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Staff Paper

Project	**Revenue Recognition**
Topic	**Contract modifications**

Purpose and summary of the staff's recommendations

1. In June 2010, the Boards jointly issued Exposure Draft, *Revenue from Contracts with Customers*. This paper considers improvements to the Exposure Draft's proposed requirements on how an entity should account for contract modifications.

2. The staff recommends the following:

   (a) If a contract modification results only in the addition of distinct goods or services at their standalone selling price, the entity should account for the additional goods or services as a separate contract.

   (b) If a contract modification does not result in a separate contract under item (a), the entity should reevaluate the performance obligations and reallocate the transaction price to each separate performance obligation.

3. This paper is organized as follows:

   (a) Proposed guidance in the Exposure Draft (paragraphs 4–7)

   (b) Feedback on the proposed guidance (paragraphs 8–13)

   (c) Staff analysis and recommendations (paragraphs 14–23).

Proposed guidance in the Exposure Draft

4. A contract modification is any change in the scope or price of a contract that may be initiated by either the entity or the customer. When a contract is modified, the Boards proposed in the Exposure Draft that an entity should apply the principle of "price interdependence" to determine whether to account for a contract modification as a separate contract or as part of the original contract. (If the price but not the scope of a contract changes, an entity would apply the proposed guidance on determining and allocating the transaction price. The Boards will discuss that topic in March 2011.)

5. The Boards proposed the following indicators of when two or more contracts have interdependent prices:

   (a) The contracts are entered into at or near the same time;

   (b) The contracts are negotiated as a package with a single commercial objective; and

   (c) The contracts are performed either concurrently or consecutively.

6. If the price of a contract modification is considered to be interdependent with the price of an existing contract, an entity would recognize the cumulative effect of the modification in the period in which the modification occurs. If an entity determines that the prices of the modification and the existing contract are not interdependent, the entity would account for the contract modification as a separate contract.

7. In some cases, a customer receives a discount on goods or services in a contract because of an existing customer relationship arising from previous contracts. To prevent all of those contracts from being considered “price interdependent,” the Exposure Draft stated that the price of a contract is not necessarily interdependent with the prices of the previous contracts solely because the customer receives a discount because of an existing customer relationship.

Feedback on the proposed guidance

Overall views

8. Many respondents stated that the proposed guidance in the Exposure Draft was confusing and would not result in consistent application in practice. Those respondents thought that the principle of “price interdependence” was insufficient to help an entity determine whether to account for a contract modification as a separate contract or as a modification of an existing contract. Many respondents observed that the proposal could result in some contract modifications being accounted for:

    (a) On a cumulative catch-up basis even though the modification relates only to the remaining performance obligations in the contract; or

    (b) As separate contracts even though the modifications relate to the original contract (for example, change orders in construction industry).

9. Several respondents mentioned that there is an inconsistency between the principle of price interdependence and the application of that principle in the implementation guidance of the Exposure Draft. Those respondents thought that Example 2 in the Exposure Draft (which is included in Appendix A) does not seem to apply the principle of price interdependence as described in the Exposure Draft but rather the example focuses on whether the prices of goods and services are at current market prices at the date of modification. Additionally, they requested additional clarification to determine whether the discount on goods and services in the contract

is a “result of an existing customer relationship arising from previous contracts” or is due to other circumstances.

10. Respondents suggest that a decision whether to account for a contract modification as a separate contract or as part of the original contract contracts should be based on a broader notion of *economic* interdependence or *functional* interdependence. Hence, they recommend adding an indicator relating to factors such as risk or the degree of functionality between the goods or services being provided in the contract(s).

11. Additionally, some respondents thought that the articulation of the proposed guidance is not clear. Those respondents suggested that the revenue standard list the common types of contract modifications and provide clear requirements for each type (for example, change orders, concessions, contract additions).

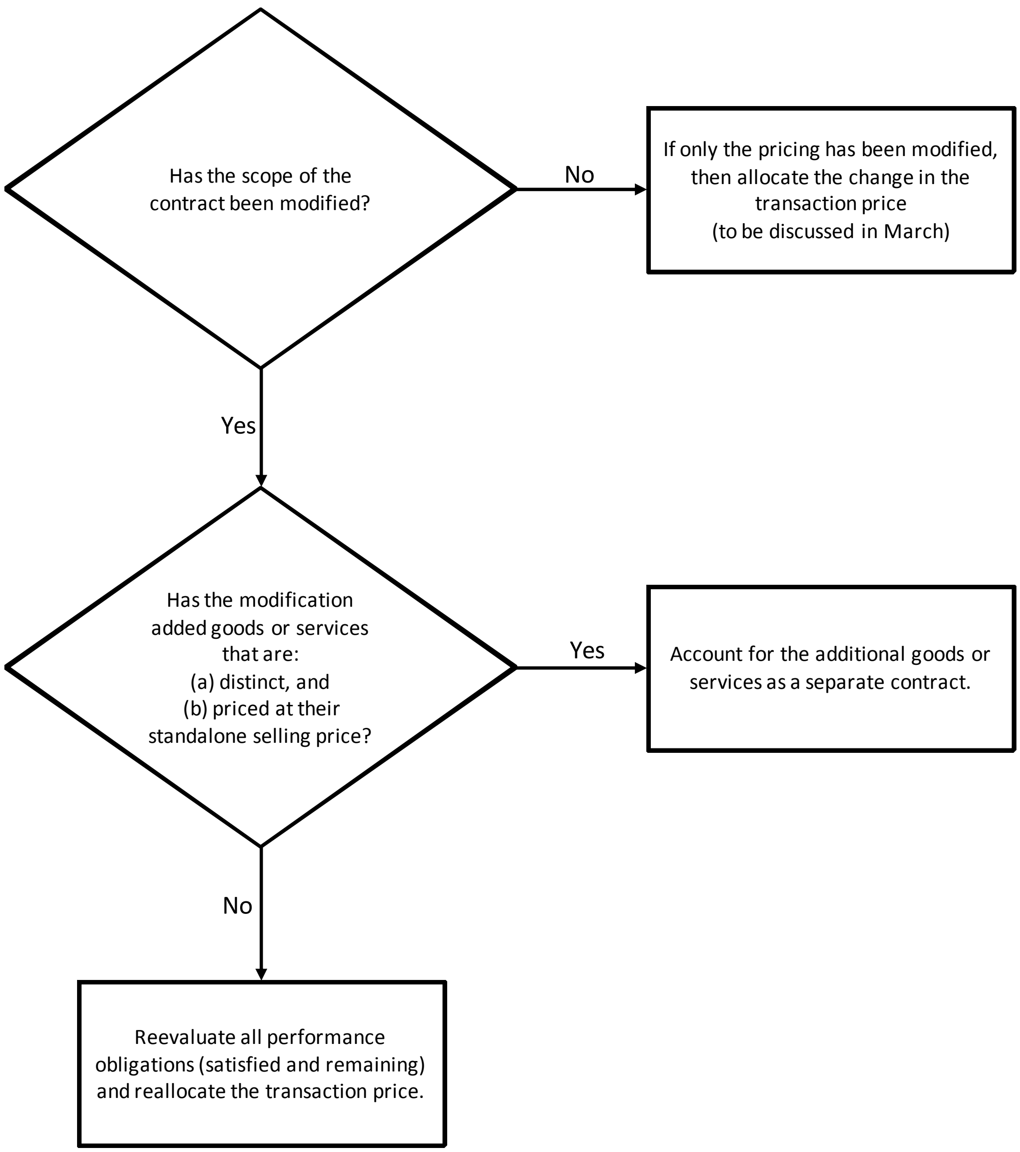
Responses by industry

12. Most respondents from the construction industry support the cumulative catch-up approach for contract modification (that is, change orders) because change orders modify the provisions of the original contract without adding new provisions.

13. Many respondents from industries other than the construction industry indicated that most contract modifications give rise to a new contract and, hence, should not be accounted for together with the original contract. Those respondents stated that the modification gives rise to a new contract because the modification is negotiated subsequently to the original contract and is based on new facts and circumstances. Consequently, the modification should not result in a cumulative catch-up adjustment and should only affect the accounting prospectively. In addition, some respondents think that prospective accounting for modifications is consistent with accounting for changes in accounting estimates.

Staff analysis and recommendations

14. The staff agrees with respondents that the proposed guidance on contract modifications should be improved. Hence, the staff proposes the following framework to determine the appropriate accounting for contract modification. An entity would use the concepts in the framework to determine how to account for various types of contract modifications. Each part of the framework is discussed subsequently in this paper:



Contract additions

15. In some cases, a contract is modified so that the entity (a) performs and collects exactly as required by the original contract and (b) promises to provide additional distinct goods or services at their standalone selling price. The Exposure Draft defines the standalone selling price as follows:

> The price at which the entity would sell a good or a service separately to the customer.

16. In accordance with that definition, a standalone selling price would consider an entity's relationship with a particular customer. Hence, the price of the additional goods or services could include a discount that is attributable solely to efficiencies of buying goods or services as a bundle.

17. In those cases, the accounting for the original contract should not be affected either currently or prospectively. Consider the following example:

> An entity agrees to sell 120 standardized products for CU1.2 million (CU10,000 per product) to be delivered to a customer evenly over the next 6 months. The contract is modified three months after contract inception, and the entity agrees to deliver an additional 30 products for an additional CU297,000 or CU9,900 per product. The pricing for the additional products is based on the then-current standalone selling price. The additional products are distinct from the original products.

18. In this example, the contract modification for the additional 30 products is, in effect, a new and separate contract for future goods that does not affect the accounting for the original contract. In addition, it would be a significant operational challenge to account for these types of contract modification together with the original contract. Accounting for the additional products as a new contract is consistent with the views of many respondents to the Exposure Draft.

19. If a contract modification does not simply result in the addition of distinct goods or services at their standalone selling prices, the entity would need to reevaluate the performance obligations and reallocate the transaction price using the proposed guidance on determining and allocating the transaction price. At a future meeting, the Boards will consider improvements to the guidance on determining and allocating the transaction price.

Remaining performance obligations are distinct

20. If a contract is modified and all the remaining performance obligations are distinct from the satisfied performance obligations, the entity should account for the modification on a prospective basis. Many respondents to the Exposure Draft support that accounting because they suggested that the purpose of the modification was to retain the customer prospectively. Consider the following example:

> An entity enters into a three-year web hosting services contract. The payment terms are CU100,000 payable annually in advance. The standalone selling price of the services at contract inception is CU100,000 per year. At the beginning of the third year, the contract is modified such that the fee for the third year of services is CU80,000 (the customer pays CU80,000 after the modification). In addition, the customer agrees to pay an additional CU200,000 to extend the contract for three additional years (that is, four remaining years). The standalone selling price of the services at the beginning of the third year is CU80,000 per year. The entity's standalone selling price multiplied by number of years is a representative selling price of multi-year contracts (i.e., 4 * CU80,000 = CU320,000 is the standalone selling price of a four year contract).

21. In this example, at the date of modification, the entity concludes that the remaining performance obligations are distinct because each act of service (i.e., each second) provides utility to the customer on its own and the risks inherent in undertaking to provide the remaining services are separable from the risks of providing the services in the past. Consequently, the entity would reallocate the transaction price at the

date of modification. In March 2011, the Boards will consider whether an entity would reallocate the transaction price to all performance obligations or only to the remaining performance obligations. If the modified transaction price is allocated only to the remaining performance obligations, the entity would have recognized revenue of CU100,000 per year for the 2 years of services provided under the original contract and would recognize revenue CU70,000 per year (CU280,000 ÷ 4 years) for services provided during the subsequent 4 years of services under the modified contract.

Remaining performance obligations are not distinct

22. In some cases, a contract modification may change a single performance obligation without adding distinct goods or services. In those situations, an entity should account for the modification on a cumulative catch-up basis. Consider the following example:

> An entity enters into a contract to construct a highly customized home for a customer, which is considered to be a single performance based on the proposed guidance on identifying performance obligation. At inception, the contractor expects the following:
>
> | | |
> |---|---|
> | Revenue | 1,000,000 |
> | Costs | 800,000 |
> | Gross profit (20%) | 200,000 |
>
> After the first year, at which point the entity estimates that it has satisfied 50% of its performance obligation, the parties to the contract agree to change the floor plan of the home. As a result, the contract revenue and expected costs increase by CU100,000 and CU75,000 respectively. As a result of the change order, the entity estimates that it has satisfied 46% of its performance obligation.

23. In this example, the entity concludes that the changed floor plan does not create a separate performance obligation. The additional service is not distinct because it is not subject to separable risks as evidenced by the existence of a significant contract

management service to integrate the highly interrelated tasks. Consequently, the entity would update its measure of progress toward completion of the home and recognize the effect of the modification on a cumulative catch-up basis.

Part of the remaining performance obligations are not distinct

24. In some cases, a contract modification may be to deliver additional distinct goods or services and to modify a partly satisfied performance obligation (as in a construction contract). In those situations, the entity would reevaluate the performance obligations and reallocate the transaction price to each separate performance obligation using the proposed guidance on determining and allocating the transaction price. The Boards will discuss that topic at a future meeting.

Staff Recommendation

25. The staff recommends the following:

    (a) If a contract modification results only in the addition of distinct goods or services at their standalone selling price, the entity should account for the additional goods or services as a separate contract.

    (b) If a contract modification does not result in a separate contract under item (a), the entity should reevaluate the performance obligations and reallocate the transaction price to each separate performance obligation.

Question for the Boards

Question
Do the Boards agree with the staff's recommendation?

Appendix A Example 2 from the Exposure Draft

A1. Paragraph 19 of the Exposure Draft requires an entity to account for a contract modification together with the existing contract if the prices of the modification and the existing contract are interdependent. The following example illustrates how an entity would apply that principle.

Example 2—Contract modifications

Scenario 1—services that do not have interdependent prices

An entity enters into a three-year services contract. The payment terms are $100,000 payable annually in advance. The standalone selling price of the services at contract inception is $100,000 per year. At the beginning of the third year (after the customer had paid the $100,000 for that year), the entity agrees to reduce the price for the third year of services to $80,000. In addition, the customer agrees to pay an additional $220,000 for an extension of the contract for 3 years. The standalone selling price of the services at the beginning of the third year is $80,000 per year.

To account for the contract modification, the entity must evaluate whether the price of the services provided before the contract modification and the price of the services provided after the contract modification are interdependent. The services provided during the first 2 years are priced at the standalone selling price of $100,000 per year. Moreover, the services provided during the subsequent 4 years are priced at the standalone selling price of $80,000 per year. Hence, the entity concludes that the price of the contract modification and the price of the original contract are not interdependent. Although the services are provided continuously, the price of the services in the first 2 years and the price of the subsequent services are negotiated at different times and in different market conditions (as evidenced by the significant change in the standalone selling price of the service).

Consequently, the entity accounts for the contract modification separately from the original contract. $20,000 of the $100,000 payment received at the beginning of the third year (before the modification) is a prepayment of services to be provided in the future years. Therefore, the entity recognizes revenue of $100,000 per year for the 2 years of services provided under the original contract and $80,000 per year for services provided during the subsequent 4 years of services under the new contract.

Scenario 2—services that have interdependent prices

The facts are the same as Scenario 1 except that at the beginning of the third year the customer agrees to pay an additional $180,000 for an extension of the contract for 3 years.

The services provided during the first 2 years are priced at their standalone selling price of $100,000 per year. However, the services provided during the subsequent 4 years are priced at a $40,000 discount [($80,000 standalone selling price per year × 4 years) – ($100,000 prepayment + $180,000 remaining payment)] and, therefore, their price is dependent on the price of the services in the original contract. Hence, the entity concludes that the price of the contract modification and the price of the original contract are interdependent.

Consequently, the entity accounts for the contract modification together with the original contract. At the date of modification, the entity recognizes the cumulative effect of the contract modification as a reduction to revenue in the amount of $40,000 [($480,000 total consideration ÷ 6 years of total services × 2 years' services provided) − $200,000 revenue recognized to date]. The entity recognizes revenue of $100,000 per year for the first 2 years' $40,000 in the third year, and $80,000 per year in the fourth, fifth, and sixth years.