Staff Paper

Project: **Revenue recognition**

Topic: **Separating a contract**

Purpose and staff recommendation

1. This paper seeks the boards' views on whether an entity should separate a contract in two steps by (a) segmenting a contract, and then (b) identifying separate performance obligations, or whether an entity should separate a contract in one step by identifying separate performance obligations.

Staff recommendations

2. The staff recommends that an entity should separate a contract in one step by identifying separate performance obligations.

Background

3. The exposure draft proposed that an entity should separate a contract in two ways.

4. First, an entity would segment a single contract and account for it as two or more contracts if the price of some goods or services in the contract is *independent* of the price of other goods or services in the contract. The purpose of segmenting a contract is to 'ring fence' allocations of the transaction price (including any discounts or subsequent changes in the transaction price) to the goods and services within a contract segment.

5. Secondly, an entity would identify the separate performance obligations in a contract (or contract segment). This step is fundamental to the operation of the proposed model because:

   (a) revenue is recognised when an entity satisfies those performance obligations; and

   (b) the amount of revenue that is recognised is based on the amount of the transaction price that is allocated to those performance obligations. That allocation is performed on the basis of relative stand-alone selling prices of the goods or services underlying those performance obligations.

Feedback from comment letters

6. Respondents think that the proposal to separate a contract in two steps is confusing and unnecessary because:

   (a) the principle used for segmenting a contract (ie price independence) is not clear and overlaps with the criteria used to identify separate performance obligations (ie sold separately, distinct profit margin, distinct function); and

   (b) the practical effect of segmenting a contract is limited mainly to clarifying how an entity would allocate changes in the transaction price. Therefore, many respondents think that segmenting a contract would be an unnecessary step if the boards clarify elsewhere in the revenue standard how an entity should allocate changes in the transaction price.

Staff analysis

7. There are two main alternatives for addressing respondents' concerns about contract segmentation:

   (a) Alternative 1: eliminate contract segmentation and separate a contract only if that contract comprises separate performance obligations (ie a single step approach); or

   (b) Alternative 2: retain contract segmentation as a discrete step for separating a contract (ie retain the proposals in the exposure draft).

Alternative 1: Separate a contract by identifying separate performance obligations

8. As noted above, many respondents commented that the purpose of the contract segmentation step was not readily apparent. Because that step is only relevant to allocating discounts or changes in the transaction price, the boards could relocate the requirement to 'ring fence' allocations of the transaction price to the part of the revenue standard that addresses allocating the transaction price. Consequently, the revenue standard would not need two steps for separating a contract.

Alternative 2: Retain contract segmentation

9. Alternatively, the boards could retain the notion of a contract segment and require a two-step approach to segmenting a contract. If Alternative 2 is preferred, the revenue standard would need to be drafted in a way that clarifies the relationship between identifying a contract segment (on the basis of price independence or a similar notion), identifying separate performance obligations, and allocating the transaction price.

Staff recommendation

10. Regardless of which alternative is chosen, the boards need to clarify and reconsider how an entity would allocate discounts and changes in the transaction price to the goods or services in a contract. This is because many respondents said that the allocation of the transaction price to all performance obligations based on relative stand-alone selling prices may not always faithfully portray the effect that the discount or the change in the transaction price has on the economics of the contract. They argue that the proposed model should clarify when it might be appropriate to allocate the transaction price using another method. For example, the revenue standard could require that an entity allocate any discount or change in transaction price only to those performance obligations to which the amounts relate.

11. The staff is not asking the boards to decide on their preferred approach to allocation at this meeting. The boards will further consider the allocation process at a future meeting (currently scheduled for March 2011).

12. Because the boards need to reconsider how an entity allocates the transaction price under either alternative, the staff thinks it would be beneficial to simplify the revenue model by separating a contract in one step rather than trying to explain the need for segmenting a contract in addition to identifying separate performance obligations in the contract.

Question for the boards
The staff recommends that an entity should separate a contract in one step by identifying separate performance obligations. Do the boards agree?