Cost Capitalization of Commissions Under ASC 606

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ASC 606 changes the way companies must recognize revenue and commission expenses. Up to this point, the standard has largely been focused on revenue recognition. But as the dust settles on revenue, businesses are discovering that they have a mountain of work ahead of them on cost capitalization of commissions.

The basic premise on which both ASC 606 and IFRS 15 have been formulated is that a company now must capitalize the incremental costs of obtaining a contract, i.e., the sales commissions. This cost must be capitalized on your balance sheet and, generally, amortized over the estimated customer life.

Ultimately, it makes the simple process of expensing sales compensation more complex. As a result, organizations are having to change the way they think about commissions from an accounting and operations standpoint. Here are seven important aspects of ASC 606 as related to the world of cost capitalization.

1 CAPITALIZING COSTS

Subtopic ASC 340-40-25 of the new accounting standard prescribes how costs related to obtaining a contract should be capitalized. According to ASC 340, costs should be capitalized only if they are incremental to the acquisition of a new customer contract.

CATEGORIZING COSTS

TYPICAL CAPITALIZED COSTS
(Tied to the execution of a customer contract)

- Sales Commissions
- Related Payroll Taxes
- MBOs
- Direct Fringe Benefits

COSTS EXPENSED AS INCURRED
(Incurred regardless of whether a customer is acquired)

- Health Benefits
- Travel Expenses
- Legal Fees

Typical capitalized costs include commissions, SPIFFS, MBOs, related payroll taxes, and fringe benefits directly tied to the execution of a customer contract. Keep in mind, expenses like health benefits, travel expenses, or legal fees will be incurred regardless of whether or not the customer is acquired and should be expensed as incurred.

2 AMORTIZATION OF COMMISSIONS

Capitalized commissions are typically required to be amortized over the expected life of the customer, which should include all anticipated renewal periods. But how does management determine that?

Companies can usually rely on historical customer retention information. However, if your company has very high retention rates or not enough historical data to support a conclusion, you may want to look at an alternative metric, such as the expected life of the software or product sold.

If your company pays a non-trivial commission upon contract renewal, your renewal payout might be considered commensurate with the initial amount paid at the time of original acquisition. In this case, your company should amortize commissions over the contract term rather than expected life. However, it's important to remember when the renewal commission is paid, it is capitalized and amortized over the newly set contract term.

3 PRACTICAL EXPEDIENT CLAUSE

The new standard provides for a practical expedient that allows your company to expense incremental costs right away if the amortization period is one year or less. This option should be determined by your accounting team.

For example, imagine a company sells hardware with a one-year warranty. It has the option to expense the sales commission at the time of contract signature because the entire arrangement's revenue will be earned within 12 months. If this option is elected, make sure your policy is consistent, and ensure all contracts one year or shorter are expensed the same way.

4 AMORTIZATION SCHEDULE

Commission amortization is a two-step process: 1) capitalization, and 2) amortization, as described below:

CAPITALIZATION

Determine the commission cost for each "performance obligation" in the contract. If, for example, the contract includes software, support, and professional services as three distinct items committed to the customer, you should calculate how much commission is paid for each item separately. Use your judgement to determine this.

AMORTIZATION

For each performance obligation in the contract, recognize the allocated commission cost over the relative period of benefit. This may be as the related revenue is recognized or over the expected customer's life.

Note that the revenue related to each performance obligation will be unique as some are delivered over time and others are delivered at a point-in-time. This can result in different commission amortization timelines for each product sold.

5 IMPACTS TO EBITDA

The requirement of commission capitalization now means companies will be amortizing the commission expense over time, but usually paying the commission immediately. This amortization is an "EBITDA add back" (Earnings Before Interest, Taxes, Depreciation, and Amortization) and is a non-GAAP measure.

The specific amortization of the commission's expense is added back to EBITDA, thus, helping improve earnings. This can be a good thing, however, keep in mind that if you have debt covenants, you may want to assess the impact it has on your reporting requirements.

Additionally, whenever companies are capitalizing costs, the disparity between cash reporting and GAAP reporting can get larger. You will want to monitor the impacts this has on your financial statement and cash reporting.

6 PORTFOLIO V. CONTRACT METHOD

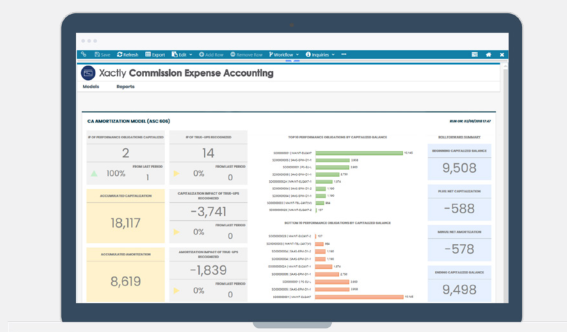
When amortizing commission costs, you have the option to choose the portfolio or individual contract method.

The portfolio method is a practical expedient for companies that have voluminous transactions with similar characteristics. The contract method specifically identifies each customer and is not aggregated into a larger portfolio.

Xactly utilizes the contract method as it produces the most accurate and supportable cost amortization.

PERSONAL EXPERIENCE: XACTLY ON XACTLY

Xactly has implemented its own solution called Commissions Expense Accounting (CEA). The CEA solution fully automates your capitalization, amortization, and impairment analysis. Plus, it can even prepare your journal entries.



This is part of a strategic initiative within Xactly to "practice what we preach" and use our own products within the organization. This initiative is called Xactly on Xactly. Key processes for implementing CEA include:

- **Input:** Automate your commission information sources into the CEA tool
- **Allocations:** Allocation of commissions based on stand-alone selling prices
- **Treatments:** Amortization logic is applied to allocations based upon predetermined categories.
- **Impairments:** Identified churned customers prior to contract term dates to determine impact
- **Outputs**: Dynamic journal entries are created to load into your general ledger

7 THE NEED FOR AUTOMATION

"Regardless of the amortization method you choose, you should automate this process."

Automation will decrease or even eliminate accounting errors, increase visibility into your activity, and reduce the stress involved in managing the process, including any related financial statement audits.

FINAL THOUGHTS

Cost capitalization under ASC 606 is complex, and it's causing organizations to overhaul their accounting processes. As a result, companies now have a lot to think about in terms of their internal data management. Ultimately, the heart of the matter is—these aren't changes and processes that manual spreadsheets and home-grown systems are built to handle.

The risk associated with error-prone spreadsheets and broken formulas simply isn't worth the cost of data integrity and non-compliance. When you automate these processes, you increase visibility into your processes and can easily create a digital audit trail—all while ensuring data accuracy—there's no comparison.

Finally, with the fundamentals of cost capitalization in hand, you will also want to ensure you get your auditors involved early. Make sure they are signed off on your cost capitalization policy before you roll it out.

If you have any cost capitalization accounting questions or want more information on how to acquire the best software automation solution to help you manage this process, reach out to me at dking@xactlycorp.com, and I will make sure you are taken care of.

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ABOUT XACTLY

Xactly delivers a scalable, cloud-based enterprise platform for planning and incenting sales organizations, including sales quota and territory planning, incentive compensation management, and predictive analytics. Using this powerful sales performance management (SPM) portfolio, customers mitigate risk, accelerate sales performance, and increase business agility.

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