Accounting for Selling Costs Gets Complicated

Why are the new contract accounting standards getting so much attention?

The new revenue recognition standards for contracts are ASC 606 for U.S. companies using the country's generally accepted accounting standards (US-GAAP) and IFRS 15 for companies using IFRS (International Financial Reporting Standards). These standards employ a completely new framework in accounting for contracts. For most companies that do business using contracts, the accounting is more detailed and can be complicated. This includes accounting for sales commissions and other direct costs of acquiring a contract. The new standards also require that, for contracts that are in force for more than a year, these costs be capitalized (that is, not immediately expensed) and then amortized over the life of the contract in proportion to the revenue recognized. All other costs of obtaining a contract are immediately expensed. Such costs include, for example, advertising, marketing and administrative expenses such as sales management.

Why are the new standards for accounting for sales commissions and other costs for acquiring contracts a challenge for companies' finance and sales organizations?

Although a great deal of attention has been paid to how the timing of revenue recognition will be different than under the existing standards, there also will be complexities in accounting for contract-acquisition costs because not all costs can be capitalized. For example, a company can capitalize commissions paid directly to a salesperson but not the compensation paid to that same individual in his or her role as a sales manager. The bookkeeping for direct-selling costs gets even more complicated when, for example, a contract includes multiple elements that are delivered at different times or over different time periods, or when a contract is subsequently modified to add or reduce goods and services provided under that contract or if the contract is cancelled before it's completed. That's because the timing of amortized costs is a function of when revenue is reported.

Which sort of companies will find the new standards especially problematic?

Companies using a subscription business model or those that have project-type businesses will most likely have the most trouble, especially if their customers routinely modify their subscriptions or make changes to the scope and schedules of projects. Those companies that are already capitalizing and amortizing incremental sales costs may still find

the new standards more difficult if, for example, their revenue recognition process changes and this affects the timing and calculations associated with the amortization schedule. And the structure of a company's compensation plan will also affect the complexity of its accounting – especially if multiple people receive sales compensation for a transaction – to the degree to which individuals receive payments that cannot be capitalized.

What is it about the accounting that's so difficult?

Whenever there's a change in deliverables or a material modification to the contract structure, the company almost always will need to adjust the amortization schedule. For example, if a customer adds or reduces services provided under a subscription agreement, expands the scope of a contract or terminates a project before it's completed, the amortization schedule for capitalized selling costs will need to be adjusted. If the change is such that the accounting rules require that the company treat the event as a termination of an existing contract and the start of a new one, it will require a set of accounting entries to reflect this. And there may also be balance sheet adjustments as well.

Won't my ERP system handle the requirements of the new accounting standards?

Yes and no. All ERP systems should be able to manage accounting for revenue. They can readily record aggregate compensation and commissions. However, sales compensation management systems are designed specifically to handle the complexities of accurately and consistently tracking the costs of obtaining a contract and providing the necessary controls and audit trails to ensure compliance. A sales compensation management system designed to comply with the new revenue recognition standards will track which costs can be capitalized and which cannot. It will also automate the calculations, which will be further complicated if the contract covers multiple performance obligations, if there are variable considerations or other contingencies, or if customers routinely modify their contracts. One common example of a multiple-element contract is one that includes some installation of equipment or some initial set-up costs followed by a subscription fee or where there are multiple deliverable elements to a contract. ERP systems generally are not designed to track the details of sales compensation, so a company would have to modify its ERP system to allocate and track the capitalized costs. Customizing an ERP system usually isn't a cost-effective approach. Companies that will be capitalizing their sales costs are likely to find that sales compensation software is the most reliable and logical system of record for documenting the capitalized costs, creating the amortization schedules and handling the impact of changes to specific contracts.

What about subscription billing and revenue management software packages?

Today, these packages focus on the revenue part of the transaction. In many instances, companies that use this type of software will use it as part of the revenue accounting process. This type of system may also serve as the authoritative source of information about the contract – its duration, the proportional allocation of revenue across each contract element and any modifications to the contract after its initial signing. This same information can be used to drive amortization calculations and schedules. However, subscription billing systems aren't designed to manage the sales commissions and their allocations to the various elements of the contract.

Why not just use spreadsheets to manage the accounting?

Our research shows that spreadsheets are an inferior way to manage sales compensation. With the advent of the new accounting standards they have become even more problematic because of their impact on accounting workloads in handling the amortization of capitalized contract acquisition costs. Accountants typically create "waterfall" spreadsheets to track and calculate amortization schedules. Although this method works for simple and static schedules, many companies will find that using spreadsheets will be unworkable under the new standards. That's because the accountants will have to create and maintain a waterfall for every individual contract. Unless the contracts are simple and rarely changed, these schedules will be too complicated and time-consuming to be practical. The degree of their complexity will be a function of, for example, the number of performance obligations in the contract, whether there is some form of variable consideration as well as the complexity of the compensation structure.

Moreover, whenever a contract is modified, the changes to those calculations would have to be recorded in each individual spreadsheet in a way that provides an audit trail through the modifications. If they are significant enough and, from an accounting perspective, require that the initial contract is terminated and replaced by a new one, it will be necessary to provide a link or reference to the original contract. This would happen if, for instance, some additional goods or services weren't priced at their standalone selling price. You would need to manually post journal entries from this spreadsheet, hoping that the journal entries are complete and error-free.

Unless your company has only a handful of sales people and a limited number of contracts with capitalized selling costs outstanding at any given time, spreadsheets aren't a practical alternative. They are likely to overburden the accounting department, reduce its productivity and increase audit costs. Since even carefully checked spreadsheets can have errors, auditors will likely spend a considerable amount of time examining your calculations (at your company's expense) to ensure there are no material errors and that your process is reasonably well controlled.

What about subscription billing and revenue management software packages?

Unless your company only needs a simple compensation plan or has few commissioned sales people, you'll probably find that using sales compensation software is beneficial. It gives your sales management team greater flexibility, enabling them to quickly set and modify compensation plans to meet sales targets. It gives reps fast and easy visibility into their compensation and ensures that they aren't over- or underpaid. The software also can simplify the accounting and analysis of compensation. The new standards amplify these benefits, especially if without the software the increased accounting workload becomes a productivity or cost issue that in turn limits sales executives' ability to tailor compensation plans to achieve their objectives.

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Robert Kugel is responsible for the Office of Finance and business research, focusing on the intersection of information technology with the finance organization and business. His research agenda includes the application of IT to finance and business process optimization, looking particularly at ERP and continuous accounting, financial performance management, predictive planning, price and revenue management, revenue and lease accounting and robotic finance.