guidance, labor costs include base pay, overtime pay, vacation and holiday pay, illness pay, shift differential, payroll taxes, and contributions to a supplemental unemployment benefit plan. Further, other employee benefit costs such as cash bonuses, profit sharing, stock bonus plans, insurance benefits, retirement benefits, and other miscellaneous benefits (both discretionary and nondiscretionary) are among the labor costs that are eligible for inclusion in fulfillment costs directly related to a contract.

3.2.4 Determining Whether ASC 985-20 or ASC 340-40 Applies

ASC 985-20-15-3 states, in part, that the guidance in ASC 985-20 does not apply to “[a]rrangements to deliver software or a software system, either alone or together with other products or services, requiring significant production, modification, or customization of software.” ASC 985-20 generally applies to the costs of computer software that is being developed for general release to the market as opposed to being developed solely to meet a specific customer’s needs. Nevertheless, some costs may be incurred for software that (1) will be delivered to a specific customer under a contract and (2) also will be marketed to others. As illustrated in the example below, the vendor should determine which costs are incurred for software that is being developed for general release and which costs are incurred for software that is being developed for specific contracts.

A vendor may be required to apply the guidance in ASC 985-20 when accounting for software costs it incurred before entering into a contract if the costs were incurred for a product that will be marketed to multiple customers. However, a vendor must use judgment to determine whether costs incurred to develop software before a contract is signed are costs associated with fulfilling the contract and therefore subject to the guidance in ASC 340-40 or costs subject to the requirements of ASC 985-20, particularly when there is a very limited market for the product and the product will require additional customization under contracts with future customers.

Example 3-12

Entity L has existing software that it has used on a previous contract for which it maintains the proprietary rights. It had begun to reconfigure the software into an open architecture format when it signed a contract for delivery of a strategic air defense system that will use at least some of the modules of the open architecture software. Entity L anticipates that it will be able to use the open architecture software on several future contracts.

Example 3-12 (continued)

Under ASC 985-20, L may be required to capitalize some of the software development costs associated with the reconfigured open architecture software if those costs meet the criteria for capitalization. However, the costs associated with developing the modules in accordance with the terms of the defense contract should not be accounted for under ASC 985-20 if significant production, modification, or customization of the software would be required; instead, such costs should be accounted for under ASC 340-40.

As noted above, ASC 985-20 does not apply to costs incurred for computer software that requires significant production, modification, or customization under a contractual agreement. Although L retains the rights to the software, at least some portion of the development effort must be used to satisfy the requirements of the defense contract. The costs associated with developing modules that are promised goods or services under that contract are costs incurred to fulfill the contract and thus within the scope of ASC 340-40; accordingly, they should not be accounted for under ASC 985-20.

If the ultimate product will include functionalities that are distinct and separable and are not promised goods or services under the current defense contract (i.e., they will be used only for future contracts), the development costs of such functionalities might be subject to the guidance in ASC 985-20 depending on the market for the software. That is, if the additional modules have a broad customer base and are not limited to one or a few contracts, ASC 985-20 would apply since the costs for these additional modules would be incurred in the absence of a specific contract.

3.3 Amortization and Impairment of Contract Costs

3.3.1 Amortization

ASC 340-40 does not provide specific guidance on the method an entity should use to amortize contract costs recognized as assets. Rather, ASC 340-40-35-1 requires an entity to amortize such costs “on a systematic basis that is consistent with the transfer to the customer of the goods or services to which the asset relates.” Entities will therefore have to determine an appropriate method for amortizing costs capitalized in accordance with ASC 340-40-25-1 or ASC 340-40-25-5.

Amortization of capitalized costs on a “systematic basis” should take into account the expected timing of transfer of the goods and services related to the asset, which typically corresponds to the period and pattern in which revenue will be recognized in the financial statements. The pattern in which the related revenue is recognized could be significantly front-loaded, back-loaded, or seasonal, and costs should be amortized accordingly.

To determine the pattern of transfer, entities may need to analyze the specific terms of each arrangement. In determining the appropriate amortization method, they should consider all relevant factors, including (1) their experience with, and ability to reasonably estimate, the pattern of transfer and (2) the timing of the transfer of control of the goods or services to the customer. In some situations, more than one amortization method may be acceptable if it reasonably approximates the expected period and pattern of transfer of goods and services. However, certain amortization methods may be unacceptable if they are not expected to reflect the period and pattern of such transfer. When entities select a method, they should apply it consistently to similar contracts. If there is no evidence to suggest that a specific pattern of transfer can be expected, a straight-line amortization method may be appropriate.

If the pattern in which the contractual goods or services are transferred over the contract term varies significantly each period, it may be appropriate to use an amortization model that more closely aligns with the transfer pattern’s variations. For example, amortization could be allocated to the periods on the basis of the proportion of the total goods or services that are transferred each period. If the cost is related to goods or services that are transferred at a point in time, the amortized cost would be recognized at the same point in time.

When the contractual goods or services are transferred over a period of uncertain duration, entities should consider whether the relationship with the customer is expected to extend beyond the initial term of a “specific anticipated contract” (as referred to in ASC 340-40-35-1 and described in ASC 340-40-25-5(a)). For example, if an entity enters into a four-year contract with a customer but the customer is expected to renew that contract for two years, the appropriate amortization period may be six years (i.e., the expected duration of the period in which the customer will purchase the related goods or services, which could be the expected life of the customer relationship).

When an entity’s customer has been granted a material right to acquire future goods or services and revenue related to the material right is being deferred, it would typically be reasonable for the entity to consider the amount allocated to that right when determining the amortization method for the costs that are capitalized in accordance with ASC 340-40-25-1 or ASC 340-40-25-5.

3.3.1.1 Allocation Among Performance Obligations

When an asset is recognized for the incremental costs of obtaining a contract, ASC 340-40-35-1 requires the asset to be amortized in a manner that is “consistent with the transfer to the customer of the **goods or services to which the asset relates**” (emphasis added). When the pattern of transfer differs for separate performance obligations in a contract, it may be appropriate to allocate the costs among the performance obligations and to amortize the capitalized costs accordingly. For example, the costs could be allocated on the basis of the stand-alone selling prices of the performance obligations.

The FASB staff has noted that an entity could satisfy the requirement in ASC 340-40-35-1 in accordance with either of the following two views:³

- (a) View A — Allocate the asset to the individual performance obligations on a relative basis (in proportion to the transaction price allocated to each performance obligation) and amortize the respective portion of the asset based on the pattern of performance for the underlying performance obligation
- (b) View B — Amortize the single asset using one measure of performance considering all of the performance obligations in the contract. Use a measure that best reflects the “use” of the asset as the goods and services are transferred. Note that this approach may result in a similar pattern of amortization as View A, but without any specific allocation of the contract cost asset to individual performance obligations.

Note that an entity is not permitted to apply the practical expedient in ASC 340-40-25-4 (recognizing the “costs of obtaining a contract as an expense when incurred if the amortization period of the asset that the entity otherwise would have recognized is one year or less”) to some performance obligations in a contract but not others. Therefore, when the costs of obtaining a contract are allocated to different performance obligations so that they are amortized over different periods, the practical expedient in ASC 340-40-25-4 can only be applied if all of the amortization periods are one year or less.

The example below illustrates an allocation of the costs of obtaining a contract among different performance obligations.

³ Quoted from [Implementation Q&A 75](#).

Example 3-13

Entity B enters into a contract with a customer to provide the following:

- Product X delivered at a point in time.
- Maintenance of Product X for one year.
- An extended warranty on Product X that covers years 2 and 3 (Product X comes with a one-year statutory warranty).

Each of the elements is determined to be a separate performance obligation.

A sales commission of \$200 is earned by the salesperson. This represents \$120 for the sale of Product X (payable irrespective of whether the customer purchases the maintenance or extended warranty) and an additional \$40 each for the sale of the maintenance contract and the sale of the extended warranty (\$80 commission for the sale of both).

The commission is determined to meet the definition of an incremental cost of obtaining the contract in ASC 340-40-25-2 and is therefore capitalized in accordance with ASC 340-40-25-1.

As discussed above, incremental costs of obtaining a contract that are capitalized in accordance with ASC 340-40-25-1 can be allocated to specific performance obligations for amortization purposes. Therefore, it would be acceptable in the circumstances under consideration to attribute the \$200 commission asset in the following manner:

- *\$120 to Product X* — To be expensed upon delivery of Product X to the customer.
- *\$40 to the maintenance contract* — To be expensed over the one-year period of maintenance.
- *\$40 to the extended warranty* — To be expensed over the two-year period of the warranty (i.e., years 2 and 3).

The asset will therefore be amortized as follows:

	Delivery (Day 1)	Year 1	Year 2	Year 3
Product X	\$ 120			
Maintenance	—	\$ 40		
Extended warranty	—	—	\$ 20	\$ 20
Total amortization expense	<u>\$ 120</u>	<u>\$ 40</u>	<u>\$ 20</u>	<u>\$ 20</u>

Note that in this fact pattern, the entity cannot apply the practical expedient in ASC 340-40-25-4 to expense the sales commission when incurred because the total amortization period for the asset exceeds one year. Neither can the expedient be applied specifically to the commission allocated to the maintenance contract (notwithstanding that it is amortized over a period of one year) because if the practical expedient is applied, it must be applied to the contract as a whole.

3.3.1.2 Determining the Amortization Period of an Asset Recognized for the Incremental Costs of Obtaining a Contract With a Customer

Stakeholders have raised questions about determining the amortization period of an asset recognized for the incurred incremental costs of obtaining a contract with a customer, including how to determine whether a commission paid on renewal is commensurate with an initial commission and under what circumstances it would be appropriate to amortize the asset over the expected customer life. The FASB staff has noted that the amortization guidance in ASC 340-40 is conceptually consistent with that on estimating the useful lives of long-lived assets. Since entities already use judgment to estimate useful lives of long-lived assets, the staff believes that entities would also do so in determining amortization periods for assets related to incremental costs of obtaining a contract.

An entity should use judgment in determining the contract(s) to which a commission is related. The staff has noted that if an entity pays a commission on the basis of only the initial contract without an expectation that the contract will be renewed (given the entity's past experience or other relevant information), amortizing the asset over the initial contract term would be an appropriate application of the revenue standard. However, if the entity's past experience indicates that a contract renewal is likely, the amortization period could be longer than the initial contract term if the asset is related to goods or services to be provided during the contract renewal term.

When estimating the amortization period of an asset arising from incremental costs of obtaining a contract, entities should (1) identify the contract(s) to which the cost (i.e., commission) is related, (2) determine whether the commission on a renewal contract is commensurate with the commission on the initial contract, and (3) evaluate the facts and circumstances to determine an appropriate amortization period that would extend beyond the contract period if there are anticipated renewals associated with the costs of obtaining the contract.

The FASB staff has confirmed that the amortization period of an asset recognized for the incremental incurred costs of obtaining a contract might be, but should not be presumed to be, the entire customer life. The staff has suggested that facts and circumstances may clearly indicate that amortizing the asset over the average customer term is inconsistent with the amortization guidance in ASC 340-40-35-1. An entity should use judgment in assessing the goods or services to which the asset is related.

In estimating the amortization period for an asset recognized in accordance with ASC 340-40-25-1 ("customer acquisition asset"), an entity will need to use judgment to identify "the goods or services to which the asset relates." The estimated amortization period could range from the initial contract term on the low end to the average customer life on the high end depending on the specific facts and circumstances. When determining the life of the customer acquisition asset, the entity will need to make judgments similar to those it makes when determining the amortization or depreciation period for other long-lived assets.

An entity should first identify the contract(s) related to the customer acquisition asset (e.g., commission payment). That is, an entity will need to consider whether the asset is related only to the initial contract with the customer or also to specific anticipated contracts (e.g., renewals) with the customer. For example, if a commission is paid on contract renewals and the commission is commensurate with the initial commission paid, the customer acquisition asset originally recorded may be related only to the initial contract.

However, if an entity's past experience indicates that a contract renewal is likely, the amortization period could be longer than the initial contract term if the asset is related to goods or services to be provided under a contract renewal. An entity will need to use judgment to determine whether the asset is related to goods or services to be provided under the contract renewal term. Amortizing an asset over a period longer than the initial contract period would not be appropriate when the entity pays a commission on a contract renewal that is commensurate with the commission paid on the initial contract.

If no commissions are incurred in connection with a contract renewal, or if the commission paid is not commensurate with the initial commission, an entity will need to use judgment when determining whether the customer acquisition asset is related to (1) all future contracts with the customer (i.e., the customer life) or (2) one or more, but not all, future contracts with the customer. The revenue standard does not require an entity to amortize a customer acquisition asset over the expected customer life. Rather, the asset should "be amortized on a systematic basis that is consistent with the transfer to the customer of the goods or service to which the asset relates." An entity will need to determine the appropriate amortization period on the basis of all relevant facts and circumstances.

Since the capitalized asset is similar to an intangible asset, an entity might consider the guidance in ASC 350-30 on determining the useful life of intangible assets. Specifically, ASC 350-30-35-3 states, in part:

The estimate of the useful life of an intangible asset to an entity shall be based on an analysis of all pertinent factors, in particular, all of the following factors with no one factor being more presumptive than the other: . . .

- f. The level of maintenance expenditures required to obtain the expected future cash flows from the asset (for example, a material level of required maintenance in relation to the carrying amount of the asset may suggest a very limited useful life). As in determining the useful life of depreciable tangible assets, regular maintenance may be assumed but enhancements may not.

Entities may perform various activities geared toward maintaining customer relationships. In some instances, there may be significant barriers to a customer's changing service providers or suppliers so that once a contractual relationship is formed between an entity and a customer, little effort may be needed for the entity to retain the customer. However, in other circumstances, entities may operate in a highly competitive environment in which there are only limited barriers, if any, to a customer's switching service providers or suppliers. In these circumstances, entities may need to make additional investments or incur other costs to maintain customer relationships (e.g., invest in innovative products or services, or provide customer incentives). The additional investments may be akin to "maintenance expenditures" that may affect the useful life of a customer acquisition asset.

While an entity will need to use judgment to determine the amortization period of the customer acquisition asset, the entity might consider the following factors:

- *Incremental costs of obtaining a sale (e.g., commissions) relative to ongoing contract value* — A small commission relative to the value of the contract could suggest that the customer acquisition asset has limited value and that the asset life is relatively short. In contrast, a higher commission payment relative to the contract value (1) could suggest that the entity believes the asset to be of greater value or (2) may be related to anticipated contracts with the customer.
- *Degree of difficulty in switching service providers or suppliers* — If it is difficult for a customer to switch service providers or suppliers, the customer acquisition asset may have a longer life. Accordingly, the entity may expect that the efforts it performed to acquire the customer will provide it with value over a longer period (i.e., over some or all contract renewals). In contrast, if there are only limited barriers to a customer's switching service providers or suppliers (and there are other service providers or suppliers available to the customer), the customer acquisition asset may have a shorter life.
- *Extent to which the product or service changes over the customer life* — Significant changes in the underlying product or service over the customer life may suggest that the life of the customer acquisition asset is shorter than the customer life. That is, the asset may be related to some, but not all, anticipated contracts with the customer. For example, if a customer's decision about whether to renew a contract is influenced by enhancements made to products or services, the activities required to initially obtain the customer may not be related to all anticipated contract renewals with the customer. In contrast, if the same service or product is provided in each renewal period, the customer acquisition asset may be attributed to all anticipated contract renewals.
- *Other customer maintenance activities* — If the entity incurs significant costs (relative to the initial incremental cost incurred) to maintain a customer relationship, the useful life of the customer acquisition asset could be short. However, if only limited costs are required to maintain a customer relationship, the useful life of the customer acquisition asset could extend to all anticipated contracts with the customer (i.e., the customer life). Fulfillment costs would not be considered customer maintenance costs. Only costs that are incremental to transferring the specified goods or services to the customer should be evaluated as maintenance costs.

The above factors are not all-inclusive, and none of them are determinative. Accordingly, an entity should consider all relevant facts and circumstances when determining the amortization period for customer acquisition assets. In addition, an entity should adequately disclose the method it uses to determine the amortization for each reporting period in accordance with ASC 340-40-50-2(b).

3.3.1.2.1 Specific Anticipated Contract Not Limited to Contract Renewals

The reference to a “specific anticipated contract” in ASC 340-40-35-1 is **not** limited to contract renewals. Although the guidance in ASC 340-40-35-1 will often be relevant in the context of contract renewals, it is not limited to contract renewals for purposes of determining the amortization period for capitalized incremental costs incurred to obtain a contract.

For example, an entity may incur incremental costs of obtaining a contract to deliver one part of an overall project for a customer. The entity may have been informed that if it successfully fulfills its performance obligations under the initial contract, the customer will award the entity an additional contract to deliver other parts of the project. If the entity will not incur any further incremental costs to obtain the additional contract, it may be appropriate to regard the additional contract as a “specific anticipated contract” under ASC 340-40-35-1.

3.3.1.2.2 Evaluating Whether Commissions Paid on a Contract Renewal Are Commensurate With Commissions Paid on the Initial Contract

Paragraph BC309 of ASU 2014-09 states that amortization of an asset over a period longer than the initial contract period would not be appropriate when a commission paid on a contract renewal is commensurate with the commission paid on the initial contract.

The FASB staff has confirmed that when commissions are paid on contract renewals, an entity should evaluate whether the commission on renewal is commensurate with the initial commission by considering the amount of the commissions relative to the contracts’ value. It has specifically noted that “assessing whether a renewal commission is commensurate with an initial commission solely on the basis of the level of effort to obtain the contract would not be consistent with the guidance in Subtopic 340-40.”⁴

In addition, the FASB staff has clarified that it holds the following views⁵ irrespective of the relative level of effort involved with obtaining the original contract and the renewal contract:

- “[I]n general, it would be reasonable for an entity to conclude that a renewal commission is ‘commensurate with’ an initial commission if the two commissions are reasonably proportional to the respective contract value (for example, 5% of the contract value is paid for both the initial and the renewal contract).”
- “Similarly, [it] would be reasonable for an entity to conclude that a renewal commission is not ‘commensurate with’ an initial commission if it is disproportionate to the initial commission (for example, 2% renewal commission as compared to a 6% initial contract commission).”

⁴ Quoted from [Implementation Q&A 72](#).

⁵ See footnote 4.

3.3.1.2.3 Determining the Appropriate Amortization Period of Commissions When a Commission Paid Upon Renewal Is Not Commensurate With the Initial Commission

Stakeholders have also raised questions about the appropriate amortization period for a commission paid to an employee for obtaining an initial contract that has a high likelihood of renewal. That is, should the commission be amortized over the initial contract term, or should the amortization period include the expected renewal period? The amortization period will depend on many factors, including whether a commission is paid on contract renewals and, if so, whether the commission paid is commensurate with the initial commission.

Example 3-14

Entity X enters into a two-year contract with a customer. On signing the initial contract, X pays its salesperson \$200 for obtaining the contract. An additional commission of \$120 is paid each time the customer renews the contract for another two years. Assume that the \$120 renewal commission is not commensurate with the \$200 initial commission, which means that some of the commission paid for the initial contract should be attributed to the contract renewal as well. On the basis of historical experience, 98 percent of X's customers are expected to renew their contract for at least two more years (i.e., the contract renewal is a specific anticipated contract), and the average customer life is four years.

In this example, we believe that there are at least two acceptable approaches to amortizing the initial \$200 commission and the \$120 renewal commission:

- *Approach 1* — Amortize the initial commission amount of \$200 over the contract period that includes the anticipated renewal (i.e., four years). When the contract is renewed, the additional \$120 commission would be combined with the remaining asset and amortized over the remaining two-year period, as shown in the following table:

	Initial Contract		Renewal Contract		Total
	Year 1	Year 2	Year 3	Year 4	
Initial commission	\$ 50	\$ 50	\$ 50	\$ 50	\$ 200
Renewal commission			60	60	120
Total expense recognized	<u>\$ 50</u>	<u>\$ 50</u>	<u>\$ 110</u>	<u>\$ 110</u>	<u>\$ 320</u>

- *Approach 2* — Bifurcate the initial commission into two parts: (1) \$120, the amount that is commensurate with the renewal commission and that pertains to obtaining a two-year contract, and (2) \$80, the amount that is considered to be paid for obtaining the initial contract plus the anticipated renewal (i.e., the customer relationship). The \$120 would then be amortized over the initial two-year contract term, and the \$80 would be amortized over the entire four-year period, as shown in the following table:

	Initial Contract		Renewal Contract		Total
	Year 1	Year 2	Year 3	Year 4	
Initial commission — Part 1 (\$120)	\$ 60	\$ 60			\$ 120
Initial commission — Part 2 (\$80 remainder)	20	20	\$ 20	\$ 20	80
Renewal commission			60	60	120
Total expense recognized	<u>\$ 80</u>	<u>\$ 80</u>	<u>\$ 80</u>	<u>\$ 80</u>	<u>\$ 320</u>

As noted in the example above, we believe that there are multiple acceptable approaches to amortizing costs of obtaining contract assets when commissions paid upon renewal are not commensurate with the initial commission paid. The example below illustrates how the alternatives may be applied when a good or service is transferred at the inception of an arrangement and another good or service is transferred over time.

Example 3-15

Company A enters into a software arrangement with a customer in exchange for consideration of \$1,300. Under the arrangement, A provides a software license (\$1,000) and three years of PCS (\$100 per year). In addition, the arrangement includes two years of optional PCS renewals for which the customer is able to renew at \$100 per year. At contract inception, A expects that the customer will renew the PCS for both years. The corresponding commission rates for the software license and PCS (including renewals) are as follows:

Goods and Services	Price	Commission Rate	Commission
Software license	\$ 1,000	10%	\$ 100
Year 1 PCS	100	10%	10
Year 2 PCS	100	5%	5
Year 3 PCS	<u>100</u>	5%	<u>5</u>
Initial contract value	1,300		Initial commission 120
Year 4 PCS (expected)	100	1%	1
Year 5 PCS (expected)	<u>100</u>	1%	<u>1</u>
Total value	1,500		Total commission <u>\$ 122</u>
Initial contract commission	120		
Total consideration	<u>1,500</u>		
Percentage 1	8.0%		
Total commission	122		
Total consideration	<u>\$ 1,500</u>		
Percentage 2	8.1%		

For purposes of this example, assume that revenue is recognized as follows:

	Year 1	Year 2	Year 3	Year 4	Year 5
Software license	\$ 1,000				
PCS	<u>100</u>	<u>\$ 100</u>	<u>\$ 100</u>	<u>\$ 100</u>	<u>\$ 100</u>
Total revenue	<u>\$ 1,100</u>	<u>\$ 100</u>	<u>\$ 100</u>	<u>\$ 100</u>	<u>\$ 100</u>

Example 3-15 (continued)

As illustrated above, the commission paid upon PCS renewal in years 4 and 5 is not commensurate with the commission paid on PCS in the initial contract; therefore, the initial commission is related to both the original contract and the renewal periods. We believe that in this example, there are at least two acceptable approaches to amortizing the initial \$120 commission and the \$2 renewal commission:

- *Approach 1* — Amortize the initial commission amount of \$120 proportionately over the contract period that includes the anticipated renewals (e.g., five years) by multiplying the annual revenue amount in each year by Percentage 1. The incremental commission from years 4 and 5 would be amortized over the remaining two-year period, as shown in the following table:

	Initial Contract		Renewal Contract			
	Year 1	Year 2	Year 3	Year 4	Year 5	Total
Initial commission	\$ 88	\$ 8	\$ 8	\$ 8	\$ 8	\$ 120
Renewal commission				1	1	2
Total expense recognized	<u>\$ 88</u>	<u>\$ 8</u>	<u>\$ 8</u>	<u>\$ 9</u>	<u>\$ 9</u>	<u>\$ 122</u>

- *Approach 2* — Amortize the total expected commission amount of \$122 over the contract period that includes the anticipated renewals (e.g., five years) by multiplying the annual revenue amount by Percentage 2, as shown in the following table:

	Initial Contract		Renewal Contract			
	Year 1	Year 2	Year 3	Year 4	Year 5	Total
Total commission	\$ 90	\$ 8	\$ 8	\$ 8	\$ 8	\$ 122
Total expense recognized	<u>\$ 90</u>	<u>\$ 8</u>	<u>\$ 8</u>	<u>\$ 8</u>	<u>\$ 8</u>	<u>\$ 122</u>

3.3.1.3 Accounting for Unamortized Contract Costs Upon Modification

ASC 606-10-25-13(a) provides that when specified criteria are met, an entity should account for a contract modification “as if it were a termination of the existing contract, and the creation of a new contract.” Although the contract modification is accounted for as *if* it were a termination of the existing contract and the creation of a new contract, the original contract was not in fact terminated. Therefore, any unamortized contract costs that existed immediately before the contract modification should not be written off unless those costs are no longer **related** to the remaining goods or services. Rather, those unamortized contract costs should be carried forward into the new contract and amortized on a systematic and rational basis that is consistent with the transfer of goods or services related to the asset.

An entity will need to use judgment when determining which remaining goods or services to be transferred under the modified contract are related to the asset. Further, the entity should consider whether the asset is impaired by applying the guidance in ASC 340-40-35-3 through 35-5.

3.3.2 Impairment

ASC 340-40

35-3 An entity shall recognize an impairment loss in profit or loss to the extent that the carrying amount of an asset recognized in accordance with paragraph 340-40-25-1 or 340-40-25-5 exceeds:

- a. The amount of consideration that the entity expects to receive in the future and that the entity has received but has not recognized as revenue, in exchange for the goods or services to which the asset relates ("the consideration"), less
- b. The costs that relate directly to providing those goods or services and that have not been recognized as expenses (see paragraphs 340-40-25-2 and 340-40-25-7).

35-4 For the purposes of applying paragraph 340-40-35-3 to determine the consideration, an entity shall use the principles for determining the transaction price (except for the guidance in paragraphs 606-10-32-11 through 32-13 on constraining estimates of variable consideration) and adjust that amount to reflect the effects of the customer's credit risk. When determining the consideration for the purposes of paragraph 340-40-35-3, an entity also shall consider expected contract renewals and extensions (with the same customer).

35-5 Before an entity recognizes an impairment loss for an asset recognized in accordance with paragraph 340-40-25-1 or 340-40-25-5, the entity shall recognize any impairment loss for assets related to the contract that are recognized in accordance with another Topic other than Topic 340 on other assets and deferred costs, Topic 350 on goodwill and other intangible assets, or Topic 360 on property, plant, and equipment (for example, Topic 330 on inventory and Subtopic 985-20 on costs of software to be sold, leased, or otherwise marketed). After applying the impairment test in paragraph 340-40-35-3, an entity shall include the resulting carrying amount of the asset recognized in accordance with paragraph 340-40-25-1 or 340-40-25-5 in the carrying amount of the asset group or reporting unit to which it belongs for the purpose of applying the guidance in Topics 360 and 350.

35-6 An entity shall not recognize a reversal of an impairment loss previously recognized.

The objective of impairment is to determine whether the carrying amount of the contract acquisition and fulfillment costs asset is recoverable. This is consistent with other impairment methods under U.S. GAAP that include an assessment of customer credit risk and expectations of whether variable consideration will be received.

Further, the FASB decided that it would not be appropriate to reverse an impairment charge when the reasons for impairment are no longer present.

To test a contract cost asset for impairment, an entity must consider the total period over which it expects to receive an economic benefit from the asset. Accordingly, to estimate the amount of remaining consideration that it expects to receive, the entity would also need to consider goods or services under a specific anticipated contract (e.g., a contract renewal).

The FASB issued [ASU 2016-20](#), which includes certain technical corrections that amend ASC 340-40 to clarify that for impairment testing, an entity should:

- Consider contract renewals and extensions when measuring the remaining amount of consideration the entity expects to receive.
- Include in the amount of consideration the entity expects to receive both (1) the amount of cash expected to be received and (2) the amount of cash already received but not yet recognized as revenue.
- Test for and recognize impairment in the following order: (1) assets outside the scope of ASC 340-40 (such as inventory under ASC 330), (2) assets accounted for under ASC 340-40, and (3) reporting units and asset groups under ASC 350 and ASC 360.

3.4 Onerous Performance Obligations

The Codification includes guidance on accounting for certain types of onerous contracts. A contract is considered onerous if the aggregate cost required to fulfill it is greater than the expected economic benefit to be obtained from it. When this condition is met, the guidance may require an entity to recognize the expected future loss before actually incurring the loss.

As indicated in ASC 605-10-05-4, existing guidance under U.S. GAAP addresses the recognition of losses on the following specific transactions (not all-inclusive):

- Separately priced extended warranty and product maintenance contracts (ASC 605-20).
- Construction- and production-type contracts (ASC 605-35).
- Certain software arrangements (ASC 985-605).

In addition, ASC 450-20 provides overall guidance on accounting for loss contingencies. Such guidance requires an entity to recognize an expected loss if the contingency is probable and the amount is reliably estimable. Further, ASC 330-10-35-17 and 35-18 provide guidance on the recognition of losses on firm purchase commitments related to inventory.

The FASB decided not to include specific guidance on accounting for onerous contracts in the revenue standard, but rather to retain existing onerous contract guidance. Consequently, contracts within the scope of the guidance referred to above may need to be evaluated as onerous contracts.

3.4.1 Separately Priced Extended Warranty and Product Maintenance Contracts

The guidance in ASC 605-20 on recognizing losses on separately priced extended warranty and product maintenance contracts may be applicable to technology entities that provide maintenance for hardware products in contracts accounted for under ASC 606. Specifically, ASC 605-20-25-6 states the following:

ASC 605-20

25-6 A loss shall be recognized on extended warranty or product maintenance contracts if the sum of the expected costs of providing services under the contracts and any asset recognized for the incremental cost of obtaining a contract exceeds the related unearned revenue (contract liability). Extended warranty or product maintenance contracts shall be grouped in a consistent manner to determine if a loss exists. A loss shall be recognized first by charging to expense any recognized asset for the incremental costs of obtaining a contract, determined in accordance with the guidance in paragraphs 340-40-25-1 through 25-4 for contracts within scope of Topic 606 on revenue from contracts with customers. If the loss is greater than the recognized asset for the incremental costs of obtaining a contract, a liability shall be recognized for the excess.

3.4.2 Construction- and Production-Type Contracts

Technology entities may enter into revenue contracts to sell customized software products that are subject to the guidance in ASC 605-35. The existing guidance in ASC 605-35-25 on provision for loss contracts was retained; however, the technical corrections of ASU 2016-20 include an update to ASC 605-35-25 that allows an entity to determine the provision for losses on contracts within the scope of ASC 605-35 at the performance obligation level or the contract level as an accounting policy election.

3.4.3 Certain Software Arrangements

Software arrangements subject to the guidance in ASC 985-605 may require a loss provision. Specifically, ASC 985-605-25-7 states the following:

ASC 985-605

25-7 If it becomes probable that the amount of the transaction price allocated to an unsatisfied or partially unsatisfied performance obligation in accordance with Topic 606 on revenue from contracts with customers will result in a loss on that performance obligation, the loss shall be recognized pursuant to Topic 450.

3.5 SEC Comment Letter Trends

The SEC staff frequently comments on the accounting for and disclosure of contract costs, including (1) the determination of whether commission costs should be capitalized or expensed, (2) the method being used to amortize capitalized costs, (3) how the selected amortization period correlates with the period of benefit, and (4) whether the practical expedient to expense sales commissions was applied.

For example, the SEC staff may question the nature of any employee service requirement when sales commissions are expensed. In addition, when sales commissions are paid upon renewal of a contract, the SEC staff may question whether commissions paid upon renewal are commensurate with initial commissions and how the renewals are considered in the amortization period.

For more information, see [Sections 2.18.3](#) and [6.5.1.2](#) of Deloitte's Roadmap *SEC Comment Letter Considerations, Including Industry Insights*.