No. 2016-51
8 November 2016

To the Point

FASB TRG reaches general agreement on four more revenue recognition issues

Members of the FASB TRG reached general agreement on all four issues they discussed at their last scheduled meeting.

What you need to know

- Members of the FASB TRG reached general agreement on implementation issues involving capitalization and amortization of incremental costs of obtaining a contract, payments to customers, over time revenue recognition and sales- or usage-based royalties that contain minimum guarantees.
- While this is the last scheduled FASB TRG meeting, FASB Vice Chairman James Kroeker said entities can continue to send the FASB questions about implementation, and more TRG meetings could be scheduled if enough broad questions are received.

Overview

The Financial Accounting Standards Board (FASB) Transition Resource Group for Revenue Recognition (TRG) reached general agreement on four implementation issues stakeholders have raised about the new revenue recognition standards[1] the FASB and the International Accounting Standards Board developed jointly. The issues involve capitalization and amortization of incremental costs of obtaining a contract, payments to customers, over time revenue recognition and sales- or usage-based royalties that contain minimum guarantees.

While TRG members' views are non-authoritative, entities should consider them as they implement the new standards. Wesley Bricker, Interim Chief Accountant of the Securities and Exchange Commission (SEC), has encouraged entities to consult with his office if they are considering applying the guidance in a manner that is different from what TRG members generally agreed on.[2]

Building a better working world

While this is the last scheduled FASB TRG meeting, FASB Vice Chairman James Kroeker said entities can continue to send the FASB questions about implementation, and more meetings could be scheduled in 2017 if enough broad questions are received. The FASB staff noted it has received questions from entities about the standard's disclosure requirements. The FASB staff indicated that entities should keep the overall disclosure objective in mind as they plan their disclosures. That is, while entities should use judgment when determining how to provide certain disclosures, the disclosures should enable users of the financial statements to understand the nature, timing and uncertainty of revenue and cash flows arising from contracts with customers.

Mr. Kroeker said the FASB also plans to host a workshop on the accounting for up-front efforts related to preproduction activities, such as tooling in the automotive industry and non-recurring engineering costs in the aerospace and defense industry.

Incremental costs of obtaining a contract

Under Accounting Standards Codification (ASC) 340-40, *Other Assets and Deferred Costs — Contracts With Customers*, incremental costs of obtaining a contract (e.g., sales commissions) will be recognized as an asset if the entity expects to recover them.

An entity will need to apply judgment to determine the amortization period for an asset recognized for the incremental costs of obtaining a contract.

FASB TRG members generally agreed that commissions paid to all employees, regardless of how directly involved they were in obtaining a contract, would be considered incremental costs if they wouldn't have been incurred if the contract had not been obtained. This would include commissions based on achieving a certain threshold of new contracts. However, if obtaining the contract was one of several factors used to determine a discretionary bonus payment to an employee, the bonus would not be considered an incremental cost of obtaining a contract.

ASC 340-40 requires that any capitalized incremental costs 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. In doing this, an entity must determine whether the capitalized 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. FASB TRG members generally agreed that the commissions would have to be reasonably proportional to the contract values (e.g., 5% of both the initial and renewal contract values) to be considered commensurate. FASB TRG members also generally agreed that it would not be reasonable for an entity to conclude, for example, that a 6% commission on an initial contract and a 2% commission on a renewal were commensurate, based on an analysis of the level of effort required to obtain the contracts.

FASB TRG members generally agreed that an entity will need to evaluate its facts and circumstances 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 term 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), FASB TRG members generally agreed that this approach is not required and that entities should not default to it. FASB TRG members said entities would use similar judgment to what they do today 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.

How we see it

Entities that expense commissions under legacy GAAP will have to record an asset for payments they expect to recover, and entities that capitalize commissions under legacy GAAP will have to capitalize all incremental costs of obtaining a contract, regardless of whether the employee is directly involved in obtaining the contract.

In addition, an entity that pays smaller commissions to employees for annual renewals than for initial one-year contracts is likely to amortize the initial contract's capitalized costs over a period of longer than one year. As a result, the entity would not qualify for the practical expedient that allows expensing of costs to obtain a contract if a capitalized asset otherwise would have been amortized over a period of one year or less.

Payments to customers

ASC 606 requires entities to record payments to customers in cash or in the form of coupons, credits or vouchers as reductions of revenue, unless the payment is in exchange for a distinct good or service. While the guidance clearly applies to payments to customers under current contracts, stakeholders have raised questions about how to account for up-front payments to potential customers and payments that relate to both current and anticipated contracts.

FASB TRG members discussed two approaches. Under View A, an entity would recognize an asset for the up-front payment and reduce revenue as the related goods or services (or as the expected related goods or services) are transferred to the customer. As a result, the payment could be recognized in the income statement over a longer period than the contract term. Entities would determine the amortization period based on facts and circumstances and would assess the asset for recoverability using the principles in other asset impairment models in US GAAP. Under View B, entities would reduce revenue from the current contract by the amount of the payment. If there is no current contract, entities would recognize a payment immediately in the income statement.

FASB TRG members generally agreed that the determination is not an accounting policy election and that entities will need to use the approach that best reflects the substance and economics of the payment to the customer. Entities would evaluate the nature of the payment, the rights and obligations under the contract and whether the payment meets the definition of an asset. Some FASB TRG members noted that this evaluation was consistent with today's accounting for payments to customers and therefore similar conclusions may be reached under ASC 606. FASB TRG members also said an entity's decision on which approach is appropriate may be a significant judgment in the determination of the transaction price that would require disclosure under ASC 606.

Over time revenue recognition

FASB TRG members generally agreed that an entity that recognizes revenue at a point in time under legacy guidance will need to analyze each of its contracts to determine whether it will be required to recognize revenue over time under the new standard. An example would be a contract manufacturer that produces goods designed to a customer's unique specifications and can reasonably conclude that the goods do not have an alternative use. If the manufacturer also has an enforceable right to payment for performance completed to date, it would meet the standard's third criterion to recognize revenue over time, even though it might recognize revenue at a point in time under legacy GAAP (e.g., based on a units-produced or units-delivered method).

FASB TRG members generally agreed that when an entity evaluates whether its performance creates an asset with no alternative use, it should consider whether it could sell the *completed* asset to another customer without incurring a significant economic loss (i.e., whether it could sell the raw materials or work-in-process to another customer is not relevant).

FASB TRG members also discussed some questions that have been raised in practice related to the determination of whether an entity has an enforceable right to payment for performance completed to date. FASB TRG members generally agreed that entities will need to evaluate the contractual provisions and determine whether the right to payment compensates the entity for performance completed to date. For example, the FASB TRG noted an entity may not always have an enforceable right to payment at contract inception, such as when an entity is producing standard goods that may be customized for a customer towards the end of the production process. FASB TRG members generally agreed that an entity should consider whether it has an enforceable right to payment related to its performance completed to date. If the entity's performance obligation is to customize its standard goods for a customer, FASB TRG members generally agreed that an entity would evaluate whether it has an enforceable right to payment at the point that the entity begins to satisfy the performance obligation to customize the goods for the customer.

Minimum guarantees of sales- or usage-based royalties

FASB TRG members generally agreed that a minimum guaranteed amount of sales- or usage-based royalties in a license of functional intellectual property (IP) should be recognized as revenue at the point in time the entity transfers control of the license to the customer, like other revenue for this type of IP license. Any royalties above the fixed minimum would be recognized in accordance with the royalty recognition constraint (i.e., at the later of when the sale or usage occurs or when the entity satisfies the performance obligation to which some or all of the royalty has been allocated).

However, FASB TRG members generally agreed that various recognition approaches could be acceptable for minimum guarantees in licenses of symbolic IP, which require revenue to be recognized over time. The TRG agenda paper describes two approaches. Under one, an entity would estimate the total consideration (i.e., the fixed minimum and the variable consideration from future royalties) and apply an appropriate measure of progress to recognize revenue as the entity satisfies the performance obligation, subject to the royalty recognition constraint. Alternatively, an entity could apply a measure of progress to the fixed consideration and begin recognizing the variable component when the fixed amount is exceeded on a cumulative basis. An entity should disclose the accounting policy it selects because this would likely affect the amount and timing of revenue recognized.

Endnotes:

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[1] ASC 606, *Revenue from Contracts with Customers* (created by Accounting Standards Update 2014-09), and IFRS 15 *Revenue from Contracts with Customers*.

[2] Speech by Wesley R. Bricker, 5 May 2016. Refer to SEC website at https://www.sec.gov/news/speech/speech-bricker-05-05-16.html.