## Contract costs

ASC 340-40 includes guidance on other assets and deferred costs relating to contracts with customers within the scope of ASC 606. This guidance specifies the accounting for costs an entity incurs to obtain and fulfill a contract to provide goods and services to customers as described below:

It is important to note that ASC 340-40 provides guidance on certain costs relating to contracts with customers in the scope of ASC 606 (i.e., incremental costs of obtaining and costs incurred to fulfill). However, it does not provide comprehensive cost guidance and should only be applied if the costs are not in the scope of other US GAAP topics. That is, if other US GAAP precludes the recognition of an asset for a particular cost, an asset cannot be recognized under ASC 340-40. If the costs are not in the scope of other US GAAP, an entity would then evaluate whether the costs meet the criteria for capitalization under ASC 340-40.

When an entity records capitalized contract costs under ASC 340-40, the guidance requires that any such assets be presented separately from contract assets and contract liabilities under ASC 606 (see section 10.1) in the statement of financial position or disclosed separately in the notes to the financial statements (assuming they are material). Further, entities with a classified balance sheet should consider the guidance in ASC 210-10 on classification of current assets when determining whether their contract cost assets should be presented as current or noncurrent.

##### Question 9-6 Can entities apply the portfolio approach practical expedient for the evaluation of and/or accounting for contract costs under ASC 340-40?

ASC 606 includes a practical expedient, as described in ASC 606-10-10-4, which allows for the use of a portfolio approach if the entity reasonably expects that the effects on the financial statements would not materially differ from applying the revenue guidance to individual contracts (see section 3.3.1). While a

similar practical expedient was not codified in ASC 340-40, we believe the portfolio approach can be applied to the evaluation of contract costs accounted for in accordance with the guidance in ASC 340-40 (e.g., for amortizing costs to obtain or fulfill a contract with a customer).

This view was expressed in a TRG agenda paper[281](#_bookmark404) that stated, “per paragraph 606-10-10-4 …, an entity might take advantage of the practical expedient to account for the incremental costs of obtaining a contract at a portfolio level (for example, in determining an amortization period). An entity’s specific facts and circumstances dictate whether it can apply the guidance at a portfolio level.”

## Costs to obtain a contract (updated September 2024)

Under ASC 340-40, the incremental costs of obtaining a contract with a customer are recognized as an asset if the entity expects to recover them.

The following flowchart illustrates this guidance:

Yes

No

Are those costs explicitly chargeable to the customer and recoverable regardless of whether the contract is

obtained? Yes

No

No

Yes

Recognize the costs of obtaining a contract as an asset.

The entity may either expense as incurred or recognize as an asset in accordance with the practical expedient in ASC 340-40-25-4.

Expense the costs as incurred.

Does the entity expect to recover those costs?

Would the entity incur the costs only if the contract is obtained (i.e., are the costs incremental)?

Would the amortization period of any asset recognized be one year or less?

Yes

No

Before applying the cost guidance, entities need to consider the scoping provisions of the guidance. Specifically, an entity needs to first consider whether the guidance on consideration payable to a customer under ASC 606 (see section 5.7 for a discussion on accounting for consideration paid or payable to a customer) applies to the costs.

To qualify for capitalization, contract acquisition costs must be incremental, and the entity must expect to recover them. An entity can expect to recover contract acquisition costs through direct recovery

(i.e., reimbursement under the contract) or indirect recovery (i.e., through the margin inherent in the contract). Incremental costs are those that an entity would not have incurred if the contract had not been obtained.

To determine whether a cost is recoverable, an entity should include the future cash inflows and outflows associated with the contract renewal or extension periods if the period of benefit of the costs under assessment is expected to extend beyond the present contract (see section 9.3.3 for further discussion). Further, when an entity determines the amount it expects to receive as part of the recoverability assessment, it would not apply the guidance on constraining estimates of variable consideration. That is, if an entity were required to reduce the estimated transaction price because of the constraint on variable consideration, it would use the unconstrained transaction price to evaluate recoverability of the contract acquisition costs. This unconstrained transaction price also needs to be adjusted to reflect the customer’s credit risk. This recoverability assessment is similar to the impairment assessment discussed in section 9.3.4.

To determine whether a cost is incremental, an entity should consider whether it would incur the cost if the customer (or the entity) decides, just as the parties are about to sign the contract, that it will not enter into the contract. If the costs would have been incurred even if the contract is not executed, the costs are not incremental to obtaining that contract. The objective of this guidance is not to allocate costs that are associated in some manner with an entity’s marketing and sales activity but only to identify those costs that an entity would not have incurred if the contract had not been obtained. For example, salaries and benefits of sales employees that are incurred regardless of whether a contract is obtained are not incremental costs.

Consider the following example from a TRG agenda paper[:282](#_bookmark405)

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| **Example of fixed employee salaries** |
| An entity pays an employee an annual salary of $100,000. The employee’s salary is based on the number of prior-year contracts he/she signed, as well as the employee’s projected signed contracts for the current year. The employee’s current year salary will not change if actual signed contracts are different from the projection; however, any difference would affect the employee’s salary the following year.  In this example, no portion of the employee’s salary should be capitalized because it is not an incremental cost of obtaining a contract. The employee’s salary would have been incurred regardless of the employee’s actual signed contracts in the current year. |

ASC 340-40 cites sales commissions as a type of an incremental cost that may require capitalization. For example, commissions that are related to sales from contracts signed during the period may represent incremental costs that would require capitalization. ASC 340-40 does not explicitly address considerations for different types of commission programs, so entities have to exercise judgment to determine whether sales commissions are incremental costs and, if so, the point in time when the costs should be capitalized. However, an employee’s title or level in the organization, or how directly involved the employee is in the sales process, are not factors in assessing whether a sales commission is incremental. Consider the following example from the TRG paper[:283](#_bookmark406)

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| **Example of commissions paid to different levels of employees** |
| 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.  In this example, all of the commissions are incremental because the commissions would not have been incurred if the contract had not been obtained. ASC 340-40 does not distinguish between commissions paid to employees based on the function or the title of the employee that receives a commission. It is the entity that decides which employee(s) are entitled to a commission as a result of obtaining a contract. |

Additionally, we believe that commissions paid to a third party related to sales from contracts signed during the period may also represent incremental costs that would require capitalization. That is, commissions paid to third parties should be evaluated in the same manner as commissions paid to employees to determine whether they are required to be capitalized.

In addition, entities should carefully evaluate all compensation plans, not just sales commission plans, to determine whether any plans contain incremental costs that should be capitalized. For example, payments under a compensation “bonus” plan may be solely tied to contracts that are obtained. Such costs would be capitalized if they are incremental costs of obtaining a contract, irrespective of the title of the plan.

|  |
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| **Illustration 9-4: Commissions paid to a pool of funds** |
| Assume that an entity has a compensation plan for support personnel in its sales department. As a group, the employees are entitled to a pool of funds calculated based on 2% of all new contracts signed during the monthly period. Once the amount of the pool is known, the amount paid to each individual employee is determined based on each employee’s rating.  While the amount paid to each employee is discretionary based on each employee’s rating, the total amount of the pool is considered an incremental cost to obtain a contract because the entity owes that amount to the employees (as a group) simply because a contract was signed. |

How we see it

Since ASC 340-40 does not require the capitalized costs to obtain a contract to be direct, entities need to evaluate all sales commissions paid to employees and capitalize any costs that are incremental, regardless of how directly involved the employee was in the sales process or the level or title of the employee. Further, any costs to obtain a contract that are not incremental would not be eligible for capitalization under ASC 340-40 unless they are explicitly chargeable to the customer regardless of whether the contract is obtained.

It should be noted that neither ASC 340-40 nor ASC 606 amended US GAAP liability guidance. Therefore, entities should first refer to the applicable liability standard to determine when they are required to accrue for certain costs. Entities would then use the guidance in ASC 340-40 to determine whether the related costs need to be capitalized. Certain aspects of the cost guidance require entities to apply significant judgment to analyze the facts and circumstances and to determine the appropriate accounting[.284](#_bookmark407)

In addition, incremental costs of obtaining a contract are not limited to initial incremental costs.[285](#_bookmark408) Commissions recognized subsequent to contract inception (e.g., commissions paid on modifications, commissions subject to contingent events or clawback) because they did not meet the liability recognition criteria at contract inception should still be considered for capitalization as costs to obtain the contract when the liability is recognized. This would include costs related to contract renewals because a renewal contract is a contract, and there isn’t anything in the guidance on costs to obtain a contract to suggest

a different treatment for contracts that are renewals of existing contracts. That is, the only difference between the two costs would be the timing of recognition based on when a liability has been incurred. See Question 9-9 below for additional discussion of capitalizing commissions paid on contract modifications.

Unlike many commissions, some incentive payments such as bonuses and other compensation that are based on quantitative or qualitative metrics not related to contracts obtained (e.g., profitability, EPS, performance evaluations) likely do not meet the criteria for capitalization because they are not incremental costs of obtaining a contract. However, a legal contingency cost may be an incremental cost of obtaining a contract if, for example, a lawyer is entitled to receive payment only upon the successful completion of a negotiation. Determining which costs must be capitalized under ASC 340-40 may require judgment, and it is possible that some contract acquisition costs will be determined to be incremental and others will not.

Consider the following example from a TRG agenda paper[:286](#_bookmark409)

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| **Example of incremental and non-incremental costs for same contract** |
| An entity pays a 5% sales commission to its employees when they obtain contracts with customers. 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.  In this example, the entity should only capitalize the $25,000 commission paid to the employee. This cost is the only cost that is incremental to obtaining the contract. While the entity incurs other costs that are necessary to facilitate a sale (e.g., legal, travel), those costs would have been incurred even if the contract was not obtained. |

ASC 340-40 provides the following example regarding incremental costs of obtaining a contract:

**Question 9-7 Does the timing of commission payments affect whether they are incremental costs?** [7 November 2016 TRG meeting, agenda paper no. 57; FASB staff Q&As, questions 67 and 78]

It depends. The timing of commission payments does not affect whether the costs would have been incurred if the contract had not been obtained. However, there could be additional factors or contingencies that need to be considered in different commission plans that could affect the determination of whether all (or a portion) of a cost is incremental. Consider the following example from the TRG agenda paper:

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| **Example of timing of commission payments** |
| An entity pays an employee a 4% sales commission on a $50,000 signed contract with a customer. For cash flow management purposes, the entity pays the employee half of the commission (i.e., 2% of the total contract value) upon completion of the sale and the remaining half of the commission 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.  In this example, the entity should capitalize the entire commission (the timing of which would coincide with the recognition of the related liability). That is, the entity would not just capitalize the portion it paid immediately and expense the rest. |

In this fact pattern, only the passage of time is required for the entity to pay the second half of the commission. In some commission plans, the employee only will be entitled to the second half of the commission payment if the employee is still employed by the entity when the commission is due. For plans such as these, an entity needs to carefully evaluate whether the requirement to remain employed in order to receive the commission (i.e., the service vesting condition) is substantive. We believe the second half of the commission payment would not be incremental if the service condition is substantive because other conditions are necessary, beyond just obtaining the contract, for the entity to incur the cost.

If the entity’s payment of a commission is only “contingent” on a customer paying the amount due in the obtained contract, we do not believe this would influence the determination of whether the commission is an incremental cost, provided the contract meets the Step 1 criteria to be accounted for a contract under the model (see section 3.1). However, if there is an extended payment term (i.e., there is a significant amount of time between contract signing and the date in which the contract consideration is due), the entity should consider whether there is a service condition or other contingency as discussed above.

**Question 9-8 Should commission payments subject to a threshold be considered incremental costs?** [7 November 2016 TRG meeting, agenda paper no. 57; FASB staff Q&As, question 78]

Yes. Basing a commission on a pool of contracts rather than paying a set percentage for each contract would not affect the determination of whether the commissions would have been incurred if the entity did not obtain the contracts with those customers. Consider the following example in the TRG agenda paper:

|  |
| --- |
| **Example of commission payments subject to a threshold** |
| 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 as follows:  0-9 contracts 0% commission  10-19 contracts 2% of value of contracts 1-19  20+ contracts 5% of value of contracts 1-20+  In this example, these costs are incremental costs of obtaining a contract with a customer and, therefore, should be capitalized when the entity incurs a liability to pay these commissions. The costs are incremental because the entity will pay the commission under the program terms as a result of entering into the contracts. See Question 9-26 in section 9.3.3 for discussion of over what period an entity should amortize a sales commission that is subject to a threshold and is considered an incremental cost of obtaining a contract. |

**Question 9-9 Should an entity capitalize commissions paid on contract modifications?** [26 January 2015 TRG meeting, agenda paper no. 23; FASB staff Q&As, question 73]

Yes, if they are incremental (i.e., they would not have been incurred if there hadn’t been a modification) and recoverable. Contract modifications are accounted for in one of three ways: (1) as a separate contract, (2) as a termination of the existing contract and the creation of a new contract or (3) as part of the existing contract (see section 3.4 for further guidance on contract modifications). In all three cases, commissions paid on contract modifications are incremental costs of obtaining a contract and should be capitalized if they are recoverable. In the first two cases, a separate or new contract is created so the costs of obtaining that contract would be incremental. Commissions paid on the modification of a contract that is accounted for as part of the existing contract are incremental costs even though they are not *initial* incremental costs. See also Question 9-12 for further discussion of accounting for capitalized commissions upon a modification of the contract that is treated as the termination of an existing contract and the creation of a new contract.

**Question 9-10 Should fringe benefits (e.g., employer portion of payroll taxes, pension/401-K matches) on commission payments be included in the capitalized amounts?** [26 January 2015 TRG meeting, agenda paper no. 23; FASB staff Q&As, question 74]

Fringe benefits should be capitalized as part of the incremental cost of obtaining a contract if the additional costs are based on the amount of commissions paid and the commissions qualify as costs to obtain a contract. However, if the costs of fringe benefits would have been incurred regardless of whether the contract had been obtained (e.g., health insurance premiums), the fringe benefits should not be capitalized. That is, an entity cannot allocate to the commission and therefore capitalize a portion of the costs of benefits it would provide regardless of whether the commission was paid.

##### Question 9-11 Must an entity apply the practical expedient to expense contract acquisition costs to all of its qualifying contracts across the entity or can it apply the practical expedient to individual contracts?

We believe the practical expedient to expense contract acquisition costs that would be amortized over a period of one year or less should be applied consistently to contracts with similar characteristics and in similar circumstances. Therefore, we believe an entity generally should apply the practical expedient to expense contract acquisition costs to all of its qualifying contracts at the entity-wide level.

##### Question 9-12 How should an entity account for capitalized commissions upon a modification of the contract that is treated as the termination of an existing contract and the creation of a new contract?

We believe an asset recognized for incremental costs to obtain a contract that exists when the related contract is modified should be carried forward into the new contract if the modification is treated as the termination of an existing contract and the creation of a new contract (see section 3.4.2) and the goods and services to which the original contract cost asset relates are part of the new contract. That is because the contract cost asset relates to goods and services that have not been transferred and the accounting for the modification is prospective. This conclusion is similar to the one reached by FASB TRG members in relation to the accounting for contract assets upon a contract modification, as discussed in Question 10-5 in section 10.1. The contract cost asset that remains on the entity’s balance sheet at the date of modification would continue to be evaluated for impairment in accordance with ASC 340-40 (see section 9.3.4). In addition, an entity should determine an appropriate amortization period for the contract cost asset (see section 9.3.3).

##### Question 9-13 Can an entity choose whether to capitalize incremental costs to obtain a contract that it expects to recover?

No. As discussed above, an entity is required to capitalize incremental costs to obtain a contract if it expects to recover those costs. However, as a practical expedient, entities are allowed to recognize the incremental costs of obtaining a contract as an expense only if the asset that would have resulted from capitalizing these costs would have been amortized in one year or less.

##### Question 9-14 Should an entity consider contract renewals when assessing whether the practical expedient applies?

Yes. As discussed above, as a practical expedient, entities are allowed to recognize the incremental costs of obtaining a contract as an expense only if the asset that would have resulted from capitalizing these costs would have been amortized in one year or less. That is, the ability to apply the practical expedient depends on the amortization period rather than the initial contract term.

As discussed further in section 9.3.3, to determine the amortization period for capitalized incremental costs to obtain a contract an entity needs to consider whether the capitalized contract costs only relate to goods or services that will be transferred under the initial contract or whether the costs also relate to goods or services that will be transferred under a specific anticipated contract.

If the entity’s past experience indicates that a renewal is likely, an entity needs to determine whether the renewal commission is commensurate with the initial commission; if not, the amortization period would be longer than the initial term. If the amortization period extends beyond one year due to expected contract renewals, the practical expedient would not be available to the entity.

##### Question 9-15 If a contract contains more than one performance obligation, can an entity apply the practical expedient?

It depends. Entities are allowed to recognize the incremental costs of obtaining a contract as an expense only if the asset resulting from capitalizing these costs would have been amortized in one year or less. As discussed further in Question 9-25 in section 9.3.3, we believe an entity can attribute capitalized contract costs to individual performance obligations in a contract, but it is not required to do so. That is, an entity can use multiple approaches to determine the amortization period provided that the asset recognized is amortized on a systematic basis that is consistent with the transfer to the customer of the goods or services to which the asset relates.

Reasonable approaches could include amortizing a single capitalized contract cost using one measure of performance considering all of the performance obligations in the contract, allocating the capitalized costs to all performance obligations in the contract on a relative basis and determining an appropriate amortization period for each performance obligation or allocating specific capitalized contracts costs to individual performance obligations in the contract (but not all) when the costs relate specifically to certain goods or services (but not all).

Regardless of the approach used to determine the appropriate amortization period for a capitalized contract cost related to a contract containing multiple performance obligations, all of the amortization periods related to the contract would have to be one year or less for an entity to apply the practical expedient. If any amortization period extends beyond one year, the entity cannot apply the practical expedient.

## Costs to fulfill a contract (updated September 2024)

ASC 340-40 divides contract fulfillment costs into two categories: (1) those that give rise to an asset and

(2) those that are expensed as incurred. When determining the appropriate accounting treatment for these costs, the guidance states that any other applicable literature should be considered first.

The following flowchart illustrates this guidance:

Yes

Recognize the fulfillment costs as an asset.

Are the costs expected to be recovered?

No

Expense the costs as incurred.

Do the costs generate or enhance resources of the entity that will be used in satisfying performance obligations in the future?

Do the costs relate directly to a contract or specifically anticipated contract?

Are the costs incurred to fulfill the contract in the scope of other Topics?

Apply the guidance in the other Topics.

No

No

Yes

No

Yes

Yes

ASC 340-40 provides guidance on other assets and deferred costs relating to contracts with customers within the scope of ASC 606. However, it does not provide comprehensive cost guidance and should only be applied if the costs are not in the scope of other US GAAP topics. That is, if other US GAAP precludes the recognition of an asset for a particular cost, an asset cannot be recognized under ASC 340-40. If the costs are not in the scope of other US GAAP, an entity would then evaluate whether the costs meet the criteria for capitalization under ASC 340-40.

Other US GAAP that is applicable to accounting for costs to fulfill a contract with a customer includes, but is not limited to, the following:

* Credit card-related costs subject to ASC 310
* Inventory costs within the scope of ASC 330
* Pre-production costs related to long-term supply arrangements subject to ASC 340-10
* Intangible assets, including internal-use software development costs and website development costs, within the scope of ASC 350
* Costs of PP&E within the scope of ASC 360
* Startup costs subject to ASC 720-15
* Research and development costs within the scope of ASC 730
* Film costs subject to ASC 926-20
* Insurance acquisition costs within the scope of ASC 944
* Real estate project costs within the scope of ASC 970
* External-use software development costs subject to ASC 985-20

Example 2 in ASC 340-40 (included below) illustrates some costs that are accounted for under other US GAAP.

When determining whether costs to fulfill a contract with a customer meet the criteria for capitalization under ASC 340-40-25-5, an entity must consider its specific facts and circumstances. ASC 340-40 says that costs can be capitalized even if the revenue contract with the customer is not finalized. However, rather than allowing costs to be related to any potential future contract, ASC 340-40 requires that the costs relate directly to a specific anticipated contract.

Significant judgment may be required to determine whether costs generate or enhance resources of the entity that will be used in satisfying performance obligations in the future as required by ASC 340-40-25-5(b). The FASB explained[287](#_bookmark411) that ASC 340-40 results in the capitalization of only costs that meet the definition of an asset and precludes an entity from deferring costs merely to normalize profit margins throughout a contract by allocating revenue and costs evenly over the contract term.

For costs to meet the “expected to be recovered” criterion (i.e., ASC 340-40-25-5(c)), the costs need to be either explicitly reimbursable under the contract or reflected through the pricing on the contract and recoverable through margin. Determining whether the costs are expected to be recovered may be challenging

and require significant judgment if some, or all, of the transaction price is contingent (e.g., success-based fees).

Similar to the discussion related to incremental costs to obtain a contract in section 9.3.1, an entity should include all future cash inflows and outflows associated with fulfilling the contract to determine whether costs to fulfill a contract are recoverable. Further, when an entity determines the amount it expects to receive as part of the recoverability assessment, it would not apply the guidance on constraining estimates of variable consideration. That is, if an entity were required to reduce the estimated transaction price because of the constraint on variable consideration, it would use the unconstrained transaction price to evaluate recoverability of the contract fulfillment costs. This unconstrained transaction price also needs to be adjusted to reflect the customer’s credit risk. This recoverability assessment is similar to the impairment assessment discussed in section 9.3.4.

How we see it

As discussed above, entities must first determine whether costs incurred to fulfill a contract with a customer are in the scope of other US GAAP before determining whether capitalization is required under ASC 340-40. As an example, an entity may determine that fulfillment costs related to a service contract are not in the scope of other guidance, such as ASC 330, so it evaluates ASC 340-40 to determine whether the fulfillment costs are required to be capitalized or expensed. The types of costs that may be capitalizable under ASC 340-40 for the service contract are similar to the types of costs that may be capitalized under ASC 330 for a contract to sell goods. That is, ASC 340-40 provides inventory-like guidance for ASC 606 contract fulfillment costs that aren’t in the scope of other guidance.

As noted in ASC 340-40-25-7, costs that are evaluated for capitalization include direct costs and allocable overhead-type costs. However, an entity will also need to consider the types of costs that should be expensed as incurred in accordance with ASC 340-40-25-8, as discussed further below.

If the costs incurred in fulfilling a contract do not give rise to an asset based on the criteria in ASC 340- 40-25-5 above, the guidance requires them to be expensed as incurred. ASC 340-40 provides some common examples of costs that should be expensed as incurred.

ASC 340-40-25-8(c) states that if a performance obligation (or a portion of a performance obligation that is satisfied over time) has been satisfied, fulfillment costs related to that performance obligation (or portion thereof) can no longer be capitalized. This is true even if the associated revenue has not yet been recognized (e.g., the contract consideration is variable and has been fully or partially constrained). Once an entity has begun satisfying a performance obligation that is satisfied over time, it should only capitalize costs that relate to future performance. Accordingly, it may be challenging for an entity to capitalize costs related to aperformance obligation that an entity has already started to satisfy. Under ASC 340-40-25-8(d), if an entity is unable to determine whether certain costs relate to past or future performance, and the costs are not eligible for capitalization under other US GAAP, the costs are expensed as incurred.

Consider the following example:[288](#_bookmark412)

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| **Example of costs to fulfill a contract related to past performance** |
| An entity enters into a contract with a customer to construct a building. It identifies a single performance obligation, being the promise to transfer the building to the customer, which it expects will take three years to complete. The entity satisfies this performance obligation (and recognizes revenue) over time in accordance with ASC 606-10-25-27(c) because its performance does not create an asset with alternative use, and it has an enforceable right to payment (see section 7.1.3).  As of the end of the reporting period, the entity has begun constructing the building and has incurred costs related to laying the foundation of the building.  We believe that the foundation costs relate to construction work done on the partly constructed building, which has been transferred to the customer. Therefore, the costs relate to the entity’s past performance in partially satisfying its performance obligation and, in accordance with ASC 340-40-25-8, should be expensed as incurred. That is, the costs do not meet the criteria to be recognized as an asset under ASC 340-40. |

ASC 340-40 provides the following example that illustrates costs that are capitalized under other US GAAP, costs that meet the capitalization criteria and costs that don’t:

##### Question 9-16 How should an entity account for pre-production costs related to long-term supply arrangements?

[9 November 2015 TRG meeting, agenda paper no. 46; FASB staff Q&As, question 66]

Manufacturing and production companies in various industries raised questions about how they should account for activities and costs incurred before the production of goods related to long-term supply arrangements. The questions arose because some long-term supply arrangements require an entity to incur up-front costs, such as nonrecurring engineering and design costs or costs related to setup activities, to create new technology or adapt existing technology to the needs of the customer. These pre-production activities are often a prerequisite to delivering any units under a production contract.

For example, a manufacturer may incur costs to perform certain services related to the design and development of products it will sell under long-term supply arrangements and may incur costs to design and develop molds, dies and other tools that will be used to produce those products. A contract may call for the customer to reimburse the manufacturer for these costs, or reimbursement may be implicitly guaranteed as part of the price of the product or by other means.

We believe that an entity should perform a thorough analysis of the facts and circumstances to assess whether the costs are in the scope of the guidance in ASC 340-10, which provides guidance on capitalizing certain pre-production costs related to long-term supply arrangements. If the pre-production costs are not in the scope of ASC 340-10, an entity should consider other US GAAP that may be applicable (e.g., ASC 340-40 on costs to fulfill a contract with a customer).

As previously discussed, for an arrangement to be in the scope of ASC 340-40, it must first be within the scope of ASC 606 (Question 2-9 in section 2.4 addresses whether pre-production activities are in the scope of ASC 606).

##### Question 9-17 Can an entity defer costs of a transferred good or service that would otherwise generate an up-front loss because variable consideration is fully or partially constrained?

An entity should not defer the costs of a transferred good or service when the application of the constraint on variable consideration results in an up-front loss even if the entity ultimately expects to recognize a profit on that good or service, unless other specific guidance requires a deferral of those costs. The criteria in ASC 340-40 must be met to capitalize costs to fulfill a contract, including the criterion that the costs must generate or enhance resources of the entity that will be used in satisfying performance obligations in the future. An entity recognizes costs of sales when control of a good or service transfers to the customer, so the cost of those sales would not generate or enhance resources of the entity used to satisfy future performance obligations. Consider the following example:

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| --- |
| **Illustration 9-5: Recognize cost of sales when control is transferred** |
| An entity sells goods with a cost of $500,000 for consideration of $600,000. The goods have a high risk of obsolescence, which may require the entity to provide price concessions in the future, resulting in variable consideration (see section 5.2.1.1). The entity constrains the transaction price and concludes that it is probable that $470,000 will not result in a significant revenue reversal, even though the entity reasonably expects the contract to be ultimately profitable. When control transfers, the entity recognizes revenue of  $470,000 and costs of $500,000, and it would not capitalize the loss of $30,000 because the loss does not generate or enhance resources of the entity that will be used in satisfying performance obligations in the future. |

**Question 9-18 How should an entity account for fulfillment costs incurred prior to the contract establishment date that are outside the scope of another standard (e.g., outside the scope of the inventory guidance in ASC 330)?** [30 March 2015 TRG meeting, agenda paper no. 33; FASB staff Q&As, question 76]

Entities may begin activities on a specific anticipated contract before the contract establishment date (e.g., before agreeing to the contract with the customer, before the contract satisfies the criteria to be accounted for under ASC 606) that are not within the scope of another standard (e.g., ASC 330). Costs relating to pre-contract establishment date activities that relate to a good or service that transfers to the customer at or after the contract establishment date may be capitalized as costs to fulfill a specific anticipated contract. However, such costs would still need to meet the criteria in ASC 340-40-25-5 to be capitalized (e.g., they are expected to be recovered under the anticipated contract). Certain costs, such as general and administrative costs that are not explicitly chargeable to the customer under the contract, would not satisfy these criteria and would need to be expensed as incurred.

Capitalized contract costs that relate to goods or services that are transferred to the customer at the contract establishment date should be expensed immediately. Any remaining capitalized contract costs would be amortized over the period that the related goods or services are transferred to the customer.

For guidance on recognizing revenue for a performance obligation satisfied over time when activities are completed before the contract establishment date, see Question 7-18 in section 7.1.4.3.

##### Question 9-19 How are the effects of learning curve costs addressed in ASC 606 and ASC 340-40?

A learning curve is the effect of efficiencies realized over time when an entity’s costs of performing a task (or producing a unit) decline in relation to how many times the entity performs that task (or produces that unit)[.289](#_bookmark413) Learning curve costs usually consist of materials, labor, overhead, rework or other costs that must be incurred to complete the contract (but do not include research and development costs). These types of efficiencies generally can be predicted at the inception of an arrangement and are often considered in the pricing of a contract between an entity and a customer.

The FASB noted[290](#_bookmark414) that in situations where learning curve costs are incurred in relation to a contract with a customer accounted for as a single performance obligation that is satisfied over time to deliver a specified number of units, ASC 606 requires an entity to select a method of progress that depicts the transfer over time of the good or service to the customer (see section 7.1.4). The FASB further noted that an entity likely would select a method, such as a costs incurred measure of progress, for these types of contracts, which would result in the entity recognizing more revenue and expense at the beginning of the contract relative to the end. The Board clarified that this would be appropriate since an entity would charge a higher price to a customer only purchasing one unit (rather than multiple units) to recover its learning curve costs.

Conversely, when learning curve costs are incurred for a performance obligation satisfied at a point in time (rather than over time), an entity should assess whether those costs are within the scope of another standard. The FASB noted[291](#_bookmark415) that in situations in which an entity incurs cost to fulfill a contract without also satisfying a performance obligation over time, the entity probably is creating an asset included within the scope of another standard (e.g., ASC 330). In such an example, the costs of producing the components would likely accumulate as inventory, and the entity would select an appropriate method

of measuring that inventory and recognizing it as revenue when control of the inventory transfers to the customer.

If the learning curve costs are not in the scope of another standard, we believe they generally will not be eligible for capitalization under ASC 340-40 (e.g., because the costs relate to past (and not future) performance).

##### Question 9-20 How should an entity account for pre-contract or setup costs, including mobilization activities?

Pre-contract costs are often incurred in anticipation of a contract and will result in no future benefit unless the contract is obtained. Examples include (1) engineering, design or other activities performed on the basis of commitments, or other indications of interest, by a customer; (2) costs for production equipment and materials relating to specific anticipated contracts (e.g., costs for the purchase of production equipment, materials or supplies); and (3) costs incurred to acquire or produce goods in excess of contractual requirements in anticipation of subsequent orders for the same item.

Mobilization activities often include costs to move personnel, equipment and supplies to the project site, calibrate tools and machinery and construct temporary facilities that will be used to satisfy a performance obligation.

Pre-contract costs and mobilization activities that are incurred in anticipation of a specific contract should first be evaluated for capitalization under other authoritative literature (e.g., ASC 330, ASC 360, ASC 985). For example, pre-contract costs incurred to acquire or produce goods in excess of contractual requirements for an existing contract in anticipation of subsequent orders for the same item would likely be evaluated under ASC 330. As another example, costs incurred to move newly acquired equipment to its intended location could be required to be capitalized under ASC 360. Pre-contract and mobilization costs incurred in anticipation of a specific contract that are not addressed under other authoritative literature will be capitalized under ASC 340-40 only if they meet all of the criteria of a cost incurred to fulfill a contract.

Further, it may be challenging for an entity to capitalize mobilization costs related to a performance obligation that it has already started to satisfy. This is because, as discussed in section 9.3.2, once an entity begins to satisfy a performance obligation satisfied over time, it can only capitalize costs that relate to future performance. Pre-contract and mobilization costs that are not in the scope of other US GAAP and do not meet the capitalization criteria under ASC 340-40 should be charged to expense as incurred.

##### Question 9-21 Can an entity defer losses incurred on a contract by capitalizing related fulfillment costs when it is expected to generate future profits on the sale of optional goods and services (i.e., loss leader)?

No. Certain contracts may be executed as part of a loss leader strategy in which a good is sold at a loss with an expectation that future sales contracts will result in higher sales and/or profits. In determining whether these anticipated contracts should be part of the accounting for the existing loss leader contract, entities should refer to the definition of a contract in ASC 606 that is based on enforceable rights and obligations in the existing contract (see section 3.1). While it may be likely that the customer will enter into a future contract or the customer may even be compelled economically or by regulation to do so, it would not be appropriate to account for an anticipated contract when there is an absence of enforceable rights and obligations. This view is consistent with that of the SEC staff[.292](#_bookmark416)

In addition, if the fulfillment costs incurred during satisfying the initial contract are within the scope of other US GAAP (e.g., ASC 330), the entity must account for those costs under that relevant guidance. Even if the costs are not identified to be within the scope of other US GAAP, the costs would relate to a satisfied or partially satisfied performance obligation (i.e., the original contract priced at a loss) and therefore must be expensed as incurred. Neither ASC 606 nor ASC 340-40 permit an entity to defer fulfillment costs or losses incurred based on the expectation of profits in a future contract.

##### Question 9-22 How should an entity account for costs associated with installation or implementation services?

Entities that provide installation or implementation services to customers incur costs to fulfill the services. To determine the appropriate accounting for these costs, entities first need to determine whether the costs are within the scope of other US GAAP (e.g., ASC 360, ASC 350).

If they are not, entities need to determine whether the installation or implementation service is a separate performance obligation (see section 4.2) that is satisfied over time (see section 7.1). If it is, the entity generally expenses the costs associated with that performance obligation as incurred because, as discussed in section 9.3.2, it may be challenging to conclude that the costs relate only to the entity’s satisfaction of performance obligations in the future, which is required for capitalization by ASC 340-40-25-5(b).

If the installation or implementation service is not a separate performance obligation, an entity needs to evaluate whether it is required to capitalize the costs to fulfill the contract under the ASC 340-40 guidance mentioned above. That is, costs incurred to fulfill a contract are required to be capitalized only if they meet all of the criteria for capitalization in ASC 340-40-25-5.

The illustrations below contrast an example of implementation services that are determined to be a separate performance obligation (and, therefore, are not capitalized as costs to fulfill a contract) with an example of implementation services that meet the criteria for capitalization as costs to fulfill a contract under ASC 340-40.

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| **Illustration 9-6: Implementation services are not capitalized costs to fulfill a contract** |
| Technology entity M enters into a three-year, $4,000,000 SaaS contract with a customer for a subscription to an inventory management application beginning 1 June 20X3. The contract includes implementation services that will be performed at the beginning of the contract, starting on 1 June 20X3. The implementation services include data migration, creation of objects for the customer’s products that will be inventoried, and customization of the application’s layout with the customer’s logo and color scheme. Several third-party service providers also sell implementation services for Technology entity M’s application. Assume that the implementation services do not represent a significant integration service (i.e., the implementation services do not significantly modify or customize the SaaS) and the SaaS is fully functional without the implementation service. Under the contract, the customer receives access to the SaaS on 1 June 20X3.  Technology entity M determines that the costs incurred related to the implementation services are not within the scope of other US GAAP (e.g., ASC 360, ASC 350).  Technology entity M then considers the implementation services and SaaS and determines that they are separate performance obligations that will be satisfied over time. This is because the implementation services and SaaS can be purchased separately. Technology entity M determines it is able to fulfill its promise to transfer the SaaS separately from the implementation services, indicating that the two are not highly interdependent or interrelated. Therefore, Technology entity M determines that the costs incurred related to implementation services do not meet the criteria for capitalization because they do not relate to the entity’s satisfaction of performance obligations in the future (i.e., the costs are expensed as incurred in the process of performing the implementation services). |

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| **Illustration 9-7: Implementation services are capitalized costs to fulfill a contract** |
| Technology entity N enters into a $2,000,000 contract with a customer for a one-year SaaS subscription to an enterprise software application beginning when the customer obtains access to the SaaS. The contract includes implementation services that will be performed at the beginning of the contract, starting on 1 January 20X5. The implementation services, which will take approximately two months to complete, must be performed in order for the customer to access the SaaS because the services involve the creation of customer-specific interfaces. Technology entity N does not sell the SaaS without these implementation services, and no other vendors are able to perform the implementation services because they require the creation of code that will reside on Technology entity N’s servers.  Technology entity N determines that the costs incurred related to the implementation services are not within the scope of other US GAAP (e.g., ASC 360, ASC 350).  Technology entity N then determines that the implementation services are not capable of being distinct. This is because they cannot be purchased separately or provided by a third party and because the services do not provide benefit on their own or with other readily available resources (since the SaaS has not yet been provided and also cannot be sold separately). Therefore, the implementation services and SaaS subscription are a combined performance obligation.  Technology entity N also concludes that the combined performance obligation meets the requirements for recognition over time. It determines that revenue will be recognized over the contract term, beginning when the customer obtains access to the SaaS.  Therefore, Technology entity N considers whether the costs incurred related to the implementation services that will be provided at the outset of the contract (i.e., before the customer obtains access to the SaaS) meet the criteria to be capitalized as a cost to fulfill the contract as follows:   * The costs relate specifically to the SaaS contract with this customer. * The costs generate a resource (i.e., the interfaces) that will be used in future performance (i.e., providing the SaaS to the customer). * The costs are expected to be recovered based on the margin included in the contract.   As such, Technology entity N determines that the costs should be capitalized as a cost to fulfill as the implementation services are performed. The costs will then be amortized over the estimated period of benefit (see section 9.3.3) beginning when the customer gains access to the SaaS. |

## Amortization of capitalized contract costs

Any capitalized contract costs are amortized, with the expense recognized as an entity transfers the related goods or services to the customer.

ASC 340-40-35-1 states that capitalized contract costs should be amortized on a systematic basis that is consistent with the transfer to the customer of the goods or services to which the asset relates. When the timing of revenue recognition (e.g., at a point in time, over time) aligns with the transfer of the goods or services to the customer, the amortization of the capitalized contract costs in a reporting period will correspond with the revenue recognition in that reporting period. However, the timing of revenue recognition may not always align with the transfer of the goods and services to the customer (e.g., when variable consideration is constrained at the time the related performance obligation is satisfied). When this occurs, the amortization of the capitalized contract costs will not correspond with the revenue recognition in a reporting period.

For example, consider an entity that enters into a contract with a customer to provide two performance obligations, a right-to-use license of intellectual property and a related service for three years, with payment from the customer based on the customer’s usage of the intellectual property (i.e., a usage- based royalty). Revenue related to the license of intellectual property would be recognized at a point in time (see section 8.3.2) and revenue related to the service would be recognized over time. The transaction price allocated to the performance obligation for the license of intellectual property cannot be recognized at a point in time when control of the license transfers to the customer due to the royalty recognition constraint (see section 8.5). Accordingly, any capitalized contract costs that relate to the license should be fully amortized upon the transfer of control of that license (i.e., at a point in time) regardless of when the related revenue will be recognized. Any capitalized contract costs that relate to the service should be amortized over the period of time consistent with the transfer of control of the service.

**Product and competitive environment**

* Historical product turnover
* Products/services road map and other future changes to products/service offerings
* Competitive landscape

**Customer life**

* Historical customer turnover
* Length of contracts and renewal patterns
* Other factors that may affect customers’

lives in the future

It is important to note that certain capitalized contract costs relate to multiple goods and services (e.g., design costs to manufacture multiple distinct goods when design services are not a separate performance obligation) in a single contract, so the amortization period could be the entire contract term. See Question 9-25 below for a discussion on how an entity might determine the appropriate amortization period when capitalized contract costs relate to multiple performance obligations. The amortization period could also extend beyond a single contract if the capitalized contract costs relate to goods or services being transferred under multiple contracts or to a specific anticipated contract (e.g., certain contract renewals). In these situations, the capitalized contract costs should be amortized over a period that is consistent with the transfer to the customer of the goods or services to which the asset relates. This can also be thought of as the expected period of benefit of the asset capitalized. The expected period of benefit may be the expected customer relationship period, but that is not always the case. To determine the appropriate amortization period, an entity needs to evaluate the type of capitalized contract costs, what the costs relate to and the specific facts and circumstances of the arrangement. Further, before including estimated renewals in the period of benefit, an entity should evaluate its history with renewals to conclude that such an estimate is supportable.

The following graphic lists some factors that should be considered in the evaluation of the period of benefit:

**Period of benefit**

Assess the customer life, product and competitive environment data points to select a period of benefit for each customer and/or product category evaluated

**Nature of company’s services**

* Product/service offerings and differences in the related customer lives
* Variations in contract terms and product sales structure

An entity should update the amortization period when there is a significant change in the entity’s expected timing of transfer to the customer of the goods or services to which the asset relates, as illustrated in the following example:

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| **Illustration 9-8: Amortization period** |
| Entity A enters into a three-year contract with a new customer for transaction processing services.  To fulfill the contract, Entity A incurred setup costs of $60,000, which it capitalized in accordance with ASC 340-40-25-5 through 25-8 and will amortize over the term of the contract.  At the beginning of the third year, the customer renews the contract for an additional two years. Because Entity A will benefit from the setup costs during the additional two-year period, it would change the remaining amortization period from one to three years and adjust the amortization expense in the period of the change and future periods in accordance with the guidance in ASC 250 on changes in accounting estimates.  The disclosure requirements of ASC 250 related to changes in accounting estimates also are applicable.  However, under ASC 340-40, if Entity A had been in the position to anticipate the contract renewal at contract inception, Entity A would have amortized the setup costs over the anticipated term of the contract, including the expected renewal (i.e., five years). |

Determining the amortization period for incremental costs of obtaining a contract with a customer can be complicated, especially when contract renewals are expected and the commission rates are not constant throughout the entire life of the contract. When evaluating whether the amortization period for an initial sales commission extends beyond the original contract period, an entity should evaluate whether an additional commission is paid for subsequent renewals and, if so, whether the renewal commission is considered “commensurate” with the original commission. See Question 9-23 below for further discussion on whether a commission is commensurate.

The FASB explained[293](#_bookmark418) that amortizing the asset over a longer period than the initial contract would not be appropriate if an entity pays a commission on a contract renewal that is commensurate with the commission paid on the initial contract. In that case, the costs of obtaining the initial contract do not relate to the subsequent contract. An entity would also need to evaluate the appropriate amortization period for any renewal commissions that are required to be capitalized under ASC 340-40 in a similar manner. See Question 9-24 below for FASB TRG discussion of how an entity should determine the amortization period of an asset recognized for the incremental costs of obtaining a contract with a customer.

How we see it

Under ASC 340-40, entities are required to evaluate whether the period of benefit is longer than the term of the initial contract. As discussed above, an entity would likely be required to amortize the capitalized sales commission cost over a period longer than the initial contract if a renewal commission is not paid or a renewal commission is paid that is not commensurate with the original commission. It is also important to note that the amortization period affects whether the practical expedient that allows entities to recognize the incremental costs of obtaining a contract as an expense can be used. That expedient requires that the asset resulting from the capitalization of these costs be amortized in one year or less. It is not dependent on the initial contract term.

In comment letters, the SEC staff has asked registrants to explain how they determined the amortization period for contract costs capitalized under ASC 340-40. In particular, the SEC staff has requested more information about costs to obtain a contract with a customer, including how renewal sales commissions (if any) are considered in the amortization period determination.

It is important for entities to document the judgments they made when determining the appropriate amortization period and disclose the same in their financial statements. ASC 340-40 disclosure requirements (see section 10.5.3) include judgments made in determining the amounts of costs that are capitalized, the amortization method chosen and other quantitative disclosures.

**Question 9-23 How should an entity determine whether a commission on a renewal contract is commensurate with the commission on the initial contract?** [7 November 2016 TRG meeting, agenda paper no. 57; FASB staff Q&As, question 72]

Commissions need to be reasonably proportional to the contract values (e.g., 5% of both the initial and renewal contract values) to be considered commensurate. It would not be appropriate for an entity to use a “level of effort” analysis to determine whether a commission is commensurate. For example, a 6% commission on an initial contract and a 2% commission on a renewal would not be commensurate even if the declining commission rate corresponds to the level of effort required to obtain the contracts.

As discussed above in section 9.3.3, if the renewal commission is considered to be commensurate with the commission on the initial contract, it would not be appropriate to amortize any asset for the initial commission over a longer period than the initial contract. In contrast, it likely would be appropriate to amortize the asset over a longer period than the initial contract if the commissions are not considered to be commensurate (such as in the example above with a 6% initial commission and 2% renewal commission). See Question 9-24 below for discussion of how an entity determines this longer amortization period.

We also believe entities need to evaluate whether any expected subsequent renewal commissions are commensurate with prior renewal commissions to determine the appropriate amortization period for any renewal commissions that are required to be capitalized under ASC 340-40. Continuing the above example, assume the original contract (for which a 6% commission is paid) and each subsequent renewal contract (for which a 2% renewal is paid) is for a one-year term. If the entity expects to renew the contract in years two through four and continue to pay a constant 2% commission upon each renewal, each renewal commission would be considered commensurate, and the appropriate amortization period for each renewal required to be capitalized would likely be one year. See Question 9-27 below for discussion of when an entity would begin to amortize an asset recognized for the incremental cost of obtaining a renewal contract.

**Question 9-24 How should an entity determine the amortization period of an asset recognized for the incremental costs of obtaining a contract with a customer?** [7 November 2016 TRG meeting; agenda paper no. 57 and 26 January 2015 TRG meeting, agenda paper no. 23; FASB staff Q&As, questions 71 and 79]

As discussed above, when an entity determines an amortization period that is consistent with the transfer to the customer of the goods or services to which the asset relates, it must determine whether the capitalized contract costs relate only to goods or services that will be transferred under the initial contract or whether the costs also relate to goods or services that will be transferred under a specific anticipated contract. For example, if an entity pays a commission based only on the initial contract and doesn’t expect a renewal (e.g., based on its past experience or other relevant information), amortizing the asset over the initial term would be appropriate.

However, if the entity’s past experience indicates that a renewal is likely, the amortization period would be longer than the initial term if the renewal commission is not “commensurate” with the initial commission. See Question 9-23 above for a discussion of commensurate.

An entity needs to evaluate its facts and circumstances and apply judgment to determine an appropriate amortization period if it determines that the period should extend beyond the initial contract term because the commission on the renewal contract is not commensurate with the commission on the initial contract. While an entity might reasonably conclude that its average customer life is the best estimate of the amortization period that is consistent with the transfer of the goods or services to which the asset relates (e.g., if the good or service does not change over time, such as a health club membership), this approach is not required and entities should not default to it. Entities should use similar judgment to that which they use when estimating the amortization period for intangible assets (e.g., a customer relationship intangible acquired in a business combination) and could consider factors such as customer “stickiness” and how quickly their products and services change.

Consider a technology entity that capitalizes a commission earned on the sale of software, which the entity estimates it will maintain and support for only the next five years, and the estimated customer life is seven years. In evaluating the period of benefit, the entity may reasonably conclude the capitalized commission should be amortized over the five-year life of the software to which the commission relates.

However, in a TRG agenda paper[294](#_bookmark419) the FASB staff discussed two acceptable methods for amortizing capitalized contract costs related both to the original contract and to renewals in cases in which the renewal commission is not commensurate with the initial commission:

* The initial capitalized amount is amortized over the period of benefit that includes expected renewals, while amounts capitalized related to renewals are amortized over the renewal period.
* The portion of the initial capitalized amount that is commensurate is amortized over the original contract term and the additional amount that is not commensurate is amortized over the period of benefit that includes expected renewals. Capitalized amounts related to renewals are amortized over the renewal period.

While both methods are acceptable because they each meet the objective of amortizing the costs on a systematic basis that is consistent with the transfer to the customer of the goods or services to which the asset relates, an entity should make a policy election to select one method and apply it consistently for similar circumstances. Other amortization methods may also be acceptable if they are consistent with the pattern of transfer to the customer of the goods or services to which the asset relates.

The following illustration demonstrates the two methods described in the TRG agenda paper:

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| **Illustration 9-9: Methods for amortizing capitalized contract costs** |
| An entity has a commission plan that pays a 6% commission to a sales representative each time that sales representative obtains a new contract with a customer and a 2% commission each time that customer renews. Based on the entity’s assessment of the guidance in ASC 340-40, it has concluded that the commissions earned as part of this commission plan are incremental costs to obtain a contract that are required to be capitalized. Further, the entity has determined that the 2% commission paid for renewals is not commensurate with the 6% commission paid for initial contracts and, therefore, the period of benefit for capitalized commissions extends beyond the initial contract term.  The entity performs an assessment of average customer life, technology turnover and competitive factors and concludes that the period of benefit for capitalized commissions is five years.  The entity executes a three-year service contract with a customer for $600,000 and pays a 6% commission to the sales representative. At the end of the three-year term, the customer renews the contract for two years for $400,000, and the entity pays a 2% commission to the sales representative. |

The following are two acceptable methods for amortizing the capitalized contract costs related to the

$36,000 commission paid on the initial contract and the $8,000 commission paid on the renewal:

##### Method 1

The $36,000 commission on the initial contract that was capitalized is amortized over the five-year period of benefit. When the contract is renewed, the $8,000 commission related to the renewal that was capitalized is amortized over the two-year renewal period. The commission would be amortized as follows:

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
|  | Year 1 | Year 2 | Year 3 | Year 4 | Year 5 |
| Initial commission | $ 7,200 | $ 7,200 | $ 7,200 | $ 7,200 | $ 7,200 |
| Renewal commission | — | — | — | 4,000 | 4,000 |
| Total amortization expense | $ 7,200 | $ 7,200 | $ 7,200 | $ 11,200 | $ 11,200 |

##### Method 2

The $36,000 commission on the initial contract that was capitalized is separated into two components:

$12,000 that is commensurate with the commission paid on renewal (i.e., the amount of commission that the $600,000 initial contract earns at the commensurate rate of 2%) and $24,000 that is not commensurate. The entity amortizes the $12,000 component over the three-year initial contract term and the $24,000 component over the five-year period of benefit. When the contract is renewed, the

$8,000 commission on the renewal that was capitalized is amortized over the two-year renewal period. The commission would be amortized as follows:

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
|  | Year 1 | Year 2 | Year 3 | Year 4 | Year 5 |
| Initial commission (not commensurate) | $ 4,800 | $ 4,800 | $ 4,800 | $ 4,800 | $ 4,800 |
| Initial commission (commensurate) | 4,000 | 4,000 | 4,000 | — | — |
| Renewal commission | — | — | — | 4,000 | 4,000 |
| Total amortization expense | $ 8,800 | $ 8,800 | $ 8,800 | $ 8,800 | $ 8,800 |

**Question 9-25 Can an entity attribute the capitalized contract costs to the individual performance obligations in the contract to determine the appropriate amortization period?** [26 January 2015 TRG meeting, agenda paper no. 23; FASB staff Q&As, question 75]

Yes. We believe an entity can attribute the capitalized contract costs to the individual performance obligations in the contract to determine the appropriate amortization period, but it is not required to do so. ASC 340-40-35-1 states that the asset recognized should be amortized on a systematic basis “that is consistent with the transfer to the customer of the goods or services to which the asset relates.” An entity may meet this objective by allocating the capitalized contract costs to performance obligations on a relative basis (i.e., in proportion to the transaction price allocated to each performance obligation) to determine the period of amortization.

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| **Illustration 9-10: Allocation of capitalized contract costs** |
| For example, a technology entity executes a contract for $600,000 for a perpetual software license and one year of PCS. Based on the standalone selling prices, the entity allocates $500,000 (83%) of the total transaction price to the license and $100,000 (17%) to the PCS. The entity pays a 4% commission to the sales representative and has determined that the commission is required to be capitalized under ASC 340-40 because it is an incremental cost of obtaining the contract. The entity concludes that the  $24,000 sales commission should be allocated between the license and the PCS and amortized over the expected period of benefit associated with each of those performance obligations. The entity allocates  $20,000 (83%) to the license and $4,000 (17%) to the PCS, consistent with the relative value of the performance obligations to the transaction price. |

Other methods for allocating capitalized contract costs may be appropriate. For example, we believe an entity may also meet the objective by allocating specific capitalized contracts costs to individual performance obligations when the costs relate specifically to certain goods or services. An entity should have objective evidence to support a conclusion that a specified amount of the costs relates to a specific performance obligation and should consistently apply any methods used for allocating capitalized contract costs to performance obligations.

In addition, as discussed above in Question 9-24, an entity that attributes capitalized contract costs to individual performance obligations needs to consider whether the amortization period for some or all of the performance obligations should extend beyond the original contract.

There is another potentially acceptable amortization pattern for capitalized contract costs that relate to multiple performance obligations that are satisfied over different periods that would not require allocation of the asset to individual performance obligations in the contract. That is, an entity may amortize a single capitalized contract cost using one measure of performance considering all of the performance obligations in the contract. An entity that uses this method should select a measure that best reflects the “use” of the asset as the goods and services are transferred to the customer. That is, the pattern of amortization must meet the objective of ASC 340-40-35-1 so it is consistent with the transfer to the customer of the goods or services to which the asset relates.

**Question 9-26 Over what period should an entity amortize a sales commission that is paid only once a threshold is met that is determined to be an incremental cost to obtain a contract?** [26 January 2015 TRG meeting, agenda paper no. 23; FASB staff Q&As, question 69]

There are at least two alternatives that meet the objective of amortizing the costs on a systematic basis that is consistent with the transfer to the customer of the goods or services to which the asset relates. Either alternative should be applied consistently to similar circumstances.

In the first alternative, an entity allocates the capitalized costs to all of the contracts that cumulatively result in the threshold being met and amortizes the costs over the expected customer relationship period of each of those contracts. In the second alternative, an entity allocates the capitalized costs to the contract that results in the threshold being met and amortizes the costs over the expected customer relationship period of that contract. The second alternative may result in a counterintuitive answer if the commission paid upon obtaining the contract that resulted in the threshold being met was large in relation to the transaction price for only that contract. While the first alternative may be easier to apply and result in a more intuitive answer than the second alternative in some situations, either approach is acceptable. However, there may be other approaches that also are acceptable.

Consider the following example in the TRG agenda paper:

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| **Example of amortization of capitalized commission payments subject to a threshold** |
| 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. In this example, the first commission is paid when the first contract is signed and subsequently, once a cumulative threshold number of contracts is reached, a commission is paid on that threshold contract as a fixed escalating amount, taking into account any commission already paid, as follows:  1 contract $3,000 commission  10 contracts $5,000 cumulative commission (including $3,000 already paid)  15 contracts $10,000 cumulative commission (including $5,000 already paid) Assume 11 new contracts are signed by a specific employee in that period.  As discussed in Question 9-8 in section 9.3.1, commission payments subject to a threshold are  incremental costs of obtaining a contract with a customer and, therefore, the costs should be capitalized when the entity incurs a liability to pay these commissions.  In the first acceptable alternative, an entity estimates the total amount of commission that is expected to be paid for the period and capitalizes an equal amount as each contract is signed. In this example, because the entity estimates that the employee will sign 11 new contracts during the period, it expects the total amount of commission to be paid will be $5,000. The entity would capitalize $455 when each contract is signed (i.e., $5,000 cumulative commission divided by the 11 contracts). The capitalized amount would be amortized over the expected customer relationship period of each of those contracts. That is, the $455 capitalized for the first contract would be amortized over the expected customer relationship period of the first contract and the $455 capitalized for the second contract would be amortized over the expected customer relationship period of the second contract.  In the second acceptable alternative, an entity capitalizes $3,000 in commission costs upon signing the first contract. This amount would be amortized over the expected customer relationship period of that contract (i.e., the first contract). The entity would not capitalize any additional costs upon signing the second contract through the ninth contract because the next commission “tier” has not been met. Once the 10th contract is signed, the entity capitalizes an additional $2,000 in commission costs. This amount would be amortized over the expected customer relationship period of that contract (i.e., the 10th contract). |

##### Question 9-27 When should an entity begin to amortize an asset recognized for the incremental cost of obtaining a renewal contract?

As discussed in Question 9-24 above, assets recognized for commensurate renewal commissions paid should be amortized over the term of the contract renewal with the expense recognized as the entity transfers the related goods or services to the customer.

We believe that the amortization of the renewal commission should begin no earlier than the beginning of the renewal period. Consider the following illustration:

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| **Illustration 9-11: Amortization of a capitalized contract costs** |
| On 1 January 20X8, an entity enters into a three-year service contract with a customer that ends on 31 December 20Y0. Upon the customer signing the contract, the entity pays a sales employee a  $50,000 sales commission for obtaining the contract. On 30 September 20Y0, the entity negotiates a three-year renewal term that will begin on 1 January 20Y1 and pays the sales employee a renewal commission that is commensurate with the initial sales commission paid. Because the entity does not begin to transfer services under the contract renewal until 1 January 20Y1, the entity would not begin amortizing the asset related to the renewal commission until 1 January 20Y1. |

##### Question 9-28 How should the amortization of capitalized contract costs under ASC 340-40 be presented on the income statement?

ASC 340-40 does not address the presentation of amortization in the income statement. However, we believe that the determination of whether a cost is capitalized or expensed under ASC 340-40 generally should not change its classification on the income statement since the nature of the costs remain the same. That is, if similar types of costs are expensed as incurred and included in cost of sales, the amortization of the capitalized asset also would generally be included in cost of sales.

Notwithstanding the above, Rule 5-03 of Regulation S-X requires registrants to separately present expenses from costs of sales and SG&A in the income statement. Because costs to obtain a contract are related to the acquisition of a contract, we believe that the amortization of these costs will generally be classified as SG&A. Further, we believe that costs to fulfill a contract directly affect the entity’s performance under the contract and will generally be classified as cost of sales.

##### Question 9-29 How should capitalized contract costs under ASC 340-40 be presented on the statement of cash flows?

ASC 340-40 does not address the presentation of capitalized contract costs in the statement of cash flows. However, we believe these costs should generally be capitalized as operating cash flows because they are similar in nature to certain operating cash outflows described in ASC 230-10-45-17, including:

* Cash payments to acquire materials for manufacture or goods for resale
* Cash payments to other suppliers and employees for other goods or services
* All other cash payments that do not stem from transactions defined as investing or financing activities, such as payments to settle lawsuits, cash contributions to charities and cash refunds to customers

ASC 340-40 refers to sales commissions as a type of an incremental cost to obtain a contract that are often paid to employees. Payroll expenses are generally considered operating expenses incurred in the ordinary course of business and, therefore, these types of costs should be presented as operating cash flows in the statement of cash flows. The fact that ASC 340-40 requires capitalization of certain selling costs that meet certain criteria does not change the nature of the cash flow. Similarly, costs incurred to fulfill a contract with a customer are generally incurred in the ordinary course of business and should also be presented as operating cash flows.

## Impairment of capitalized contract costs

Because costs that give rise to an asset must continue to be recoverable throughout the contract period (or period of benefit, if longer) to meet the criteria for capitalization, any asset recorded by the entity is subject to an impairment assessment.

An impairment exists if the carrying amount of any asset(s) exceeds the amount of consideration the entity has received that has not been recognized as revenue and consideration it expects to receive in exchange for providing those goods and services, less the remaining costs that relate directly to providing those goods and services.

An entity should include future cash inflows and outflows associated with contract renewal or extension periods when it determines the amount it expects to receive for purposes of the impairment test if the period of benefit of the costs under assessment is expected to extend beyond the present contract. In other words, an entity should consider the total period over which it expects to receive economic benefits relating to the asset both for purposes of determining the amortization period (see section 9.3.3) and estimating cash flows for impairment purposes.

In addition, as noted by the Board[,295](#_bookmark421) if an entity includes anticipated revenue due to contract renewals under ASC 340-40-35-3(a), the Board expects the entity also would include renewal costs

(e.g., commissions) in the amount calculated under ASC 340-40-35-3(b).

Note that when an entity determines the amount it expects to receive, it would not apply the guidance on constraining estimates of variable consideration. That is, if an entity were required to reduce the estimated transaction price because of the constraint on variable consideration, it would use the unconstrained transaction price for the impairment test. This would include any amounts expected to be received but not yet recognized because of the royalty recognition constraint (see section 8.5) or the ”right to invoice” practical expedient (see section 7.1.4.1). While the amount expected to be received is unconstrained, it needs to be adjusted to reflect the customer’s credit risk before it is used in the impairment test.

However, before recognizing an impairment loss on capitalized contract costs incurred to obtain or fulfill a contract, the entity needs to consider impairment losses recognized in accordance with other topics (e.g., ASC 330, ASC 985-20). After applying the impairment test to the capitalized contract costs in the scope of other topics and those in the scope of ASC 340-40, an entity includes the resulting carrying amounts in the carrying amount of the asset group or reporting unit for purposes of applying the guidance in ASC 360 or ASC 350*.*

Consistent with impairment guidance in other standards (e.g., ASC 360), entities following US GAAP are not permitted to reverse impairment losses previously recognized.

##### Question 9-30 How often should an entity assess its capitalized contract costs for impairment under 340-40?

ASC 340-40 does not address how often an entity should assess its capitalized contract costs for impairment. We believe an entity should assess its capitalized contract costs for impairment whenever events or changes in circumstances indicate that their carrying amounts may not be recoverable, similar to how an entity assesses impairment of long-lived assets under ASC 360-10-35-21. ASC 606-10-25-5 also requires an entity to reassess the criteria for an arrangement to be a contract under the standard when “there is an indication of a significant change in facts and circumstances.”