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Project	Revenue Recognition		
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Purpose

1. This paper considers possible improvements and clarifications to the requirements for contract modifications that were proposed in paragraphs 18 – 22 of the revised Exposure Draft *Revenue from Contracts with Customers* (the ‘2011 ED’).

Staff recommendations

2. The staff recommends that the Boards refine the proposed requirements for accounting for contract modifications as follows:
 - (a) *Clarify the proposed requirements for recognizing revenue from contract claims:* Clarify the requirements by including an illustrative example.
 - (b) *Remove paragraph 20 from the 2011 ED:* This will eliminate the difference in accounting between contract modifications that result only in a change in price and contract modifications that result in a change in the scope and price where the remaining goods or services are distinct.
 - (c) *Clarify the interaction of paragraph 22(a) with contract assets:* Clarify that the transaction price available for allocation should be “...the

amount of consideration received from the customer but not yet recognized as revenue plus the amount of any remaining consideration that the customer has promised to pay and that has not been recognized as revenue”.

- (d) *Clarify the interaction of paragraph 22(a) with variable consideration:* Clarify that modifications that fall into paragraph 22(a) should generally be accounted for prospectively, but any changes in variable consideration should be accounted for on a cumulative catch-up basis if the variable component of the transaction price relates to satisfied performance obligations.

Structure of the paper

3. The remainder of this paper is organized into the following sections:
- (a) Background (paragraphs 4-8);
 - (b) Summary of respondent feedback (paragraphs 9-12);
 - (c) Unpriced change orders and contract claims (paragraphs 13-23);
 - (d) Suggested improvements and clarifications to the proposals (paragraphs 24-48)
 - (i) Accounting for modifications that affect only price (paragraphs 24-28);
 - (ii) Application of paragraph 22(a) to modifications with variable consideration and contract assets (paragraphs 29-41); and
 - (iii) Other drafting improvements to address confusion in applying paragraph 22 (paragraphs 42-48).
 - (e) Appendix A – Summary of proposed changes

Background

4. In some types of contracts with customers, it is common for the parties to the contract to subsequently agree to change their respective rights and obligations in the contract. Those changes to the contract may be described as contract modifications, change orders, variations and amendments. In the proposed revenue model, those changes are described generally as contract modifications. As the revenue model has developed, the Boards have proposed different approaches to account for contract modifications. However, each approach has been developed with the overall objective of faithfully depicting an entity's rights and obligations in the modified contract. To faithfully depict the rights and obligations arising from the modified contract, the Boards acknowledged that some modifications should be accounted for prospectively, while other modifications should be accounted for on a cumulative catch-up basis.

The 2010 ED proposals for contract modifications

5. The 2010 ED proposed to distinguish between modifications by assessing whether the prices of the modification and the existing contract are interdependent. If the prices were interdependent, an entity would account for the modification as part of the existing contract and recognize revenue on a cumulative catch-up basis. If the prices were independent, an entity would account for the modification as a separate contract. Many respondents to the 2010 ED suggested that the principle of 'price interdependence' was too broad and would result in an entity accounting for too many contract modifications on a cumulative catch-up basis. This is because there might be a price interdependence between the modification and the existing contract but the modification relates only to the remaining performance obligations in the contract.

The 2011 ED proposals for contract modifications

6. In the 2011 ED, the Boards responded to those concerns by instead proposing that the accounting for a contract modification should depend on whether the modification affects the price and/or scope of a contract.
7. In summary, the 2011 ED proposed that an entity should account for a contract modification as:
 - (a) a change in the transaction price (which would involve reallocating the change in the transaction price to both satisfied and unsatisfied performance obligations) if the contract modification results only in a change in price (refer paragraph 20 of the 2011 ED);
 - (b) a separate contract if the contract modification results in the addition of distinct goods or services at their standalone selling price (paragraph 21 of the 2011 ED);
 - (c) for all other modifications:
 - (i) as the termination of the original contract and creation of a new contract if the remaining goods or services in the modified contract are distinct from the goods or services already transferred to the customer at the date of the contract modification (refer paragraph 22(a) of the 2011 ED)
 - (ii) as an amendment to the original contract if the remaining goods or services in the modified contract are not distinct and are part of a single performance obligation that is partially satisfied at the date of the contract modification (refer paragraph 22(b) of the 2011 ED). In that case, the entity would account for the modification on a cumulative catch-up basis by updating the measure of progress towards complete satisfaction of the performance obligation.
8. The proposed requirements in the 2011 ED for contract modifications are reproduced in Appendix A.

Summary of feedback

9. Although the Boards did not specifically ask a question on the proposed requirements for contract modifications, many respondents commented on the proposals, including accounting firms and preparers from the following industries:
- (a) Aerospace and defense;
 - (b) Engineering and construction;
 - (c) Professional services;
 - (d) Software; and
 - (e) Telecommunications.
10. Generally, respondents indicated that the proposed requirements for contract modifications are substantially improved from the 2010 ED. In particular, many think that it more appropriately distinguishes between contract modifications that should be accounted for prospectively rather than with a cumulative catch-up adjustment. However, many respondents think that the guidance is complex and difficult to understand.
11. The specific feedback from those respondents concentrated on the following topics:
- (a) The application of the proposals to what US GAAP describes as unpriced change orders (i.e. modification in which the change in scope is approved but the corresponding change in price is still to be negotiated) and contract claims (specifically those modifications in which the changes in scope and price are unapproved or in dispute);
 - (b) Suggested improvements or clarifications to the proposals, specifically relating to:
 - (i) accounting for modifications that affect only price (paragraph 20);
 - (ii) application of paragraph 22(a) to situations with variable consideration and contract assets; and

- (iii) other drafting improvements to address confusion in applying paragraph 22.

12. These issues are analyzed in the sections below.

Unpriced change orders and contract claims

13. Existing standards on construction contract accounting (ie IAS 11 *Construction Contracts* and Topic 605-35 *Construction-Type and Production-Type Contracts*) have specific guidance on accounting for various types of contract modifications. The feedback from respondents in the construction and production industry was focused on the accounting for modifications that are commonly described in US GAAP as:

- (a) unpriced change orders in which the change in scope is approved but the corresponding change in price is still to be negotiated; and
- (b) contract claims in which the entity is seeking additional consideration from the customer because of factors such as customer-caused delays, errors in specifications and designs, contract terminations changes orders in dispute or unapproved as to both scope and price.

14. The 2011 ED does not use those descriptions in specifying how an entity should account for a contract modification; however, paragraph 19 of the 2011 ED applies to situations that are similar to the unpriced change order fact patterns most commonly raised by respondents. Paragraph 19 states:

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 apply the proposed revenue guidance to the modified contract when the entity has an expectation that the price of the modification will be approved. To estimate the transaction price in such cases, an entity shall apply the proposed guidance in paragraphs 50 – 67.

15. Respondents generally agreed with the proposal in paragraph 19 of the 2011 ED. However, by including a proposed requirement that would apply to unpriced change orders, several respondents queried whether the 2011 ED had omitted requirements for accounting for contract claims—particularly, for changes for which both the scope and price are unapproved or are in dispute.
16. Those respondents commented that contracts are often modified without approval in industries in which many contracts are long-term in nature and/or entities contract to construct or develop an asset that is transferred to the customer as progress is made. In those arrangements, the parties to the contract generally understand that modifications will occur and that it would be counterproductive to seek approval each time. The respondents were concerned that paragraph 18 of the 2011 ED would not permit those contract claims to be accounted for as a contract modification until the claims are formally approved. Paragraph 18 states:
- A contract modification exists when the parties to a contract approve a change in the scope or price of a contract (or both). If a contract modification has not been approved by the parties to a contract, an entity shall continue to apply the proposed revenue guidance to the existing contract until the contract modification is approved.
17. Consequently, those respondents were concerned that the proposals would change current practice in accounting for contract claims (and for some variations). For that reason, they suggested that the Boards should incorporate the existing contract claims requirements from Topic 605-35 and IAS 11 into the revenue standard.

Staff analysis

18. Although the contract modifications proposals in the 2011 ED do not specifically refer to contract claims, an entity should apply the requirements of the proposed model to account for a contract claim. As explained in paragraph 18 of the 2011 ED, an entity would need to assess whether the claim has been approved by the

parties. A contract claim that has been approved by the parties is accounted for as a contract modification because the approved claim creates or modifies each party's enforceable rights and obligations under the modified contract. In contrast, an unapproved contract claim (ie an unapproved change in scope and price) does not change each party's enforceable rights and obligations and, as a result, would not be a contract modification that is within the scope of the proposed standard.

19. In identifying whether a contract claim has been approved and creates (or modifies) the parties' enforceable rights and obligations, the staff notes that the approval of the claim need not be in writing. Paragraph 13 of the 2011 ED, which relates to identifying the contract in step 1 of applying the model, states that "Enforceability is a matter of law [and that] contracts can be written, oral, or implied by an entity's customary business practices". For contract claims, an entity must assess whether the claim is enforceable in those circumstances when it has not yet been formally approved. In some cases, the staff expects that the original contract might already provide a legal basis for the enforceability of the claim, such as a claim for additional consideration arising from a customer-caused delay or an error in design or specification. In other cases, a claim may only be enforceable if there is evidence that the customer has approved the claim. The staff thinks that, similar to paragraph 13 of the 2011 ED, the customer equally could approve the claim implicitly by their actions or customary business practices. If that approval has been implicitly provided by the customer, the contract claim would be accounted for on the same basis as paragraph 19 of the 2011 ED (which applies if the parties to the contract have agreed the change in scope but have not yet determined the corresponding change in price).
20. However, if the claim has not been approved implicitly by the customer's actions or customary business practices, the entity would be unable to enforce that claim against the customer. Similarly, if the parties to the contract are in dispute over the scope and/or price of a change to the contract and that dispute affects the enforceability of the entity's rights under the contract, the staff think the contract claim should not be accounted for as a contract modification. In either of those

situations, the entity does not have the right to recognize revenue from the claim until the entity obtains the customer's approval.

21. The staff acknowledges that applying the proposed model to contract claims might result in a change in practice for those types of claims that do not create or modify the parties' enforceable rights or obligations in the contract. However, the staff thinks that the extent of the change in practice might not be significant because the existing requirements for accounting for contract claims in Topic 605-35 specify that, among other things, an entity must have evidence that indicates that the claim has a legal basis in order for the entity to recognize additional amount of contract revenue relating to the claims. Paragraph 605-35-25-31 states:

Recognition of amounts of additional contract revenue relating to claims is appropriate only if it is probable that the claim will result in additional contract revenue and if the amount can be reliably estimated. Those two requirements are satisfied by the existence of all of the following conditions:

- a. The contract or other evidence provides a legal basis for the claim; or a legal opinion has been obtained, stating that under the circumstances there is a reasonable basis to support the claim.
- b. Additional costs are caused by circumstances that were unforeseen at the contract date and are not the result of deficiencies in the contractor's performance.
- c. Costs associated with the claim are identifiable or otherwise determinable and are reasonable in view of the work performed.
- d. The evidence supporting the claim is objective and verifiable, not based on management's feel for the situation or on unsupported representations.

If the foregoing requirements are met, revenue from a claim should be recorded only to the extent that contract costs relating to the claim have been incurred. Costs attributable to claims should be treated as costs of contract performance as incurred. However, a practice such as recording revenues from claims only when the amounts have been received or awarded may be used.

Staff recommendation

22. The staff recommends that the proposed requirements for contract modifications should not be revised to explicitly refer to the accounting for contract claims. The existing accounting requirements for contract claims apply to a subset of contracts with customers—specifically, construction-type and production-type contracts. Instead of introducing industry-specific terminology and requirements in accounting for contract modifications, the staff recommends that the accounting for contract claims should be based on whether the claim creates or modifies the rights and obligations of the parties to the contract. If the claim is enforceable but the price of the claim is subject to further negotiation, an entity should account for the claim in accordance with paragraph 19 of the 2011 ED. The staff suggest including an illustrative example that addresses these types of modifications.

Question 1 – Contract claims

Do the Boards agree with the staff's recommendation to:

- (a) not amend the requirements for contract modifications to provide additional prescriptive guidance for contract claims; and
- (b) include an illustrative example that addresses these types of contracts modifications.

Applying the constraint to unpriced change orders

23. Paragraph 19 of the 2011 ED proposes that, if the parties to the contract have agreed to a change in scope but have not yet determined the corresponding change in price, an entity should account for that contract modification when there is an expectation that the price of the modification will be approved. Some respondents requested guidance on determining when an entity would have that expectation and whether the entity would need to evaluate whether it has predictive experience to estimate the price of the modification to which the entity expects to be entitled (in accordance with paragraph 81 of the 2011 ED). The staff notes that the constraint in paragraphs 81-85 of the 2011 ED would apply to the estimates of the price of the modification. This was acknowledged in paragraph BC61 of the 2011 ED, but was not explicitly stated in the contract modifications proposals. The staff recommend clarifying in the revenue standard that these unpriced change orders would be a form of variable consideration once the entity has the expectation of approval of the price and, therefore, that the constraint would apply to those estimates.

Suggested improvements and clarifications to the proposals

Accounting for modifications that affect only price (paragraph 20 of the 2011 ED)

24. Paragraph 20 of the 2011 ED proposes that, if a contract modification results only in a change to the price of the modified contract, an entity should account for that modification as a change in the transaction price in accordance with paragraphs 77-80 of the 2011 ED. The change in the transaction price arising from the modification would typically be allocated to all performance obligations in the contract, including any performance obligations that have already been satisfied (as per paragraph 78 of the 2011 ED). As a consequence, contract modifications that affect only price would be accounted for on a cumulative catch-up basis.
25. However, a few respondents contrasted the proposed accounting for modifications that affect only price (which would be accounted for on a cumulative catch-up

basis) with modifications that affect scope and price and that would be accounted for prospectively if the following criteria proposed in paragraph 22(a) of the 2011 ED are met:

- (a) The additional goods or services promised in the modification are distinct;
- (b) The price of the modification does not equate to the standalone selling prices of those additional goods or services; and
- (c) The remaining goods or services in the modified contract are distinct from the goods or services that were transferred to the customer prior to the modification.

26. Those respondents were concerned that the difference in accounting outcomes creates an inconsistency in accounting for contract modifications that is unnecessary and could be prone to manipulation. For instance, in commenting on that inconsistency, one respondent stated:

With one exception, we support the proposed approach to contract modifications. The exception is the requirement in paragraph 20, which states that when the only modification to the contract is a change in transaction price, this should be accounted for retrospectively (by reference to paragraphs 77 – 80). We would agree with this where the remaining goods or services are not distinct and are part of a single performance obligation that is partially satisfied at the date of modification. But where the remaining goods or services are distinct, this creates a 'bright line' difference with other contract modifications: e.g. if, as well as a change in transaction price, the entity supplies one extra good or service, however small, this will result in the contract modification being accounted for prospectively from the date of modification (by reference to the guidance in paragraph 22). We believe it would be appropriate to apply a consistent treatment to all contract modifications in accordance with the guidance set out in paragraph 22,

including where the only modification to the contract is a change in transaction price. (CL#75 Deloitte)

Staff analysis and recommendation

27. Although paragraph 20 of the 2011 ED proposed a consistent approach to accounting for changes in the transaction price regardless of whether the change arose from variable consideration or from a contract modification that changed only the price, the staff think that, for the reasons identified by respondents, it is more important for the revenue standard to specify a consistent basis for accounting for contract modifications. Furthermore, the staff note that the change in transaction price arising from variable consideration and from contract modifications are the result of different economic events—a change in the estimate of variable consideration arises from the change in a variable that was identified and agreed at contract inception whereas a change in price arising from a contract modification arises from a separate and subsequent negotiation between the parties to the contract.
28. The staff recommends that the revenue standard should not include the proposal to account for modifications that affect only price on a cumulative catch-up basis (as proposed in paragraph 20 of 2011 ED). Deleting paragraph 20 will eliminate the bright line difference between accounting for changes in transaction price and changes in scope and price where the remaining goods or services are distinct. Instead, the staff recommends that an entity should account for modifications that affect only price on the same basis as any other modification—that is, in accordance with paragraphs 21 and 22 of the 2011 ED.

Question 2 – Accounting for modifications that affect only price (paragraph 20)

Do the Boards agree with the staff's recommendation to remove paragraph 20 from the proposed requirements?

Application of paragraph 22(a) to modifications with variable consideration and contract assets

29. Paragraph 22(a) of the 2011 ED states that when the remaining goods or services in the contract are distinct, an entity should account for the modification prospectively. As such, an entity would allocate consideration only to those remaining performance obligations that are not satisfied at the modification date.

Paragraph 22(a) states:

If the remaining goods or services are distinct from the goods or services transferred on or before the date of the contract modification, then the entity shall allocate to the remaining separate performance obligations the amount of consideration received from the customer but not yet recognized as revenue plus the amount of any remaining consideration that the customer has promised to pay. In effect, an entity shall account for the contract modification as a termination of the original contract and the creation of a new contract.

30. Paragraph 22(a) specifies how an entity should determine the amount of the transaction price that should be allocated to the remaining performance obligations in the modified contract. However, some respondents to the 2011 ED requested clarification on how an entity should allocate the transaction price if, prior to the modification, either of the following events occurred:

- (a) The entity had recognized a contract asset; or
- (b) The consideration promised by the customer included amounts of variable consideration, which may or may not have been constrained the date of the modification.

Contract assets

31. As stated in paragraph 22(a), the amount of the transaction price to be allocated to the remaining performance obligation is the sum of the following amounts:

- (a) the amount of consideration received from the customer but not yet recognized as revenue (this amount would be recognised as a contract liability); and
 - (b) the amount of any remaining consideration that the customer has promised to pay.
32. Some respondents identified an error in this calculation of the transaction price available for allocation because no adjustment is proposed for promised amounts of consideration already allocated to performance obligations that have been satisfied and recognized as revenue. Those amounts would be recognized as contract assets (or as receivables). Without deducting (a) promised amounts of consideration that have already been recognized from (b) the transaction price that is available for allocation to the remaining performance obligations as revenue, the amount of transaction price could be recognized as revenue twice.
33. The staff recommend correcting this drafting error by stating in paragraph 22(a) that the transaction price available for allocation should be "...the amount of consideration received from the customer but not yet recognized as revenue plus the amount of any remaining consideration that the customer has promised to pay and that has not been recognized as revenue".

Question 3 – Interaction of paragraph 22(a) with contract assets

Do the Boards agree with the staff's recommendation to clarify that the transaction price available for allocation should be "...the amount of consideration received from the customer but not yet recognized as revenue plus the amount of any remaining consideration that the customer has promised to pay and that has not been recognized as revenue"?

Variable consideration

34. The prospective application of paragraph 22(a) is clear when the consideration for all performance obligations is fixed. However, some respondents noted that it is unclear how paragraph 22(a) would apply when the transaction price allocated to some or all of the satisfied performance obligations includes variable

consideration. Respondents requested that the Boards clarify whether the change in variable consideration should be accounted for prospectively (as paragraph 22(a) would require) or on a cumulative catch-up basis (as paragraphs 77–80 would require for changes in the transaction price generally). For instance, one respondent explained that clarification was needed because:

...before the contract modification, changes in variable consideration would be allocated to satisfied and unsatisfied performance obligations (in accordance with paragraphs 77-80). However, once the modification occurs, it appears from paragraphs 22(a) and (c) that future changes in variable consideration would be allocated only to performance obligations that were not satisfied at the modification date. This appears to be the case even if the variable consideration originally was determined to relate to all performance obligations, including those that are fully satisfied at the modification date. We believe it would be helpful to provide an example of the application of paragraphs 22(a) and (c) to arrangements that contain variable consideration. (CL#77 Ernst & Young)

Staff analysis

35. In order to illustrate how an entity should account for contract modifications within the scope of paragraph 22(a) that include variable consideration, consider the following:

Scenario A—prior to the modification, the revenue that had been recognised for satisfied performance obligations included amounts of variable consideration and, subsequent to the modification, the estimate of the variable consideration changed.

36. Scenario A is intended to describe contracts in which there are subsequent changes in the transaction price because of changes in the estimate of the variable consideration. This change in the estimate of the variable consideration is

assumed to arise for reasons that are unrelated to the modification to the scope or price of the contract. The following example illustrates a scenario A contract modification.

Example 1 – Scenario A contract modification

On 1 July 20X0, an entity promises to transfer two identical goods to a customer—good X transfers to the customer at contract inception and good Y transfers on 30 June 20X1. The consideration promised by the customer includes fixed consideration of CU1,000 and variable consideration that is estimated to be CU200 (and which is allocated to goods X and Y equally).

The entity recognises revenue of CU600 when good X transfers to the customer (comprising an allocation of CU500 of fixed consideration and CU100 of variable consideration).

On 30 November 20X0, the scope of the contract is modified to include the promise to transfer good Z (in addition to good Y) to the customer on 30 June 20X1 and the price of the contract is increased by CU300 (which does not represent the standalone selling price of good Z).

At the reporting date of 31 December 20X0, the estimate of the variable consideration to which the entity is entitled is CU240 (rather than the previous estimate of CU200).

37. If there was no contract modification in this example, the entity would allocate the change in the estimate of the variable consideration to the performance obligation for good X and the performance obligation for good Y. As a result, the entity would recognise revenue of CU20, which is the amount of the change in the estimate of the transaction price that is attributable to the satisfied performance obligation for good X. The staff thinks that, in accounting for the modification to a Scenario A contract, the change in the estimate of the transaction price should be allocated to both satisfied and unsatisfied performance obligation (as paragraphs 77–80 of the 2011 ED would require for changes in the transaction price generally) rather than reallocating that amount to the remaining separate performance obligations in the modified contract (ie for good Y and good Z), as is proposed by paragraph 22(a) of the 2011 ED. The staff consider that this outcome

is appropriate because the promised variable consideration and the resolution of the uncertainty associated with that amount of variable consideration is not affected by the contract modification.

38. The staff thinks that the conclusion in Scenario A would also apply to circumstances in which prior to a modification, some revenue was constrained and, subsequent to the modification, the uncertainty associated with the variable consideration has been resolved and the amount of revenue is no longer constrained.
39. Other fact patterns may occur where the modification changes the terms of the promised variable consideration (among other things). For example, the modification might change the amount or eligibility criteria for a performance bonus. In those cases, the staff thinks that an entity would need to assess the effect that the modification has on the entity's entitlement to variable consideration in the original contract. That is, an entity should assess whether any of the variable consideration in the modified contract should be viewed as unsettled consideration relating to performance obligations that were satisfied prior to the modification.
40. The staff think that there are a multitude of fact patterns that increase the complexity of the analysis by combining modifications (including changes in scope, price or both) and the settlement of variable consideration. Furthermore, the staff think that the Boards cannot anticipate all combinations of modifications and changes in transaction price and provide guidance. Overall, the staff think that entities should evaluate the facts and circumstances associated with the modification to determine the accurate depiction of the entity's performance to date and consider, in addition to the contract modifications requirements in paragraphs 18-22, other aspects of the model including:
- (a) Allocation of transaction price, in particular the requirements in paragraph 75 (allocating discounts) and paragraph 76 (allocating contingent consideration)
 - (b) Changes in transaction price – paragraphs 77 – 80

Staff recommendation

41. The staff recommends the Boards clarify that, under paragraph 22(a), modifications should generally be accounted for prospectively, but consistent with the requirements in paragraphs 77-80 changes in estimates of variable consideration would be accounted for on a cumulative catch-up basis if the variable component of the transaction price relates to satisfied performance obligations.

Question 4 – Interaction of paragraph 22(a) with variable consideration

Do the Boards agree with the staff's recommendation to clarify that modifications that fall into paragraph 22(a) should generally be accounted for prospectively, but consistent with the requirements in paragraphs 77-80 changes in estimates of variable consideration should be accounted for on a cumulative catch-up basis if the variable component of the transaction price relates to satisfied performance obligations?

Other drafting improvements to address confusion in applying paragraph 22

42. In the comment letters and during outreach, the staff became aware that many commentators were misinterpreting the contract modification requirements and, as a consequence, raising concerns that the proposals seemed to be requiring too many contract modifications to be accounted for on a cumulative catch up basis in accordance with paragraph 22(b) of the 2011 ED. Those misinterpretations appear to have arisen because of confusion about the relationship between the assessment of whether a good or service is 'distinct' and the identification of a 'single performance obligations'.
43. Paragraphs 22(a) and 22(b) of the 2011 ED use the notions of 'distinct' and 'single performance obligation' to determine whether a contract modification should be accounted for prospectively or on a cumulative catch-up basis.
44. For the modification to be accounted for prospectively (in effect, as the termination of the original contract and the creation of a new contract), paragraph

22(a) specifies that the remaining goods or services in the modified contract must be distinct from the goods or services transferred on or before the date of the modification. By focusing the criterion on whether the remaining goods or services are distinct from the goods or services already transferred to the customer, paragraph 22(a) will apply to those modifications in which the entity's performance in the contract to date is separate from its remaining performance (eg a repetitive service contract such as a cleaning contract). In those cases, the Boards concluded that accounting for the modification on a prospective basis is appropriate because, as noted in paragraph BC59 of the 2011 ED, "that approach avoids opening up the accounting for previously satisfied performance obligations and, thus, avoids any adjustments to revenue that has already been recognized".

45. For the modification to be accounted for on a cumulative catch-up basis, paragraph 22(b) specifies that the remaining goods or services in the modified contract are not distinct and are part of a single performance obligation that is partially satisfied at the date of the contract modification. The proposal that the remaining goods or services are not distinct and are part of a single performance obligation would be typically met for most construction contracts. In those cases in which the criteria in paragraph 22(b) are met, the Boards concluded that accounting for the modification on a cumulative catch-up basis is appropriate because, as noted in paragraph BC60 of the 2011 ED, the modification "would not typically result in the transfer of additional goods or services that are distinct from those promised in the existing contract and, accordingly, the modification affects the entity's measure of progress towards completion of the contract".
46. The staff think that one of the reasons for confusion about whether an entity should account for a contract modification in accordance with paragraph 22(a) or 22(b) is because of the practical expedient proposed in paragraph 30 of the 2011 ED, which states that "an entity may account for two or more distinct goods or services promised in a contract as a single performance obligation if those goods or services have the same pattern of transfer to the customer". Feedback from comment letters and outreach indicated that many commentators considered that this practical expedient intuitively would apply to many repetitive service

contracts and to some production contracts in which each unit of service or individual good would be distinct, but the promise to transfer those services or goods to the customer could be accounted for as a single performance obligation. Consequently, the staff think that those commentators incorrectly interpreted that those contract modifications would be within the scope of paragraph 22(b)—and therefore accounted for on a cumulative catch-up basis. That was not the intent of paragraph 22(b), because each unit of service or individual good would be distinct. Therefore, those contract modifications should be accounted for in accordance with paragraph 22(a)—on a prospective basis. As a consequence, this clarification on the application of paragraph 22 should ease the concerns raised by many of the respondents about the relevance and practical challenges of accounting for modification of a cumulative catch-up basis (especially respondents from the utilities and telecommunications industries that have large populations of relatively homogenous contracts).

47. The staff thinks that some of the confusion in interpreting paragraph 22 will subside as constituents become more familiar with the concepts of distinct goods or services and single performance obligations. To address that confusion, the staff suggests that the implementation guidance that accompanies the standard should include a flowchart to illustrate the decision points in assessing how to account for a contract modification.
48. Consequential changes will also need to be made to the contract modifications requirements as a result of the Boards' decisions in July 2012 to refine and clarify the requirements for identifying separate performance obligations. The staff thinks that the notions of distinct and single performance obligations remain relevant to specifying the accounting for contract modifications.

Appendix A

A1. The following table lists the proposed requirements from the 2011 Exposure Draft that relate to contract modifications and identifies which of those proposals might change as a result of the staff recommendations in this paper.

Proposals from the 2011 Exposure Draft	Anticipated change?
Contract modifications (see paragraph IG61)	
18 A contract modification exists when the parties to a contract approve a change in the scope or price of a contract (or both). If a contract modification has not been approved by the parties to a contract, an entity shall continue to apply the proposed revenue guidance to the existing contract until the contract modification is approved.	No material change is anticipated.
19 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 apply the proposed revenue guidance to the modified contract when the entity has an expectation that the price of the modification will be approved. To estimate the transaction price in such cases, an entity shall apply the proposed guidance in paragraphs 50 – 67.	No material change is anticipated.
20 If a contract modification results only in a change to the transaction price, an entity shall account for the modification as a change in the transaction price in accordance with paragraphs 77 – 80.	Staff recommends removing this paragraph – refer to paragraphs 27-28 of this paper.
21 An entity shall account for a contract modification as a separate contract if the contract modification results in the addition to the contract of both of the following: <ul style="list-style-type: none"> (a) Promised goods or services that are distinct in accordance with paragraphs 27 – 30. (b) An entity’s right to receive an amount of consideration that reflects the entity’s standalone selling price of the promised good(s) or service(s) and any appropriate adjustments to that price to reflect the circumstances of the particular contract. For example, an entity would adjust the standalone selling price for a discount that the customer receives because it is not necessary for the entity to incur the selling-related costs that it would incur when selling a similar good or service to a new customer. 	No material change is anticipated.

<p>22 For a contract modification that is not a separate contract in accordance with paragraph 21, an entity shall evaluate the remaining goods or services in the modified contract (that is, the promised goods or services not yet transferred at the date of the contract modification) and shall account for the modified contract in whichever of the following ways is applicable:</p> <p>(a) If the remaining goods or services are distinct from the goods or services transferred on or before the date of the contract modification, then the entity shall allocate to the remaining separate performance obligations the amount of consideration received from the customer but not yet recognized as revenue plus the amount of any remaining consideration that the customer has promised to pay. In effect, an entity shall account for the contract modification as a termination of the original contract and the creation of a new contract.</p> <p>(b) If the remaining goods or services are not distinct and are part of a single performance obligation that is partially satisfied at the date of the contract modification, then the entity shall update the transaction price and the measure of progress toward complete satisfaction of the performance obligation. The entity shall recognize the effect of the contract modification as revenue (or as a reduction of revenue) at the date of the contract modification on a cumulative catch-up basis. In effect, the entity shall account for the contract modification as if it were a part of the original contract.</p> <p>(c) If the remaining goods or services are a combination of items (a) and (b), then the entity shall allocate to the unsatisfied (including partially unsatisfied) separate performance obligations the amount of consideration received from the customer but not yet recognized as revenue plus the amount of any remaining consideration that the customer has promised to pay. For a performance obligation satisfied over time, an entity shall update the transaction price and the measure of progress toward complete satisfaction of the performance obligation. An entity shall not reallocate consideration to, and adjust the amount of revenue recognized for, separate performance obligations that are completely satisfied on or before the date of the contract modification.</p>	<p>The staff recommends amending paragraph 22(a) as discussed in paragraphs 29 – 41 of this paper.</p>
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