

Contract Costs, Disclosures, and Tax Considerations in ASC 606

Wrapping up the ASC 606 series, this course covers contract costs, presentation rules, and the disclosure requirements that come with the standard. It also addresses transition guidance and effective dates, so you understand how organizations moved to the new standard. Critically, it explores the concept of applicable financial statements and how the Tax Cuts and Jobs Act intersects with ASC 606—making it especially relevant for tax professionals navigating the relationship between financial reporting and tax compliance.

CREDIT HOURS 2 | FIELD OF STUDY ACCOUNTING | EXAM QUESTIONS 10

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LEARNING ASSIGNMENTS AND OBJECTIVES

Assignment

- Study the full course materials included here.
- Complete the review questions after each chapter.
- Answer 10 final exam questions.
- Final exam is scored immediately, 70% or better passes.
- Certificate of completion is available in your account.
- Failed exams can be retaken free of charge.

Course Objectives

- Recall how certain contract costs are accounted for under the revenue standard.
- Recognize certain disclosures required by the revenue standard for nonpublic entities.
- Recall an applicable financial statement (AFS).

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Section 8

Chapter Objective

After completing this assignment, you should be able to:

- Recall how certain contract costs are accounted for under the revenue standard.
- Recognize certain disclosures required by the revenue standard for nonpublic entities.
- Recall an applicable financial statement (AFS).

VIII. CONTRACT COSTS

In most instances, entities must incur costs to obtain a contract with a customer. Some, but not all, of those costs would not otherwise have been incurred had it not been for seeking and obtaining the contract.

ASC 606 offers guidance on how an entity should account for the costs to obtain and fulfill a contract. In certain instances, such costs are expensed as period costs while in others, the costs must be capitalized and amortized over the period that the related goods and services transfer to the customer.

ASU 2014-09 amends ASC 606 and adds a new subtopic, ASC 340-40, Other Assets and Deferred Costs: *Contracts with Customers*, which deals with the capitalization as assets of costs incurred to obtain or fulfill a contract with a customer. ASC 340-40 specifically addresses certain situations in which an asset is required to reflect those costs.

There are two categories of costs that are addressed in ASC 340 that might be capitalized in certain cases:

- Incremental costs to obtain a contract
- Costs to fulfill a contract

Here are the general rules for accounting for costs to obtain a contract found in ASC 606 and ASC 340-40.

1. Incremental costs of obtaining a contract

- a) 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. Examples of such incremental costs include:
 - Sales commissions and fringe benefits related to obtaining the original contract

- Sales commissions and fringe benefits related to obtaining contract₁₀ renewals
- b) 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.
- c) Practical expedient: An entity may recognize the incremental 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.

2. Costs not considered incremental costs to obtain a contract

- a) Costs to obtain a contract that would have been incurred regardless of whether the contract was obtained are not incremental costs and shall be recognized as an expense when incurred, unless those costs are explicitly chargeable to the customer regardless of whether the contract is obtained.
 - 1) Examples of costs that are not incremental costs include the following because they would be incurred regardless of whether the deal is ultimately completed and the contract executed. Such costs are expensed:
 - Selling and marketing costs
 - Bid and proposal costs in pursuit of the contract
 - Legal costs incurred to review a transaction and create and submit a proposal for a contract
 - Fixed salaries and wages for employees

3. Costs to fulfill a contract

- a) Costs to fulfill the obligations under a contract once it is obtained, but before transferring goods or services to the customer are considered costs to fulfill a contract.
- b) An entity shall recognize an asset from the costs incurred to fulfill a contract only if those costs meet all of the following criteria:
 - 1) The costs relate directly to a contract or to an anticipated contract that the entity can specifically identify.

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.
 - 2) 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) Costs that relate directly to a contract (or a specific anticipated contract) include any of the following:
 - 1) Direct labor (such as salaries and wages of employees who provide the promised services directly to the customer)

- 2) Direct materials (consisting of supplies used in providing the promised services to a customer)
- 3) Allocations of costs that relate directly to the contract or to contract activities such as:
 - Costs of contract management and supervision
 - Insurance, and
 - Depreciation of tools and equipment used in fulfilling the contract.
- 4) Costs that are explicitly chargeable to the customer under the contract
- 5) Other costs that are incurred only because an entity entered into the contract (for example, payments to subcontractors)

Note

If costs incurred in fulfilling a contract with a customer are covered within the scope of another ASC topic, an entity should account for those costs under that other topic and not under the guidance of ASC 606 and 340-40.

Observation

ASC 340 provides an opportunity for abuse with respect to the capitalization of costs to fulfill a contract. An entity is permitted to allocate costs that relate directly to the contract, such as costs of contract management and supervision. This allocation appears arbitrary and might motivate companies to over allocate certain overheads to costs to fulfill a contract in order to capitalize those costs as assets.

4. Other costs

- a) An entity shall recognize the following costs as expenses when incurred:
 - 1) General and administrative costs (unless those costs are explicitly chargeable to the customer under the contract, and capitalized as costs to fulfill the contract);
 - 2) Costs of wasted materials, labor, or other resources to fulfill the contract that were not reflected in the price of the contract;
 - 3) Costs that relate to satisfied performance obligations (or partially satisfied performance obligations) in the contract (that is, costs that relate to past performance); and
 - 4) 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).

5. Subsequent measurement of capitalized costs

- a) There are two categories of costs that are capitalized as assets in ASC 340:
- Incremental costs to obtain a contract
 - Costs to fulfill a contract
- b) An asset recognized due to the capitalization of incremental costs of obtaining a contract, or costs to fulfill a contract, shall 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. Examples of amortization periods include the following:
- Contract term¹¹
 - Average customer life

Note

The FASB stated that the amortization period could be longer than the initial contract term if the costs also relate to an anticipated future contract or renewal. That is, the amortization period could include the initial contract term plus options to renew. However, amortizing the asset over a longer period than the initial contract (e.g., to include option renewal periods) would not be appropriate in situations in which an entity pays a commission on a contract renewal that is commensurate with the commission paid on the initial contract¹².

- c) An entity shall update the amortization to reflect a significant change in the entity's expected timing of transfer to the customer of the goods or services to which the asset relates. Such a change shall be accounted for as a change in accounting estimate in accordance with ASC 250-10, *Accounting Changes and Error Corrections*.
- d) An entity shall recognize an impairment loss in its income statement to the extent that the carrying amount of an asset capitalized exceeds:
- 1) The remaining amount of consideration that the entity expects to receive in exchange for the goods or services to which the asset relates, less the costs that relate directly to providing those goods or services and that have not been recognized as expenses.

Note

An entity shall not recognize a *reversal* of an impairment loss previously recognized.

6. Disclosures of capitalized contract costs

- a) Per ASC 340-40-50-2 and 50-3, *Other Assets and Deferred Costs*, the following disclosures are required for costs capitalized related to contracts with customers.

- 1) The judgments made in determining the amount of costs to obtain or fulfilling a contract with a customer;
- 2) The method it used to determine the amortization for each reporting period;
- 3) The closing balances of assets recognized from the costs incurred to obtain or fulfill a contract with a customer, by main category of asset (such as costs to obtain contracts with customers, precontract costs, and setup costs); and
- 4) The amount of any amortization costs and impairment losses recognized in the reporting period.

Examples:

Following examples are extracted from ASC 606, as modified by the Author.

Example 1: Incremental Costs of Obtaining a Contract

An entity, a provider of consulting services, wins a competitive bid to provide consulting services to a new customer. The entity incurred the following costs to obtain the contract:

External legal fees for due diligence	\$15,000
Travel costs to deliver proposal	25,000
Commissions to sales employees	<u>10,000</u>
	<u>\$50,000</u>

The entity also pays discretionary annual bonuses to sales supervisors based on annual sales targets, overall profitability of the entity, and individual performance evaluations.

Conclusion:

The entity recognizes an asset for the \$10,000 incremental costs of obtaining the contract arising from the commissions to sales employees because the entity expects to recover those costs through future fees for the consulting services. Once capitalized, the \$10,000 should be amortized in a systematic and rational manner that is consistent with the way in which the underlying revenue is recognized.

The external legal fees (\$15,000) and travel costs (\$25,000) would have been incurred regardless of whether the contract was obtained. The fact that they relate to the transaction and original proposal and due diligence is not relevant because they would have been incurred if the entity had not won the contract. Therefore, the external legal fees and travel costs are recognized as expenses when incurred.

The entity does not recognize an asset for the bonuses paid to sales supervisors because the bonuses are not incremental to obtaining a contract. The amounts are discretionary and are based on other

factors, including the profitability of the entity and the individuals' performance. The bonuses are not directly attributable to identifiable contracts.

Example 2: Costs That Give Rise to an Asset

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 beyond the initial five-year period.

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.

The initial costs incurred to set up the technology platform, which will continue to be owned by the entity, are as follows:

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

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.

Conclusion:

The entity recognizes an asset for the \$10,000 incremental costs of obtaining the contract for the sales commission because the entity expects to recover those costs through future fees for the services to be provided.

The entity amortizes the \$10,000 asset over seven years because the asset relates to the services transferred to the customer during the contract term of five years and the entity anticipates that the contract will be renewed for two subsequent one-year periods.

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:

1. Hardware costs: \$120,000: Should be capitalized, depreciated, and accounted for in accordance with ASC 360, *Property, Plant, and Equipment*.