STAFF PAPER

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Project	**FASB/IASB Joint Transition Resource Group for Revenue Recognition**
Paper topic	Evaluating Contract Modifications Prior to the Date of Initial Application

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Purpose

1. Some stakeholders informed the staff that there might be challenges in applying the transition guidance in Accounting Standards Update No. 2014-09, *Revenue from Contracts with Customers*, and IFRS 15 *Revenue from Contracts with Customers* (collectively referred to as the "new revenue standard"), for contract modifications prior to the date of initial application of the new revenue standard.[1] This paper summarizes the potential challenges that were reported to the staff. The staff will seek input from members of the FASB-IASB Joint Transition Resource Group for Revenue Recognition on the potential challenges.

Accounting Guidance

Transition

2. Paragraph 606-10-65-1(d) [C3][2] requires application of the new revenue standard using one of the following transition methods:

[1] The date of initial application is the beginning of the reporting period in which an entity first applies the new revenue standard.
[2] IFRS 15 references are included in "[XX]" throughout this paper.

(a) Retrospectively to each period presented in the financial statements in accordance with the guidance on accounting changes in paragraphs 250-10-45-5 through 45-10 [IAS 8.23 through .27 and .50 through .53],[3] subject to certain expedients ("full retrospective approach").

(b) Retrospectively only to the most current period presented in the financial statements, with the cumulative effect of initially applying the new revenue standard recognized as an adjustment to the opening balance of retained earnings at the date of initial application ("modified retrospective approach").

3. Paragraph 606-10-65-1(f) [C5] includes the following practical expedients that may be used by an entity electing the full retrospective approach:

(a) For completed contracts,[4] an entity need not restate contracts that begin and end within the same annual reporting period.

(b) For completed contracts that have variable consideration, an entity may use the transaction price at the date the contract was completed rather than estimating variable consideration amounts in the comparative reporting periods.

(c) For all reporting periods presented before the date of initial application, an entity need not disclose the amount of the transaction price allocated to the remaining performance obligations and an explanation of when the entity expects to recognize that amount as revenue.

4. An entity using the full retrospective approach is permitted to apply none, some or all of the expedients in paragraph 606-10-65-1(f) [C5]. However, paragraph 606-10-65-1(g) [C6] requires that any expedients used by an entity be applied

[3] Paragraph 250-10-45-5 [IAS 8.23] states that an entity shall report a change in accounting principle through retrospective application of the new accounting principle to all prior periods, unless it is impracticable to do so. Paragraphs 250-10-45-6 through 45-7 [IAS 8.3 through .4] provide guidance about the accounting in the event it is impracticable to apply an accounting standard retrospectively. That guidance essentially states that if it is impracticable to apply an accounting principle retrospectively to all prior periods, an entity should apply the new accounting principle as of the earliest date practicable.

[4] Paragraph 606-10-65-1(c) [C2] states that a completed contract is a contract for which an entity has transferred all of the goods or services identified in accordance with revenue guidance that is in effect before the date of initial application.

consistently to all contracts within all reporting periods presented. In addition, an entity is required to disclose the following:

(a) The expedients that have been used

(b) To the extent reasonably possible, a qualitative assessment of the estimated effect of applying each of those expedients.

5. Paragraph 606-10-65-1(h) [C7] requires an entity using the modified retrospective approach to apply the new revenue standard to contracts that are in progress at the date of initial application, with an adjustment to opening retained earnings, as necessary. That is, contracts that are not completed before the date of initial application will have to be evaluated as if the entity had applied the new standard to those arrangements since inception of the arrangement.

Contract Modifications

6. Paragraph 606-10-25-10 [18] states that a contract modification is a change in the scope or price (or both) of a contract that is approved by the parties to the contract. A contract modification exists when the parties to a contract approve a modification that either creates new or changes existing enforceable rights and obligations of the parties to the contract. A contract modification could be approved in writing, by oral agreement, or implied by customary business practices.

7. An entity might be required to account for a contract modification prior to finalization of the modification. Paragraph 606-10-25-11 [19] states that a contract modification might exist even though the parties to the contract have a dispute about the scope or price (or both) of the modification or the parties have approved a change in the scope of the contract but have not yet determined the corresponding change in price. In determining whether the rights and obligations that are created or changed by a modification are enforceable, an entity shall consider all relevant facts and circumstances including the terms of the contract and other evidence. If the parties to a contract have approved a change in the scope of the contract but have not yet determined the corresponding change in price, an entity shall estimate the change to the transaction price arising from the modification.

8. Paragraph 606-10-25-12 [20] requires that an entity account for a contract modification as a separate contract if both of the following conditions are present:

    (a) The scope of the contract increases because of the addition of promised goods or services that are distinct.

    (b) The price of the contract increases by an amount of consideration that reflects the entity's standalone selling prices of the additional promised goods or services and any appropriate adjustments to reflect the circumstances of the particular contract.

9. If a contract modification is not accounted for as a separate contract, paragraph 606-10-25-13 [21] requires an entity to account for the promised goods or services that are not yet transferred at the date of the modification (that is, the remaining promised goods or services) in whichever of the following ways is applicable:

    (a) If the remaining goods and services after the contract modification are distinct from the goods or services transferred on or before the contract modification, an entity shall account for the modification as if it were the termination of the old contract and the creation of a new contract. Revenue recognized to date on the original contract is not adjusted. Rather, the remaining portion of the original contract and the modification are accounted for together on a prospective basis by allocating the remaining consideration to the remaining performance obligations.

    (b) If the remaining goods and services to be provided after the contract modification are not distinct from those goods and services already provided and, therefore, form part of a single performance obligation that is partially satisfied at the date of modification, the entity should account for the contract modification as if it were part of the original contract. Revenue previously recognized is adjusted, either up or down, to reflect the effect that the contract modification has on the transaction price and the measure of progress (that is, the revenue adjustment is made on a cumulative catch-up basis).

(c) A change in a contract also might be treated as a combination of items (a) and (b). The accounting for completed performance obligations that are distinct from the modified goods or services is not adjusted. However, the revenue previously recognized is adjusted, either up or down, to reflect the effect of the contract modification on the estimated transaction price allocated to performance obligations that are not distinct from the modified portion of the contract and the measure of progress.

Potential Practical Challenges

10. Some entities have a significant volume of customer contracts that are frequently modified. For example, the staff is aware of some entities that have millions of customer contracts that are frequently modified. The duration of those contracts varies, but in some cases those contracts span decades. Some stakeholders think that an evaluation of contract modifications taking place prior to the date of initial adoption might be challenging, regardless of the transition method selected. Some stakeholders also think it is unclear whether such challenges would render retrospective application of the contract modification guidance as impracticable (as that term is used in Topic 250 [IAS 8]) in certain circumstances.

11. Further, some stakeholders question the usefulness of the information provided by applying the contract modification guidance to periods prior to the date of initial application. Those stakeholders think the cost of providing such information is not justified by its benefits.

12. Consequently, some stakeholders have requested that the Boards consider adding a practical expedient or expedients about contract modifications to the new revenue standard.

Questions for the TRG Members
1. Do you believe a practical expedient (and disclosure about use of that practical expedient) should be provided to address some of the potential challenges (and cost) that an entity might face when applying the guidance for contract modifications prior to the date of initial adoption? 2. Is there a specific practical expedient that you believe should be provided? 3. Are you aware of any significant disadvantages or unintended consequences that may result from use of that practical expedient?