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Staff Paper

Project	**Revenue Recognition**
Topic	**Combining contracts**

Purpose and summary of staff recommendations

1. This paper considers improvements to the proposed requirements for combining contracts in the Exposure Draft, Revenue from Contracts with Customers.

2. The staff recommends the following:

   (a) An entity should account for two or more contracts as a single contract if the timing or amount of revenue recognition would differ depending on whether the entity accounts for the contracts together or separately, and

   (b) An entity should consider the following indicators that the contracts should be combined:

      (i) The contracts are entered into at or near the same time,

      (ii) The contracts are negotiated as a package with a single commercial objective,

      (iii) The amount of consideration received in one contract depends on the performance of the other contract,

      (iv) The goods and services in the contracts are closely interrelated or interdependent in terms of design, technology, or function, and

      (v) The contracts are with the same customer (or related entities).

3. This paper is organized as follows:

   (a) Background (paragraphs 4–6)

   (b) Feedback on the proposed guidance (paragraphs 7–10)

   (c) The principle for combining contracts (paragraphs 11–20)

   (d) Applying the principle for combining contracts (paragraphs 21–24)

Background

4. Entities can structure contracts in various ways to achieve similar economic results. Hence, the accounting for a contract should depend on an entity's present rights and obligations rather than on how the entity structures the contract.

5. The Exposure Draft explains that, in most cases, an entity would apply the proposed recognition requirements to a single contract. However, in some cases, the Boards proposed that the principle of 'price interdependence' should determine whether an entity should combine two or more contracts and account for them as a single contract. The prices of two or more contracts are interdependent if the amount of consideration for goods or services in one contract is dependent on the amount of consideration for goods or services in another contract. The Boards proposed the following indicators that 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. The Exposure Draft also states that the price of a contract is not interdependent with the price of another contract solely because the customer receives a discount on goods or services in the contract as a result of an existing customer relationship arising from previous contracts.

Feedback on the proposed guidance

7. Most respondents agreed that an entity should consider price interdependence for determining whether to combine contracts. However, some respondents thought that the notion of price interdependence was confusing as the overall principle for combining contracts.

8. Some respondents suggested that two or more contracts should be combined using the principle in IAS 18, *Revenue*, namely that the contracts "are linked in such a way that the commercial effect cannot be understood without reference to the series of transactions as a whole". Other respondents suggested that an entity also should consider "technological and functional interdependency" of the goods or services in the contracts and "payment interdependency" between contracts (i.e., the amount of consideration is one contract is dependent on performance by the entity on another contract).

9. A few respondents commented on paragraph 14 of the Exposure Draft (see paragraph 6 in this paper) that it could be difficult to determine whether a discount offered on one contract arises because of price interdependency with another contract or because the discount relates to an existing customer relationship. They added that making that distinction would be particularly difficult for entities that negotiate each contract *individually* rather than enter into contracts with standard terms.

10. Some respondents suggested that the Boards clarify that in order for two or more contracts to be combined, the contracts must be with the same party. Therefore, those respondents encouraged the Boards to clarify that contracts can be combined only if the contracts are with the same counterparty. That would be consistent with existing requirements such as the guidance on multiple-element arrangements in ASC 605-25 which states that separate contracts with the same entity or related parties that are consummated at or near the same time create a presumption that the contracts were negotiated as a package and should therefore be evaluated as a single arrangement.

The principle for combining contracts

11. The purpose of combining two or more contracts into a single contract is to faithfully depict an entity's performance regardless of the structure of the contracts. This objective is consistent with the objective for identifying separate performance obligations, that is, it would result in an entity recognizing revenue and profit margins in a manner that faithfully depicts the transfer of goods or services to the customer.

12. To alleviate respondents' concerns about the principle of price interdependence, the staff thinks that the principle for combining contracts should be articulated in a way that is more consistent with the articulation in existing standards.

Existing requirements in US GAAP and IFRSs

13. IAS 18, 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.

14. ASC 605-35-25, paragraph .5

> 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.

15. IAS 11, paragraph 7

> …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.

16. ASC 985-605-55, paragraph 4

> Software vendors may execute more than one contract or agreement with a single customer. However, a group of contracts or agreements may be so closely related that they are, in effect, parts of a single arrangement and should be viewed as one

> multiple-element arrangement when determining the appropriate amount of revenue to be recognized in accordance with this Subtopic. The form of an arrangement is not necessarily the only indicator of the substance of an arrangement. The existence of any of the following factors (which are not all-inclusive) may indicate that a group of contracts should be accounted for as a single multiple-element arrangement:
>
> a. The contracts or agreements are negotiated or executed within a short timeframe of each other.
>
> b. The different elements are closely interrelated or interdependent in terms of design, technology, or function.
>
> c. The fee for one or more contracts or agreements is subject to refund, forfeiture, or other concession if another contract is not completed satisfactorily.
>
> d. One or more elements in one contract or agreement are essential to the functionality of an element in another contract or agreement.
>
> e. Payment terms under one contract or agreement coincide with performance criteria of another contract or agreement.
>
> f. The negotiations are conducted jointly with two or more parties (for example, from different divisions of the same entity) to do what in essence is a single project.

17. Appendix A includes criteria that were developed by the IFRIC for linking contracts but that were not finalized.

Staff's proposed principle

18. In the light of responses to the Exposure Draft (and existing requirements), the staff proposes the following principle for combining contracts:

> An entity should account for two or more contracts as a single contract if the timing or amount of revenue recognition would differ depending on whether the entity accounts for the contracts together or separately.

19. The proposed principle would broaden the principle of price interdependence proposed in the Exposure Draft. However, it would not eliminate the consideration of price interdependence when combining contracts. In fact, the staff thinks that

interdependence of pricing between contracts is often the reason why the accounting would differ depending on whether the contracts are accounted for together or separately.

20. For example, if an entity sells a bundle of goods or services for a total amount of consideration that equals the sum of the standalone selling prices of those goods or services, then the accounting would not differ if the entity provides those goods or services in a single contract or in separate contracts.

Question 1
The staff recommends that an entity should account for two or more contracts as a single contract if the timing or amount of revenue recognition would differ depending on whether the entity accounts for the contracts together or separately. Do the Boards agree?

Applying the principle for combining contracts

21. In applying the staff's recommended principle, an entity would consider various indicators to determine when two or more contracts should be combined. The staff thinks the revenue standard should carry forward the following indicators from the Exposure Draft:

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

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

22. The only indicator that the staff recommends not carrying forward from the Exposure Draft is the indicator "the contracts are performed either concurrently or consecutively". Some respondents highlighted that applying that indicator could result in an entity combining contracts perpetually when the entity enters into a series of independent contracts with customers (e.g. services contract with high renewal rates).

23. In addition to two of the indicators from the Exposure Draft, the staff thinks the revenue standard should include the following additional indicators on the basis of feedback received from respondents:

(a) The goods and services in the contracts are closely interrelated or interdependent in terms of design, technology, or function,

(b) The amount of consideration received in one contract depends on the performance of the other contract, and

(c) The contracts are with the same customer (or related entities).

24. The staff thinks these additional criteria would enhance the proposed principle for combining contracts and ensure that an entity does not structure contracts to effectively bypass the requirements of the revenue standard. In addition, these additional indicators are consistent with indicators in existing requirements and reflect the feedback received from respondents to the Exposure Draft.

Question 2
Do the Boards agree with the following indicators that two or more contracts should be combined and accounted for as a single contract? (i) The contracts are entered into at or near the same time, (ii) The contracts are negotiated as a package with a single commercial objective, (iii) The amount of consideration received in one contract depends on the performance of the other contract, (iv) The goods and services in the contracts are closely interrelated or interdependent in terms of design, technology, or function, and (v) The contracts are with the same customer (or related entities)

Appendix A Additional guidance for combining contracts

A1. 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."

A2. 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:
>
> (a) The transactions are entered into at the same time or as part of a continuous sequence and in contemplation of one another. 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.
>
> (b) The transactions, in substance, form a single arrangement that achieves or is designed to achieve an overall commercial effect.
>
> (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.
>
> (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.
>
> (e) The occurrence (or non-reversal) of one transaction is dependent on the other transaction(s) occurring.