Working Draft:
Telecommunications Revenue Recognition Implementation Issue

Issue #15-4– Accounting for Contract Costs

Expected Overall Level of Impact to Industry Accounting:
Significant

Wording to be Included in the Revenue Recognition Guide:

Costs to obtain and costs to fulfill a contract that are eligible for deferral

Incremental costs to obtaining a contract

1. Under FASB ASC 606, entities should identify incremental costs for all activities associated with contract acquisition that fall under ASC 340-40 to assess whether they need to be deferred. Historically, some entities only deferred such costs up to the amount of any activation fees charged to customers. Under this historical approach, both the revenue and any deferred direct and incremental contract acquisition activities were recognized over a period not to exceed the expected customer relationship period.

2. Under FASB ASC 606, in order for contract acquisition costs to be deferred they must be incremental (e.g., costs that would not have been incurred had it not been for acquiring a specific contract) and recoverable. The following paragraphs include examples of costs to consider for new contracts, contract renewals and contract modifications in accordance with the guidance of FASB ASC 340-40-25-1 to 25-4.

Commissions (and bonuses) to internal sales agents and third-party dealers

3. Commissions paid for connecting new customers can vary depending on the length of the service contract and the type of service plan, including any enhanced services sold. Generally, the longer the service contract and the greater the monthly proceeds (e.g., service plans with relatively high or unlimited minutes of use), the greater the commission paid. Commissions must be incremental costs to acquiring contracts in order to be deferred; therefore fixed salary amounts would not be deferred as contract acquisition costs because such costs will be incurred whether or not contracts are acquired. In instances where there are commissions paid over the term of a customer contract (e.g., commissions, or retention costs, payable after the customer has maintained service for six months), entities should consider whether such costs qualify for deferral as acquisition costs in accordance with FASB ASC 340-40-25. If the entity determines such a commission should be accrued at the inception of the customer

relationship (in accordance with FASB ASC 450), then the entity should then apply the guidance in FASB ASC 340-40 to determine whether the amount should be capitalized or expensed. There could also be instances where an entity incurs incremental costs related to the modification of a contract and the entity will need to assess whether the costs meet the criteria for deferral under FASB ASC 340-40 at that time, which could depend on if the retention costs relate to past or future performance.

4. FinREC believes that customer-facing sales agents generally are the appropriate personnel level to consider for deferral of commission costs. While it may also be appropriate to consider a portion of managers' commissions (and bonuses) for deferral, it could be challenging to identify the portion that is associated with obtaining a contract, given that management compensation structures often have multiple components, many of which are not directly attributable to identifiable contracts. However, if such manager compensation structures (or individual components thereof) are identifiable as being directly attributable to customer contracts, an entity would need to defer such costs if they meet the other criteria in FASB ASC 340-40-25.

5. If entities sell devices to their third party dealers, entities should ascertain if any payments to their dealers represent device subsidies as opposed to commissions. Consideration paid to a customer (e.g., third party dealers) is further discussed in Issue #15-11, Indirect Sales Channels.

6. Entities should also consider the impact of commission claw back provisions (for sales agents and third-party dealers), as well as whether amounts paid are to cover efforts beyond contract acquisition activities, and should assess the facts and circumstances in order to apply the guidance of FASB ASC 340-40-25. Tiered commission structures (e.g., amounts earned based on quantitative metrics over a period of time) should also be analyzed, as judgment may be required to identify the amount that is incremental to obtaining each underlying contract, for deferral purposes. There could be accounting ramifications related to these concepts that entities will need to consider.

7. Bonuses and other compensation based on quantitative or qualitative metrics other than the expected consideration (total transaction price) (e.g., profitability, earnings per share (EPS), performance evaluations) may not meet the criteria for deferral under FASB ASC 340-40-25 as they likely are not related directly to a specific contract's acquisition.

8. For further consideration regarding potential implementation issues related to commission arrangements, entities are encouraged to refer to the FASB-IASB Joint Transition Resource Group for Revenue Recognition (TRG) Agenda Item from the January 26, 2015 meeting.[1]

Handset subsidies

9. Some wireless entities provide free or heavily discounted handsets to attract customers to sign a service contract. The discount is not considered a cost of the contract, but instead impacts the total amount of contract consideration. The associated cost of the handset is also not a deferrable cost under the guidance of FASB ASC 340-40-25, as handsets generally are treated as inventory under FASB ASC 330 and are accounted for as separate performance obligations and recorded as cost of goods sold when control transfers to the customer. This is also further discussed in Issue #15-11, Indirect Sales Channels.

Gift cards and debit cards

10. Debit cards are generally considered as consideration paid to the customer and accounted for as a reduction of revenue. Gift cards generally constitute a separate performance obligation given to a customer (e.g., generally third party retail gift cards). Therefore gift card costs would not be considered contract acquisition costs if they do not meet the criteria for deferral under FASB ASC 340-40-25. Also refer to the implementation issue related to identification of performance obligations.

[1] Refer to paragraphs 13-15 of Ref#25, "January 2015 Meeting – Summary of Issues Discussed and Next Steps." The TRG discussed the recognition of incremental costs of obtaining a contract (for example, sales commissions) and determining the amortization period. The TRG discussion focused broadly on the high-level principles for applying the guidance.

General and administrative costs

11. As discussed in FASB ASC 340-40-25-8(a), general and administrative costs are expensed as incurred unless they are explicitly charged to the contract in which case the entity would apply ASC 340-40-25-7.

Costs to Fulfill a Contract

12. Costs to fulfill contracts may be recorded as an asset under the scope of other standards (e.g., inventory, fixed assets, or intangible assets) or if they meet specific requirements under FASB ASC 340-40-25. Entities must first determine whether the accounting for costs is addressed by other standards and if so, apply that guidance. Costs that are required to be expensed in accordance with other standards (e.g., inventory shrinkage) cannot be recognized as an asset under FASB ASC 340-40-25. Fulfillment costs not addressed by other standards qualify for deferral if certain criteria are met. Entities should consider their existing cost deferral policies to understand the potential effect upon implementation of these changes, as well as determine their procedures for ongoing assessment of the guidance in evaluating which related costs are expensed or deferred.

Services provided by internal employees and third-party subcontractors for connecting new customers to their networks

13. Services provided to connect a customer to the network are often considered by telecommunications entities to be directly related to the fulfillment of a contract and would, therefore, qualify for deferral (assuming the costs are not within the scope of FASB ASC 360 or other accounting literature). FinREC believes costs for both internal employees and third-party subcontractors would generally result in the same conclusion as it relates to deferral for fulfillment since the nature of the work is the same whether sourced internally or externally.

14. Internal employees who provide fulfillment services can be hourly or salaried employees. When costs meet the criteria of FASB ASC 340-40-25, entities will need to determine an appropriate allocation of direct costs for purposes of deferral (e.g., time studies). Many telecommunications entities historically have performed time studies for a limited number of the applicable activities, but such entities may need to consider expanding those studies to include activities in other areas or segments of the business where costs to fulfill a contract should be evaluated. When third party contractors are utilized and details of services provided are not available, entities may need to ascertain what proportion of amounts paid to these third parties represents deferrable fulfillment activities vs. other services. Entities may need to allocate such costs when amounts are paid for a combination of both acquisition and fulfillment costs.

<u>Amortization period of deferred contract costs</u>

Subsequent Measurement - Amortization

15. The costs that have been deferred in accordance with FASB ASC 340-40-25 should be amortized consistent with the pattern of when goods or services to which the asset relates are transferred to the customer. Entities should use judgment to determine the amortization period as FASB ASC 606 requires entities to consider periods beyond the initial contract period such as renewal periods or periods related to anticipated contracts, as well as how month-to-month service arrangements impact the determination of the amortization period. The guidance also provides a practical expedient that allows contract acquisition costs to be recognized immediately if the deferral period (including expected renewals) is less than one year. Additionally, based on specific facts and circumstances, entities may be able to adopt an approach to track and amortize deferred costs utilizing a portfolio approach instead of specific asset identification. Both approaches appear to be acceptable under the guidance, as it states that entities can elect, as a practical expedient, to apply a portfolio approach to assessing contracts (or performance obligations) with similar characteristics if the entity reasonably expects that the effects on the financial statements of applying the guidance to the portfolio would not differ materially from applying the guidance to the individual contracts (or performance obligations) within that portfolio. As indicated in FASB ASC 606-10-10-4, when accounting for a portfolio an entity shall use estimates and assumptions that reflect the size and composition of the portfolio. Accounting for a portfolio is further discussed in Issue #15-1, Portfolio Accounting.

16. In determining the amortization period, entities should give consideration to all factors that might reasonably impact the period of benefit, including the contractual life, customer life, class of customer, and customer turnover (or churn) rates. Further, entities should consider whether they are evaluating acquisition costs or fulfillment costs as the amortizable lives may not always be the same.

17. The amortization period could be longer than the contract term in some circumstances. For example, a contract may include a renewal option that is anticipated to be exercised. In such situations, the asset recognized for contract costs might relate to the transfer of goods or services under both the initial contract and renewal periods, and therefore should be amortized over both the initial and expected renewal periods. Entities should also consider if the amortization period should be limited to the initial contract term if the entity also pays a commensurate cost for contract renewals. In that situation, the costs incurred to acquire the initial contract may not relate to the subsequent contract renewal.

18. FASB ASC 340-40-35-1 requires that the amortization pattern should be consistent with the pattern of revenue recognition. Therefore straight line amortization may not always be appropriate. Entities should exercise judgment when selecting an alternative systematic basis of amortization in line with the pattern of revenue recognition, for instance in situations where revenue is front loaded (e.g., bundled service plans). Additionally, entities should consider if there could be a different approach to the amortization of acquisition vs. fulfillment costs.

19. FASB ASC 340-40-35-2 requires that "an entity should update the amortization of a deferred cost asset if there is a significant change in the expected pattern of transfer of the goods or services to which the asset relates". FASB ASC 250-10 requires such a change to be accounted for as a change in accounting estimate. Such change could be indicative of impairment of the related assets, and entities should evaluate the facts and circumstances to determine the appropriate conclusions.

Evaluation of impairment for deferred costs

Subsequent Measurement - Impairment

20. An impairment loss is recognized to the extent that the carrying amount of an asset exceeds: (a) the amount of consideration to which an entity expects to be entitled in exchange for the goods or services to which the asset relates; less (b) the remaining costs that relate directly to providing those goods or services. Entities are not permitted to reverse impairment charges under U.S. GAAP.

21. Based on specific facts and circumstances, entities may adopt an approach to track and assess deferred costs for impairment by specifically identifying assets or utilizing a portfolio approach. As discussed above, both approaches are acceptable under the guidance.

22. Entities may develop a systematic approach to recognize an asset for contract acquisition and fulfillment costs and test such assets for impairment. FASB ASC 606-10-10-4 allows for a practical expedient to apply the guidance to a portfolio of contracts (or performance obligations) with similar characteristics if the entity reasonably expects that the effects on the financial statements of applying to the portfolio would not differ materially from applying to the individual contracts (or performance obligations). Judgment will be needed to determine whether the practical expedient in FASB ASC 606-10-10-4 could be applied when testing for impairment. The use of a portfolio approach is further discussed in Issue #15-1, Portfolio Accounting.

23. FASB ASC 340-40-35 states that an impairment would exist when the carrying amount of the deferred cost asset exceeds 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. However, before an entity recognizes an impairment loss for an asset recognized in accordance with the guidance, the entity shall recognize any impairment loss for assets related to the contract that are recognized in accordance with other applicable guidance (e.g., inventory; costs of software to be sold, leased, or otherwise marketed; property, plant, and equipment; and goodwill and other intangibles).

24. As entities may utilize customer turnover (or churn) rates in their continual assessment of deferred costs to acquire or fulfill a customer contract, FinREC believes they should also consider if variances in such rates may be indicative of potential impairment of the related deferred costs.

25. Entities should also consider if there are different approaches to apply to different classes of customer (e.g., post-pay under contract, month to month post-pay, prepay, etc.), as well as acquisition vs. fulfillment costs when evaluating impairment of deferred costs. Entities may determine that different characteristics of contracts or the related deferred costs are indicative of different amounts or timing of cash flows to be considered for impairment assessment.

26. Any asset recorded by an entity is subject to an assessment of impairment at the end of each reporting period. This is because deferred costs that give rise to an asset must continue to be recoverable throughout the arrangement. Such assets should also be assessed upon circumstances that give rise to a triggering event indicative of impairment.

APPENDIX - EXAMPLES:

27. The following examples are meant to be illustrative, and the determination of the accounting treatment should be based on the facts and circumstances of an entity's specific situation.

28. *Example: Contract acquisition costs, identifying incremental costs* - Telecom sells wireless mobile phone and other telecom service plans from its corporate retail store. Sales agents employed at the store signed 120 customers to two-year service contracts in a particular month. Telecom pays its sales agents' commissions for the sale of service contracts in addition to their salaries. Salaries paid to sales agents during the month were $12,000, and commissions paid were $2,400 ($20 per contract). The retail store also incurred $2,000 in advertising costs during the month. How should Telecom account for the costs?

    The only costs that the telecom entity determined qualify as incremental costs of obtaining a contract under ASC 340-40-25 are the commissions paid to the sales agents. The commissions are costs to obtain a contract that Telecom would not have incurred if it had not obtained the contracts. Telecom should record an asset only for those costs, assuming they are recoverable. The sales agents' salaries and the advertising expenses are expenses Telecom would have incurred whether or not it obtained the customer contracts and are therefore expensed as incurred. The entity may elect to record 120 individual assets of $20 per contract or could utilize a portfolio approach and record one asset for $2,400 that will be monitored at the portfolio level.

29. *Example: Contract acquisition costs* - A telecommunications entity enters into a contract with a customer to provide telecom services. The entity pays a third-party dealer a commission to connect customers to its network. The customer signs an enforceable contract to receive telecom services for one year. Analyses performed demonstrate that customers usually renew their contracts and stay committed for 18 months on average. Dealers are not paid an additional commission upon customer renewal. How should the telecommunications entity account for the third-party dealer commission?

    The entity will identify incremental contract acquisition costs eligible for deferral under ASC 340-40-25 and defer those costs that are recoverable. The entity determines the amortization period is 18 months in this case after considering expected renewals. The telecommunications entity cannot use the practical expedient and expense these costs when incurred. Also refer to Issue #15-11, Indirect Sales Channels, for additional considerations.

30. *Example: Contract acquisition costs, amortization period for prepaid services* - A telecommunications entity sells wireless services to a customer under a prepaid, unlimited monthly plan. The telecommunications entity pays commissions to sales agents when they activate a customer on a prepaid wireless service plan. While the stated contract term is one month, the telecommunications entity expects the customer, based on the customer's demographics (for example, geography, type of plan, and age), to renew for six additional months. What period should the telecommunications entity use to amortize the contract acquisition costs (that is, the commission costs)?

The entity could use the practical expedient to expense the costs as incurred because the period over which the costs would have otherwise been amortized is less than one year. If the entity chooses to defer the costs, it will use judgment to determine an amortization period that represents the period during which the entity transfers the telecom services. In this example, the entity determines an amortization period of seven months based on anticipated renewals.

If the fact pattern included an expected renewal period of sixteen additional months, the entity would not be able to utilize the practical expedient and would amortize the asset over that period. Consideration would also need to be given to the pattern of consumption in order to select the most appropriate amortization method.

31. *Example: Change to the amortization period* - Entity A enters into a three-year contract with a customer for telecommunication services. To fulfil the contract, Entity A incurred set-up costs of $60,000, which it deferred and will amortize over the term of the contract as renewals were not expected. At the beginning of the third year, the customer renews the contract for an additional two years.

    Entity A will benefit from the set-up costs during the additional two-year period. Therefore, it changes the remaining amortization period from one to three years and adjusts the amortization expense recognized prospectively in accordance with the guidance for changes in accounting estimates. However, if Entity A had anticipated the contract renewal at contract inception, Entity A would have amortized the entire set-up cost over the anticipated term of the contract including the expected renewal (e.g., five years).

32. *Example: Impairment of contract cost assets* - Telco enters into a two-year contract with a customer to manage telecommunications services in exchange for consideration of $1,000,000. Telco incurs incremental costs to obtain the contract and costs to fulfill the contract that are recognized as assets and amortized over the expected period of benefit. The economy subsequently deteriorates and the parties agree to renegotiate the pricing in the contract, resulting in a modification of the contract terms. The remaining amount of consideration to which Telco expects to be entitled is $650,000. The carrying value of the assets recognized for contract costs is $600,000. There is also an expected cost of $150,000 that would be required in relation to the contract. How should Telco account for the assets after the contract modification?

    Telco should recognize an impairment loss of $100,000. The carrying amount of the asset recognized for contract asset ($600,000) exceeds the remaining amount of consideration to which the entity expects to be entitled less the costs that relate directly to providing the services in the contract ($650,000 less $150,000). Therefore, an impairment loss of that amount is recognized. This conclusion assumes that the entity previously recognized any necessary impairment loss for inventory or other assets related to the contract prior to recognizing an impairment loss under ASC 606. Impairment of other assets could impact the remaining costs required to complete the services in the contract.

Comments should be received by October 1, 2016, and sent by electronic mail to Desiré Carroll at dcarroll@aicpa.org, or you can send them by mail to Desiré Carroll, Accounting Standards, AICPA, 1211 Avenue of the Americas, NY 10036.