Project **Revenue Recognition**

Topic **Combination, segmentation and modification of contracts**

Background and objective

1. This paper considers some contract-related issues that were not addressed in the Discussion Paper, *Preliminary Views on Revenue Recognition in Contracts with Customers*. The objective of this paper is to help the boards reach a tentative decision on how to address those issues in the boards' proposed revenue recognition model.

2. The boards' proposed model applies to contracts with customers. An entity's contract with a customer (net contract position) arises from the combination of the remaining rights and performance obligations in the contract. In developing the model to date, it has been assumed that those rights and performance obligations relate to a single contract that does not change for reasons other than performance by the entity and the customer.

3. However, in some cases it may be necessary for an entity to combine a group of contracts into a single bundle of rights and performance obligations—i.e. a single net contract position. Conversely, an entity might segment a single contract into multiple bundles of rights and performance obligations—i.e. more than one net contract position. Moreover, the proposed model must address how an entity would account for changes in rights and performance obligations (contract modifications) for reasons other than performance by the entity and the customer.

4. This paper recommends that:

(a) two or more contracts with the same customer should be combined into a single net contract position if the prices of those contracts are interdependent. (paragraphs 5–18)

(b) a single contract with a customer should be segmented into more than one net contract position only if each segment is priced independently. (paragraphs 19–32)

(c) an entity must consider various indicators and exercise judgment in determining whether the prices of contracts (or segments) are interdependent. (paragraphs 33–37)

(d) a modification of an existing contract should be accounted for as a separate contract if it is priced independently. If the prices are interdependent, the contract modification and the original contract should be accounted for as a single net contract position. Changes in a net contract position because of price-interdependent contract modifications should be applied to the net contract position on a cumulative catch-up basis. (paragraphs 38–51)

Combination of contracts

5. For various reasons entities often enter into two or more contracts with the same customer.[1] Those contracts may be entered into at approximately the same time or in a sequence over an extended period of time. The goods and services promised in the contracts might be similar and interdependent or they may be entirely dissimilar and independent. The accounting can vary depending on whether the contracts are accounted for separately or together.

[1] This paper does not consider whether there might be circumstances in which it is appropriate to combine contracts with more than one customer or counterparty (e.g. combining a customer contract with a supplier contract, or accounting for many homogeneous contracts with various customers as a single portfolio of contracts).

6. This section of the paper considers first why and then in what circumstances it would be necessary to combine two or more contracts with a single customer when applying the boards' proposed model.

Why should a group of contracts be combined into a single net contract position?

7. Entities can structure contracts in various ways to achieve similar economic results. The accounting for those contracts should depend on an entity's present rights and obligations rather than on how the entity structures the contracts. Therefore, it is necessary in some circumstances to combine contracts so the accounting provides relevant information by faithfully representing the economics.

8. In U.S. GAAP, AICPA Statement of Position 81-1 *Accounting for Performance of Construction-Type and Certain Production-Type Contracts* paragraph 35 explains why a group of construction contracts might need to be combined into a single net contract position:

> A group of contracts may be so closely related that they are, in effect, parts of a single project with an overall profit margin, and accounting for the contracts individually may not be feasible or appropriate. Under those circumstances, consideration should be given to combining such contracts for profit recognition purposes.

9. In IFRSs, IAS 11 *Construction Contracts* paragraph 7 states:

> …in certain circumstances, it is necessary to apply the Standard to the separately identifiable components of a single contract or to a group of contracts together in order to reflect the substance of a contract or a group of contracts.

10. Although SOP 81-1 and IAS 11 apply only to construction contracts, the staff thinks the rationale quoted above applies to all contracts with customers. That is, combining contracts is necessary in some circumstances to avoid misrepresentation of revenue (and profit).

11. To illustrate, consider an entity that sells equipment and services related to that equipment. As part of a marketing campaign, the entity might offer "free" services with the purchase of equipment. Of course, the services would not be free but would be priced in contemplation of the equipment sale. If those two

transactions are structured and accounted for as separate contracts, the entity would inappropriately accelerate revenue and profit recognition upon delivery of the equipment.

12. Conversely, if the two contracts are accounted for as a single net contract position, then the customer consideration would be allocated to all the performance obligations. The entity would then recognize revenue and profit as it satisfies each performance obligation—thus representing the economics more faithfully.

In what circumstances should a group of contracts be combined?

13. Because it is necessary sometimes for an entity to account for two or more contracts as a single net contract position, the boards must consider the circumstances in which an entity would do that. Existing standards specify various criteria for combining contracts. The staff thinks that existing standards contain a consistent principle that would be appropriate for the boards' proposed model.

14. Some of those standards, both in U.S. GAAP and IFRSs, are listed below along with their criteria for combining contracts:

SOP 81-1, paragraph .37

> A group of contracts may be combined for accounting purposes if the contracts
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> a. Are negotiated as a package in the same economic environment with an overall profit margin objective. Contracts not executed at the same time may be considered to have been negotiated as a package in the same economic environment only if the time period between the commitments of the parties to the individual contracts is reasonably short. The longer the period between the commitments of the parties to the contracts, the more likely it is that the economic circumstances affecting the negotiations have changed.
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> b. Constitute in essence an agreement to do a single project. A project for this purpose consists of construction, or related service activity with different elements, phases, or units of output that are closely interrelated or interdependent in terms of their design, technology, and function or their ultimate purpose or use.

c. Require closely interrelated construction activities with substantial common costs that cannot be separately identified with, or reasonably allocated to, the elements, phases, or units of output.

d. Are performed concurrently or in a continuous sequence under the same project management at the same location or at different locations in the same general vicinity.

e. Constitute in substance an agreement with a single customer. In assessing whether the contracts meet this criterion, the facts and circumstances relating to the other criteria should be considered. In some circumstances different divisions of the same entity would not constitute a single customer if, for example, the negotiations are conducted independently with the different divisions. On the other hand, two or more parties may constitute in substance a single customer if, for example, the negotiations are conducted jointly with the parties to do what in essence is a single project.

IAS 11 Construction Contracts, paragraph 9

A group of contracts, whether with a single customer or with several customers, shall be treated as a single construction contract when:

(a) the group of contracts is negotiated as a single package;

(b) the contracts are so closely interrelated that they are, in effect, part of a single project with an overall profit margin; and

(c) the contracts are performed concurrently or in a continuous sequence.

EITF Issue No. 00-21 "Revenue Arrangements with Multiple Deliverables," paragraph 2

In applying this Issue, separate contracts with the same entity or related parties that are entered into at or near the same time are presumed to have been negotiated as a package and should, therefore, be evaluated as a single arrangement in considering whether there are one or more units of accounting. That presumption may be overcome if there is sufficient evidence to the contrary.

IAS 18 Revenue, paragraph 13

…the recognition criteria are applied to two or more transactions together when they are linked in such a way that the commercial effect cannot be understood without reference to the series of transactions as a whole.

IFRS 4 Insurance Contracts, footnote 3 to paragraph B25

> …contracts entered into simultaneously with a single counterparty (or contracts that are otherwise interdependent) form a single contract.

15. Appendix A to this paper includes additional criteria for combining contracts that were developed by the EITF and the IFRIC in projects that did not result in a final standard.

A consistent principle in existing standards and an objective for the proposed model

16. Existing standards are similar in their description of when contracts should be combined. Consistent terminology includes “negotiated as a package,” “single project,” “interrelated,” “linked,” and a combined “commercial effect”. The staff thinks that the criteria and terminology of existing standards relate to a consistent principle for combining contracts. That principle is:

> The rights and performance obligations of two or more contracts should be combined into a single net contract position when the prices of those contracts are interdependent.

17. The staff thinks that the above principle provides a clear objective for the boards’ proposed model. The various criteria of existing standards could then be used as indicators or characteristics of contracts with interdependent prices. For example, contracts with interdependent prices typically are contracts that:

    (a) are entered into simultaneously with the same customer

    (b) are negotiated as a package with a single commercial objective

    (c) constitute a single project with interrelated activities, products, services, costs, technologies, locations, etc.

    (d) are performed either concurrently or continuously.

18. Hence, a single contract typically gives rise to a single net contract position because the contract includes all the rights and performance obligations with interdependent prices. Possibly the best evidence of contracts with interdependent prices is when the customer either does not have the right to accept a contract on a standalone basis or clearly would not do so because it would not make sense economically or commercially.

Staff recommendation and questions for the boards

Question 1 – the principle for combining contracts
The staff recommends that two or more contracts with the same customer should be combined into a single net contract position when the prices of those contracts are interdependent. Do the boards agree with that general principle? If not, what should be the principle for combining contracts?

Segmentation of contracts

19. As noted above, entities can structure contracts differently to achieve similar economic results. If it is necessary sometimes to combine two or more contracts into a single net contract position, it might also be appropriate sometimes to segment a single contract into more than one net contract position.

How is segmenting a contract different from identifying separate performance obligations?

20. Segmenting a contract differs from identifying separate performance obligations. Segmenting a contract creates separate bundles of rights and performance obligations, each of which has a distinct allocation process. In other words, the rights in one segment of a contract would not be allocated to the performance obligations of another segment. In contrast, identifying separate performance obligations is the process of identifying all the promised goods and services to which an entity allocates the customer's consideration.

21. The boards considered that difference in recent discussions on uncertain consideration.[2] If a transaction price is uncertain at contract inception because a customer promises a variable consideration amount, any subsequent changes in the transaction price are allocated to all performance obligations in the net contract position. However, if the contract is segmented into more than one net

[2] The issue was discussed by the FASB on April 1, 2009 (FASB memorandum 116B) and by the IASB on March 17, 2009 (IASB Agenda Paper 6B).

contract position, then any subsequent changes in the transaction price of one net contract position would not be allocated to other net contract positions.

22. This paper does not discuss how to identify separate performance obligations or how to determine the amount of consideration to allocate to them. Rather, this paper focuses only on identifying the circumstances in which it would be appropriate for an entity to segment contracts.

In what circumstances should a contract be segmented?

23. The principle for segmenting contracts should be consistent with the principle for combining contracts—i.e. the one should be the inverse of the other. Above, the staff recommends that two or more contracts with the same customer should be combined into a single net contract position when the prices of those contracts are interdependent. Hence, the principle for *segmenting* contracts would be to do it only when each segment of a contract is priced independently. In other words:

> The rights and performance obligations of a single contract should be segmented into more than one net contract position when each segment is priced independently.

24. That principle suggests that if each segment of a contract is priced independently (i.e. without regard for the other segments), the customer would not be receiving a discount on the bundle of goods and services. If there is not a discount on the bundle of promised goods and services, then the accounting in the proposed model would be the same whether the contract is segmented or not.

25. Existing standards are consistent with the principle described above. In U.S. GAAP, SOP 81-1 paragraph .39 states:

> A single contract or a group of contracts that otherwise meet the test for combining may include several elements or phases, each of which the contractor negotiated separately with the same customer and agreed to perform without regard to the performance of the others.

26. SOP 81-1 paragraph .40 then provides the following segmentation criteria

> A project may be segmented if all the following steps were taken and are documented and verifiable:

a. The contractor submitted bona fide proposals on the separate components of the project and on the entire project.

b. The customer had the right to accept the proposals on either basis.

c. The aggregate amount of the proposals on the separate components approximated the amount of the proposal on the entire project.

27. In IFRSs IAS 11 paragraph 8 provides similar segmentation criteria.

> When a contract covers a number of assets, the construction of each asset shall be treated as a separate construction contract when:
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> (a) separate proposals have been submitted for each asset;
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> (b) each asset has been subject to separate negotiation and the contractor and customer have been able to accept or reject that part of the contract relating to each asset; and
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> (c) the costs and revenues of each asset can be identified.

28. The segmentation criteria of SOP 81-1 and IAS 11 are similar in that they require (a) separate proposals for each segment of a contract and (b) the customer's right to accept or reject any of those proposals. However, the segmentation criteria differ in a few ways.

29. IAS 11 differs from SOP 81-1 in that it requires an ability to identify the costs and revenues of each asset. Presumably, an entity that submits a separate proposal for an asset would have the ability to identify costs and revenues for that asset. If not, then it's likely that the asset is too interrelated with other assets to have been priced independently.

30. SOP 81-1 differs from IAS 11 in that it requires the aggregate amount of the proposals on the segments of the contract to approximate the amount of the proposal on the entire contract. In other words, the customer cannot receive a significant discount on the bundle of goods and services in the contract. A discount on the bundle of goods and services would be an indicator that prices of the segments are interdependent and, hence, would be combined into a single net contract position.

31. In contrast to IAS 11, SOP 81-1 paragraph .41 provides segmentation criteria in addition to the criteria quoted above. That is, a contract that does not meet the

criteria quoted in paragraph 26 of this paper can be segmented only if it meets all of the following criteria:

> a. The terms and scope of the contract or project clearly call for separable phases or elements.
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> b. The separable phases or elements of the project are often bid or negotiated separately.
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> c. The market assigns different gross profit rates to the segments because of factors such as different levels of risk or differences in the relationship of the supply and demand for the services provided in different segments.
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> d. The contractor has a significant history of providing similar services to other customers under separate contracts for each significant segment to which a profit margin higher than the overall profit margin on the profit is ascribed.
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> e. The significant history with customers who have contracted for services separately is one that is relatively stable in terms of pricing policy rather than one unduly weighted by erratic pricing decisions (responding, for example, to extraordinary economic circumstances or to unique customer-contractor relationships).
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> f. The excess of the sum of the prices of the separate elements over the price of the total project is clearly attributable to cost savings incident to combined performance of the contract obligations (for example, cost savings in supervision, overhead, or equipment mobilization). Unless this condition is met, segmenting a contract with a price substantially less than the sum of the prices of the separate phases or elements would be inappropriate even if the other conditions are met. Acceptable price variations should be allocated to the separate phases or elements in proportion to the prices ascribed to each. In all other situations a substantial difference in price (whether more or less) between the separate elements and the price of the total project is evidence that the contractor has accepted different profit margins. Accordingly, segmenting is not appropriate, and the contracts should be the profit centers.
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> g. The similarity of services and prices in the contract segments and services and the prices of such services to other customers contracted separately should be documented and verifiable.

32. The staff thinks that those additional segmentation criteria in SOP 81-1 relate to a segmentation issue slightly different from the one this paper focuses on. That is, they seem to focus more on whether it’s appropriate for some performance obligations in a contract to have a different margin from other performance obligations in the same contract. That issue relates to the measurement of

performance obligations. The staff plans on further analyzing that issue and taking a recommendation to the board at a future meeting.

Staff recommendation and questions for the boards

Question 2 – the principle for segmenting contracts
The staff recommends that a single contract with a customer should be segmented into more than one net contract position only if each segment is priced independently. Do the boards agree with that general principle? If not, what should be the principle for segmenting contracts?

Indicators versus conditions

33. The sections above propose principles for the combination and segmentation of contracts. They also discuss various indicators that an entity might consider when applying those principles. Paragraph 17 lists some of the indicators (or characteristics) of contracts that should be combined. Paragraphs 26 and 27 contain criteria in existing standards that the staff thinks would provide useful indicators (or characteristics) of contracts that should be segmented.

34. One issue for the boards to consider is whether a standard should have 'indicators' or 'conditions' for when contracts should be combined or segmented. Arguably, providing a clear objective along with indicators would result in a more principles-based standard. However, some people might think that a list of required conditions would be less vague.

35. In the projects summarized in Appendix A, the EITF and the IFRIC considered that issue and the role of management judgment in determining whether to combine contracts. A working group in Issue 02-2 made the following observation in considering the criteria for combining financial instrument contracts:

> … it does not appear possible (or desirable) to remove all judgment from the decision to combine multiple financial instruments for accounting purposes.

36. The IFRIC also considered the issue in their broader project on reporting of linked transactions and concluded that the guidance for when to combine contracts should be characterized as indicators rather than conditions.

37. The staff recommends that a standard should contain indicators of whether contracts (or segments of a contract) are priced together or separately. Those indicators would be similar to the indicators summarized in paragraph 17 of this paper. Management of an entity would be required to exercise judgment when applying those indicators.

Staff recommendation and questions for the boards

Question 3 – applying the principle for combining and segmenting contracts
The staff recommends that an entity must consider various indicators and exercise judgment in determining whether the prices of contracts (or segments) are interdependent. Do the boards agree? If so, do the boards agree with the indicators the staff suggests in paragraph 17?

Modification of contracts

38. In developing the proposed model to date, the boards have assumed that the rights and performance obligations of a contract do not change for reasons other than performance by the entity and the customer. However, in many contracts it is common for the rights and performance obligations to change because of negotiations by the parties to the contract. Common terms used to describe those changes include contract modifications, change orders, variations and amendments.

39. SOP 81-1 paragraph .61 describes change orders as follows:

> Change orders are modifications of an original contract that effectively change the provisions of the contract without adding new provisions. They may be initiated by either the contractor or the customer, and they include changes in specifications or design, method or manner of performance, facilities, equipment, materials, sites, and period for completion of the work.

40. When rights and performance obligations arise (or are changed), it is necessary for an entity to determine whether those rights and performance obligations give rise to a separate net contract position or if they affect an existing net contract position.

A principle for accounting for contract modifications

41. The staff thinks that the principle for accounting for contract modifications is the same as for the combination and segmentation of contracts. That is, an entity would account for a contract modification as a separate net contract position if that contract modification is priced independently. As a separate net contract position, the boards' proposed model would be applied as it would to any other contract.

42. However, if the prices are interdependent, the boards must consider how an entity would apply the proposed model. Consider the following:

> An entity promises to manufacture 10 products to a customer's specifications. Six months after the manufacturing process begins, the customer and the entity agree to add 2 products of the same design for a price per unit less than the original 10 products.

43. To determine whether the price of the modification and the price of the original contract are interdependent, the entity would consider the indicators in paragraph 17. Although the contract modification was not entered into simultaneously with the original contract, the other indicators suggest that the prices are interdependent. That is, the additional products are negotiated as part of the same overall project with a single commercial objective. The product design and manufacturing process are the same for all units. Moreover, all the products are manufactured either concurrently or continuously.

44. Because the price of the contract modification and the price of the original contract are interdependent, it would affect the accounting for the existing net contract position. How should the contract modification affect the net contract position?

45. When discussing measurement of rights, the boards decided tentatively that changes in the transaction price throughout a contract would be reallocated to all performance obligations. An entity would adjust revenue on a cumulative basis for any portion of the change in the transaction price that was allocated to satisfied performance obligations.

46. To be consistent with that cumulative catch-up approach, the staff recommends that changes in a net contract position because of price-interdependent contract modifications also should be applied to the net contract position on a cumulative catch-up basis. That is, the net contract position would be measured as if the contract modification were part of the original contract.

47. The staff thinks that recommendation is consistent with existing standards. For example, SOP 81-1, paragraph .61, states the following:

> Contract revenue and costs should be adjusted to reflect change orders approved by the customer and the contractor regarding both scope and price.

48. In IFRSs, IAS 11 paragraph 13 states:

> A variation is an instruction by the customer for a change in the scope of the work to be performed under the contract. A variation may lead to an increase or a decrease in contract revenue. Examples of variations are changes in the specifications or design of the asset and changes in the duration of the contract. A variation is included in contract revenue when: (a) it is probable that the customer will approve the variation and the amount of revenue arising from the variation; and (b) the amount of revenue can be reliably measured.

49. In some contracts, an entity and a customer agree to a change in the goods and services provided in the contract before agreeing to the price for that change. In those cases, existing standards require an assessment of whether the customer approves the contract modification. SOP 81-1 requires approval by the entity and the customer whereas IAS 11 requires that it be probable that the customer will approve the price. Those standards also require a reliable estimate of the price for the change order.

50. The staff thinks that those requirements are addressed (or will be addressed) in other parts of the boards' proposed model. The probability of whether the customer approves the contract modification relates to uncertainty of contractual

rights and performance obligations for which the staff thinks the boards will need to consider application guidance at a future date.

51. The reliability of estimates requirement could be addressed along with the boards' tentative decision to constrain the measurement of rights (i.e. the expected consideration approach) only if an amount cannot be reliably estimated. The boards have not yet considered the factors that an entity would consider when determining whether an estimate is reliable. When developed, those factors could apply to estimates in the proposed model other than just estimates of the amount of consideration to be received.

Staff recommendation and questions for the boards

Question 4 – applying the principle to contract modifications
The staff recommends that: (a) a modification of an existing contract should be accounted for as a separate contract if it is priced independently (b) if the prices are interdependent, the contract modification and the original contract should be accounted for as a single net contract position (c) changes in a net contract position because of price-interdependent contract modifications should be applied to the net contract position on a cumulative catch-up basis. Do the boards agree? If not, what alternative do the boards prefer for accounting for contract modifications?

Appendix A Additional criteria for combining contracts

A1. The issue of when to account for a group of contracts together has been considered by the EITF and the IFRIC in contexts other than revenue contracts.

EITF Issue No. 02-2

A2. The EITF considered the issue in the context of financial instruments with Issue 02-2 "When Certain Contracts That Meet the Definition of Financial Instruments Should Be Combined for Accounting Purposes." That project did not issue criteria for combining financial instrument contracts because of other ongoing projects at the time that dealt with related issues. However, a working group on that issue developed the following criteria:

> At the January 23-24, 2002 meeting, the FASB staff reported on the initial meeting of the Working Group formed to address this Issue. The Working Group preliminarily agreed that two or more financial instruments should be required to be combined for accounting purposes if all of the following four criteria are met:
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> - The transactions or contracts are with the same counterparties (or are structured through an intermediary).
> - The transactions or contracts are entered into in contemplation of one another.
> - The separate transactions or contracts share at least one underlying, and changes in that underlying (holding the other underlyings constant) result in at least one substantially offsetting change in fair value for those transactions or contracts.
> - The structure of the arrangement (separate contracts) does not serve a substantive business purpose that is fundamentally unrelated to the accounting (that is, the business purpose is not directly or indirectly based on the accounting result) and that could not have been accomplished in a single contract or transaction.
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> The Working Group also observed that it does not appear possible (or desirable) to remove all judgment from the decision to combine multiple financial instruments for accounting purposes.

IFRIC project on linkage of transactions

A3. The IFRIC considered the issue in a broader context in the project "Reporting of Linked Transactions." IFRIC Agenda Paper 11 from February 2003 describes linkage as the issue of "when the accounting treatment for two or more transactions or contracts differs depending on whether the contracts are accounted for separately or together."

A4. The IFRIC discussed the issue from April 2002 to February 2003. Subsequently, the project was merged into IFRIC's project on the criteria for combining and segmenting contracts in IAS 11. That project was removed from the IFRIC's agenda in November 2006.

A5. Although the project ultimately was removed from the agenda, the IFRIC tentatively agreed to the following indicators that transactions should be linked:

> Indicators/conditions that transactions should be linked are:
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> (a) The transactions are entered into at the same time or as part of a continuous sequence and in contemplation of one another (IFRIC). Where this is the case, the transactions are usually with the same counterparty or with an entity that acts as an agent of that counterparty. (IFRIC)
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> (b) The transactions, in substance, form a single arrangement that achieves or is designed to achieve an overall commercial effect. (IFRIC)
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> (c) One or more of the transactions, considered on its own, does not make commercial sense, but they do when considered together. An example is where one transaction – such as the granting of a loan – is priced on nonmarket terms, compensated for by another transaction – such as a sale of inventory to the same counterparty – also priced on non-market terms. (IFRIC and Board)
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> (d) The contracts include one or more options or conditional provisions for which there is no genuine commercial possibility that the option(s) or conditional provision(s) will, or alternatively will not, be exercised or fulfilled. (IFRIC)
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> (e) The occurrence (or non-reversal) of one transaction is dependent on the other transaction(s) occurring. (IFRIC)