CHANGES TO SALES COMMISSION ACCOUNTING UNDER ASC 606

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The winds of change have been gathering in financial accounting since the FASB and the IASB issued a converged standard on revenue recognition in May 2014. ASC Topic 606 is the codification of several Accounting Standards Updates (ASUs), starting with ASU 2014-09, Revenue from Contracts with Customers.

Public entities are to apply ASC 606 to their revenue recognition accounting for the first annual reporting period beginning after December 15, 2017 — including interim reporting periods within that annual reporting period.

This means that any public entity whose first 2018 fiscal quarter ends after March 15 will have to report Q1 financials that are ASC 606-compliant. If your organization is in the public entity category , time is getting short to prepare for these changes.

Nonpublic entities have an additional year to apply ASC 606.

Coverage and discussion of ASC 606 has properly focused on the major changes to revenue recognition, such as accounting for the distinct performance obligations under the contract, allocating the transaction price to these performance obligations, the timing of recognizing revenue, and expanded disclosure requirements. For a quick tour of the highlights of ASC 606, please see our post.

The new revenue guidance requires significant changes to expense recognition that include new rules for capitalizing and amortizing incremental costs to obtain a contract. These changes will affect all companies with sales commissions or other variable compensation incurred in obtaining a contract, as laid out in ASC Subtopic 340-40.

One of the most significant changes to the revenue guidance that will affect all companies with sales commissions are the rules for capitalizing and amortizing incremental costs to obtain a contract, including sales commissions, as laid out in ASC Subtopic 340-40.

Paragraph 606-10-15-5 of ASC 606 references ASC Subtopic 340-40 for guidance on accounting for:

1. the incremental costs of obtaining a contract with a customer
2. the costs incurred to fulfill a contract with a customer

The first item, incremental costs of obtaining a contract with a customer, is of great interest to Iconixx Software customers and everyone involved in sales compensation accounting, as sales commissions fall within its scope. This subject is the focus of the remainder of this post.

CHANGES TO ACCOUNTING FOR SALES COMMISSIONS

Subtopic 340-40 states that the "incremental costs of obtaining a contract with a customer" shall be recognized as an asset if the entity expects to recover those costs. By incremental costs, the FASB is referring to costs that occur only if the contract is obtained. Sales commissions are the most common example of a cost that is incurred only upon successfully obtaining a contract. Another example is a contingency legal agreement in which a lawyer agrees to receive payment only if settlement negotiations are successful.

Costs incurred during the sales process in an effort to win the contract, such as proposal preparation, occur regardless of whether the contract is won or lost. Such costs are accounted for as an expense.

Accountants will have to exercise judgment to determine whether some types of sales commissions are incremental costs—for example, managers' commissions or commissions based on reaching an overall sales level. Application for different types of commission programs is not explicitly addressed by the standard.

The need for judgment and interpretation is a major theme of the changes in accounting for the incremental costs of obtaining a customer contract. This will be apparent as you read through the information below. ASC 606 overall is a move from rule-based, complex standards to a set of principles-based standards which will require revenue accounting teams to make judgments on applying the principles.

AMORTIZING CAPITALIZED INCREMENTAL COSTS TO OBTAIN A CONTRACT

Any capitalized contract costs are amortized. The expense is recognized as an entity transfers the related goods or services to the customer, so that the timing of expenses matches the timing of revenue. In ASC 606 terminology, the asset is amortized as the performance obligations in the contract are fulfilled to the customer.

If the expected timing of fulfillment of performance obligations changes significantly, the amortization schedule should be updated.

The amortization period for the initial commission costs is not necessarily the same as the contract term. If the company anticipates that the customer will renew, the amortization period may be the "expected period of benefit," which may be longer than the initial contract term. However, this depends on whether additional commission is paid for subsequent renewals, which is covered in more detail below.

There will be some cases in which the amortization pattern will be uneven. For example, an entity enters into a contract with two performance obligations. The first performance obligation is satisfied at contract inception and represents 80% of the total allocable transaction price. The second is satisfied over the 2-year contract term and represents 20% of the transaction price. The capitalized commission cost should be allocated to each performance obligation in the same proportion as the transaction price allocation percentages.

After issuing new revenue recognition standards in mid-2014, the FASB and the IASB formed the Joint Transition Resource Group for Revenue Recognition (TRG). TRG members include financial statement preparers, auditors, and users representing a wide spectrum of industries, geographical locations and public and private companies and organizations. The TRG reviewed issues and published papers on their discussions. TRG comments are not authoritative, but they do provide the community with insight on applying ASC 606 and Subtopic 340-40.

Following are summaries of TRG commentary on some of the issues they considered:

Modification to contract to purchase additional goods.

As an example, based on company policy, the salesperson is paid an additional commission due to the increase in the contract price from a contract modification. Even though the modification is not accounted for as a separate contract, the increase in the contract price results in an incremental commission cost to the company. The TRG concluded that the additional commission paid is an incremental cost of obtaining a contract and should be capitalized.

Contract Renewals.

ASC 606 does not suggest a different treatment for contracts that are renewals of existing contracts. There is a difference in the timing of recognition. For example, if the sales commission for a new contract was $1000 and $200 for each renewal, the entity would capitalize $1000 at contract inception and amortize the $1000 over the initial contract term. Upon renewal, $200 would be capitalized.

The FASB added another consideration for renewals: It is appropriate to amortize the initial commission cost asset entirely within the initial contract term if the commission on the renewal is commensurate with the commission paid on the initial contract.

What if the renewal commission is not commensurate? For example, the commission rate on the initial contract is

6% and the rate for the renewal is 2%. In this instance, one could argue that the initial commission cost asset should be amortized over a longer period than the initial contract term. This is another area requiring judgment, as determining whether a renewal commission is commensurate with the initial commission will sometimes be more complex than simply comparing commission rates.

Commissions paid once a threshold is met.

For example, 0% is paid for the first $250,000 in contracts, 4% on the next $500,000 (from $250K to $750K), and 6% above $750,000. According to the TRG, when the contract taking the aggregate value over $250K is signed, 4% of the contract price of that and successive contracts should be capitalized until the $750K aggregate value is reached, when 6% of the contract price of that and successive contracts would be capitalized.

Commission paid in installments.

For example, one-fourth of the total commission is paid every 6 months but the payments cease if the customer fails to perform. The TRG said the total contract commission should be capitalized at contract inception. Then, if the customer fails to perform, any unamortized capitalized costs would be considered for impairment.

Bonuses.

A company pays discretionary annual bonuses to sales supervisors based on annual sales targets, overall profitability of the entity, and individual performance evaluations. The TRG concluded that an asset is not recognized for the bonuses because they are not solely incremental to obtaining identifiable contracts.

ASC 606 and Subtopic 340-40 include two practical expedients that might apply to accounting for commissions in some situations.

First, if the amortization period would be one year or less, the incremental costs may be recognized as an expense, i.e. not capitalized.

Second, ASC 606 provides a practical expedient for an entity to apply the new revenue recognition principles to a portfolio of contracts, if the contracts have similar characteristics and the entity reasonably expects that the effects on the financial statements of applying this guidance at a portfolio level would not differ materially from applying ASC 606 guidance to the individual contracts within that portfolio. The TRG indicated that the portfolio approach can be applied to accounting for incremental costs of obtaining a contract (Subtopic 340-40) as well as ASC 606 broadly. Specific facts and circumstances regarding a company and its contracts will determine whether the portfolio practical expedient is an available option.

An impairment loss needs to be recognized to the contract cost asset if the remaining amount of consideration the company expects to recognize as revenue in exchange for the goods and services, less the costs that relate directly to providing those goods and services (and have not been recognized as expense) is less than the carrying amount of capitalized costs to obtain the contract.

In late 2016, the FASB issued ASU 2016-20, which included additional guidance that said: When performing impairment tests of capitalized costs to obtain or fulfill a contract, an entity should consider expected contract renewals and extensions, and include both the amount of consideration it already has received but has not recognized as revenue and the amount it expects to receive in the future.

To enrich the information provided to financial statement users, ASC 606 requires disclosures regarding contract balances, performance obligations, contracts, and so forth. Subtopic 340 contains similar disclosure requirements regarding assets recognized from the incremental costs to obtain or fulfill a contract with a customer.

Companies must describe the judgments they made in determining the amount of the costs incurred to obtain or fulfill a customer contract. The method used to determine the amortization for each reporting period also must be described.

Closing balances for capitalized contract cost account balances are to be disclosed, as is the amount of amortization and any impairment losses recognized in the reporting period.

The FASB allows nonpublic entities to choose to provide reduced disclosures if they choose, mainly because the costs of providing the more extensive disclosures may outweigh the benefits.

The major changes coming to accounting for sales compensation add to the already lengthy list of compelling reasons for companies to employ robust sales compensation management (SCM) software such as Iconixx SalesTM.

Under ASC 606 and Subtopic 340-40, it is important to have timely, accurate, auditable compensation calculations, reportable and updatable, for each individual contract that has deferred revenue generated. Sales compensation management software provides accurate calculations of variable compensation and can (and should) calculate and report this compensation for each individual contract. These calculations may change over time with the existence of accelerators and other variables, and the system accurately maintains these calculations to allow contract-specific compensation to be recorded.

Further, the SCM system's reporting capabilities should support the accountant's need for auditable data for disclosure tables, impairment testing, and preparing amortization schedules. The level of detail available from an SCM database will help facilitate auditable accounting for costs of modified contracts.

Last, detailed compensation cost data can help greatly with determining the profitability of a contract, as well as forecasting financial statements.

Capabilities like these go far beyond what even the most skilled Excel pilot can accomplish with a spreadsheet.

Iconixx SalesTM has the ability to handle the most complex sales compensation structures, and the flexibility to adapt as interpretations and guidance for ASC 606 and Subtopic 340-40 continue to evolve.