Accounting for Contract Costs

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During the calendar year 2019, Accounting Standards Codification ("ASC") 606 changes revenue recognition and contract cost capitalization.

ASC 606 requires an entity to apply the five-step model to recognize revenue:

1. Identify the contract with the customer
2. Identify the performance obligations in the contract
3. Determine the transaction price
4. Allocate the transaction price to the performance obligations
5. Recognize revenue when the performance obligations have been satisfied

In addition, Accounting Standards Update 2014-09 added a new subtopic to the codification, ASC 340-40*, Other Assets and Deferred Costs: Contract with Customers*, to address the accounting for cost incurred as part of obtaining or fulfilling a contract with a customer.

Entities may incur various costs to obtain or acquire a contract with a customer, including, but not limited to, legal fees, advertising expenses, travel expenses, commissions, etc.

Financial Accounting Standards Board ("FASB") ASC 340-40-25-1 states that an entity should recognize an asset for the incremental costs of obtaining a contract with a customer if the entity expects to recover those costs. FASB ASC 340-40-25-2 further defines 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, costs such as a sales commission that is only paid if a specified contract is obtained are an incremental cost. FASB ASC 340-40-25-3 clarifies costs to obtain a contract that would have been incurred regardless of whether a 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 was obtained. For example, legal expenses are costs that would be expensed, because the legal expenses to obtain a contract are incurred regardless of whether the contract was ultimately signed and executed by both parties. Incremental costs to obtain a contract that an entity expects to recover should be capitalized, while costs to obtain a contract that does not qualify for capitalization should be expensed as incurred.

- To further clarify, a commission paid to a sales supervisor based on achieving a certain threshold of new contracts would be capitalized.

* However, commissions paid on multiple factors, which obtaining a contract was only one factor would not be included and those costs would be expensed.

As a practical expedient, incremental costs of acquiring a contract can be expensed immediately if the amortization period would have been one year or less. Topic 606, *Revenue from Contracts with Customers,* may represent a change for entities because incremental contract costs are required to be capitalized, subject to the one-year practical expedient. This may require a contract analysis to track and record costs that were previously expensed.

To summarize evaluating costs to obtain a contract are as follows:

Costs

Capitalize or Expense

Reason

Legal fees for drafting new contracts

Expense

Not incremental, both parties can walk away from negotiations.

Travel expense for pitching new contracts

Expense

Not incremental, costs are incurred regardless if the new contract was obtained.

Salaries of sales reps working on landing new contracts

Expense

Not incremental, salary expenses are incurred regardless if the new contract was obtained.

Bonus on quarterly sales targets for new contracts

Capitalized

Incremental, bonuses are only paid on new contracts that were signed.

Commissions paid to sales managers managing sales reps for new contracts

Capitalized

Incremental, commissions are only paid on new contracts that were signed.

About Neal Sheth, Audit Senior Manager

Neal brings over 16 years of private industry and public accounting experience to his client engagements. Neal provides audit and assurance services to privately held business across several industry sectors including the technology, manufacturing, retail, distribution, professional services firms, management services organizations, and life sciences and healthcare. Neal is a member of the firm's Mergers and Acquisition practice and performs quality of earnings analysis and other financial due diligence projects for buy-side and sell-side transactions. Contact Neal Sheth to learn more about ASC 606 and contract costs.

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