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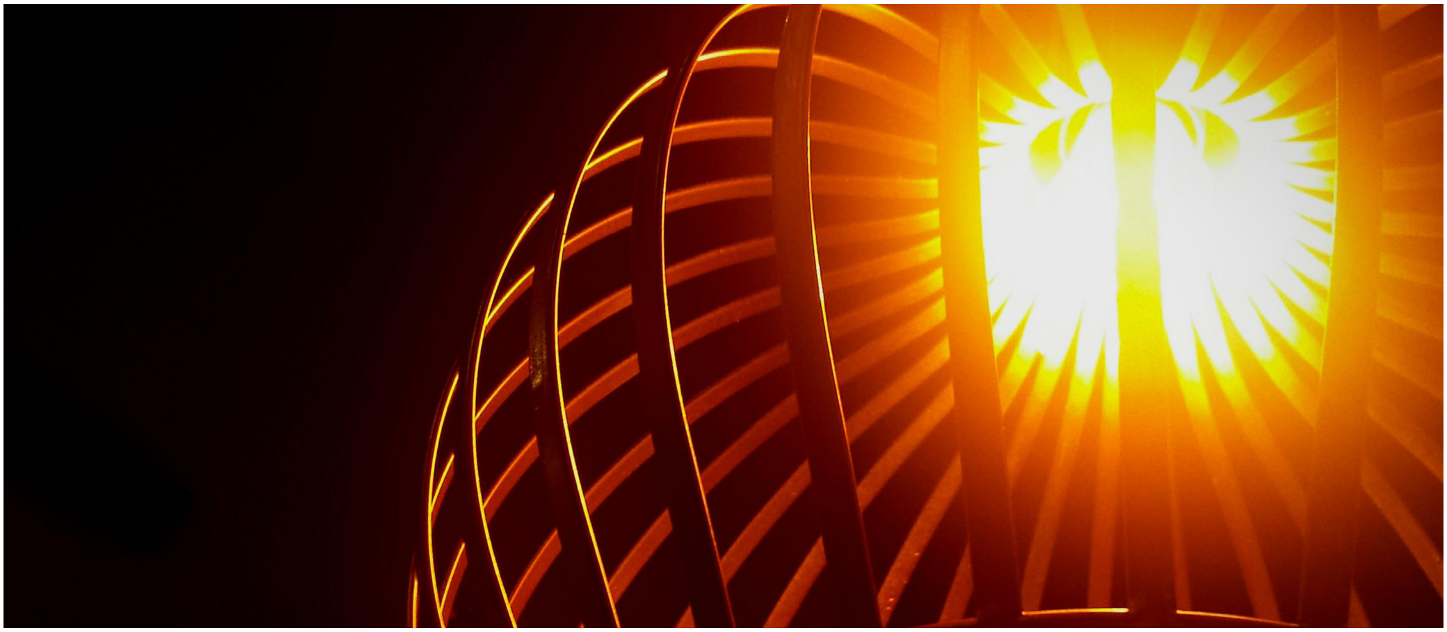
Accounting Spotlight
June 29, 2020



In This Issue

Revenue Recognition
Contract Modifications

Background

Did you know that under the new revenue standard (i.e., the guidance in ASU 2014-09,[1] as amended[2]), contract modifications may be one of the accounting considerations that require the most judgment? The purpose of the contract modification guidance in the new revenue standard is to provide a single framework that entities in all industries can consistently apply to account for changes to rights and obligations in contracts with customers.

Identifying a Contract Modification

Whenever an entity and its customer agree to change what the entity promises to deliver (i.e., the contract's scope) or the amount of consideration the customer will pay (i.e., the contractual price), there is a contract modification. ASC 606-10-25-10 notes that a contract modification exists if "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." Consequently, whenever the enforceable rights and obligations in a contract with a customer change, a contract modification is present and the modification framework should be applied.

Accounting for Contract Modifications

If a change in an entity's contract with a customer qualifies as a contract modification, the entity must assess the goods and services and their selling prices. Depending on whether

[1] FASB Accounting Standards Update (ASU) No. 2014-09, *Revenue From Contracts With Customers (Topic 606)*.

[2] For a list of final ASUs issued by the FASB to amend and clarify the guidance in ASU 2014-09, see Section 19.2.2 of Deloitte's *A Roadmap to Applying the New Revenue Recognition Standard*. The guidance in ASU 2014-09, as amended, is codified primarily in FASB Accounting Standards Codification (ASC) Topic 606, *Revenue From Contracts With Customers*, and Subtopic 340-40, *Other Assets and Deferred Costs — Contracts With Customers*.

those goods and services are distinct or sold at their stand-alone selling prices, a modification can be accounted for as:

- A separate contract.
- One of the following (if the modification is **not** accounted for as a separate contract):
  - A termination of the old contract and the creation of a new contract (with no adjustment to the historical accounting).
  - A cumulative catch-up adjustment to revenue under the original contract combined with the modification.
  - A combination of the two sub-bullet points above that faithfully reflects the economics of the transaction.

Contract Modification Accounted for as a Separate Contract

When an entity determines that its contract has been modified, it should first determine whether the modification should be accounted for as a separate contract. ASC 606-10-25-12 specifies that an entity should account for a contract modification as a separate contract if both of the following criteria are met:

- The modification adds **distinct** goods or services to the contract.
- The price of the contract increases by an amount equal to the **stand-alone selling prices** of the additional distinct goods or services.

When an entity accounts for a contract modification as a separate contract, the entity's accounting for the original contract is not affected by the modification. Any revenue recognized through the date of the modification is not adjusted, and remaining performance obligations will continue to be accounted for under the original contract. The new contract is accounted for separately from the original contract on a prospective basis.

A contract modification that changes only the price of the contract (and not the contract's scope) would not be accounted for as a separate contract because the modification does not add distinct goods or services to the contract. For example, a modification that only decreases the price a customer is obligated to pay for goods or services to be transferred in the future would not be accounted for as a separate contract.

Contract Modification Not Accounted for as a Separate Contract

If a contract modification does not meet the criteria in ASC 606-10-25-12 to be accounted for as a separate contract, the accounting for the contract modification depends on whether the remaining goods or services are **distinct** from the goods and services already transferred under the contract. It is important to note that to meet this condition, the remaining goods or services do not need to be accounted for as a performance obligation that is separate from the goods or services already delivered; the key factor is whether the remaining goods or services are distinct. Therefore, if a contract contains a single performance obligation that meets the criteria to be accounted for as a series under ASC 606-10-25-15, a modification to the contract could qualify for prospective accounting treatment because each good or service in the series is distinct.

Contract Modification Accounted for Prospectively

In accordance with ASC 606-10-25-13(a), if the remaining goods or services are distinct from the goods or services already provided under the original arrangement, the entity would in effect establish a "new" contract that includes only the remaining goods or services. In this situation, the entity would allocate the following to the remaining performance obligations in the contract:

- Consideration from the original contract that has not yet been recognized as revenue.
- Any additional consideration from the modification.

The entity would not typically reallocate consideration to goods or services that were transferred to the customer before the modification (see the Contract Modifications Versus Price Concessions section below). That is, the contract modification is accounted for prospectively.

Contract Modification Accounted for on a Cumulative Catch-Up Basis

In contrast to the guidance in ASC 606-10-25-13(a) on prospective contract modifications, the guidance in ASC 606-10-25-13(b) provides that if the remaining promised goods and services at the time of the contract modification are not distinct, the entity should account for the modification as though any additional goods and services were an addition to an incomplete performance obligation. This may be the case when the entity and its customer modify the terms of a construction-type contract (for which revenue is recognized over time) as the construction progresses to change certain requested features of the complex the entity is building for the customer and change the price accordingly. In this instance, the entity would update both the transaction price and the measure of progress after considering the enforceable rights and obligations under the modified contract. As a result of the modification, the entity would calculate an updated revenue amount on the basis of the revised contract and record a cumulative catch-up adjustment to revenue.

Combination of Contract Modification Types

There may be modified contracts in which some performance obligations include remaining goods or services that are distinct from the goods or services already provided under the original arrangement, but other performance obligations include remaining goods and services that are not (e.g., a change in scope of a partially satisfied performance obligation). In those circumstances, it may be appropriate for an entity to apply both the ASC 606-10-25-13(a) model and the ASC 606-10-25-13(b) model to a single contract, in the manner described in ASC 606-10-25-13(c).

Accounting for Contract Assets as Part of a Contract Modification

ASC 606 requires recognition of a contract asset in certain circumstances, such as when an entity has a contract with a customer for which revenue has been recognized (i.e., goods or services have been transferred to the customer), but customer payment is contingent on something other than the passage of time, such as the satisfaction of additional performance obligations. A contract asset may exist at the time of a contract modification. Upon a contract modification, existing contract assets should be carried forward to the new contract. That is, the contract assets should not be impaired or reversed unless (1) their impairment or reversal is otherwise required by ASC 310[3] (or ASC 326-20[4] once the guidance in ASU 2016-13,[5] as amended,[6] is adopted) or (2) the customer was provided with a price concession.

Contract Modifications Versus Price Concessions

While contract modifications often result in a change in the transaction price, not all changes in the transaction price should be accounted for as a contract modification. This is because a contract modification results in a *change* to enforceable rights and obligations in a contract.

[3] FASB Accounting Standards Codification Topic 310, *Receivables*.
[4] FASB Accounting Standards Codification Subtopic 326-20, *Financial Instruments — Credit Losses: Measured at Amortized Cost*.
[5] FASB Accounting Standards Update No. 2016-13, *Measurement of Credit Losses on Financial Instruments*.
[6] For a list of final ASUs issued by the FASB to amend and clarify the guidance in ASU 2016-13, see Section 10.2.1 of Deloitte's *A Roadmap to Accounting for Current Expected Credit Losses*.

Some changes in the transaction price may result from new information that confirms what could be enforced under an existing contract. This could be case when a price concession is granted for goods or services already delivered (even if the price concession is granted through a prospective price adjustment). When determining whether a price concession should be accounted for as a contract modification, an entity should consider whether the price concession is due to (1) the resolution of variability that existed at contract inception or (2) a modification that changes the parties' rights and obligations after contract inception. This distinction is important because the resolution of variability that existed at contract inception (even if not initially identified as a form of variable consideration) is accounted for in accordance with ASC 606-10-32-43 and 32-44, whereas ASC 606-10-32-45 states that changes in the transaction price that are related to a contract modification are accounted for in accordance with the contract modification guidance in ASC 606-10-25-10 through 25-13.

Price concessions may be provided solely as a result of current economic conditions. If such conditions did not exist at contract inception (e.g., an unexpected economic downturn), a price concession most likely represents a contract modification. However, if an entity's customer has a valid expectation that it could be entitled to a price concession (e.g., because of past business practices or statements made by the entity), the entity should consider whether a price concession ultimately granted should be accounted for as a change in the transaction price (related to variability that existed at contract inception) rather than as a contract modification. Accounting for the price concession as a contract modification would be appropriate if the price concession resulted from a *change* to the enforceable rights and obligations in the contract. This distinction may require significant professional judgment.

Examples of Contract Modifications and Price Concessions That May Arise in the Current Economic Environment

In light of the current economic downturn, an entity may negotiate various contract modifications or price concessions with its customers. Such contract modifications or price concessions may include the following:

- Extending the term of a contract to provide additional goods or services for no additional consideration (or at a significant discount).
- Extending payment terms (e.g., permitting a customer to pay within 90 days instead of the standard 30 days or 45 days).
- Granting price concessions because of service issues or general environmental factors.

The examples below illustrate various contract modifications and price concessions.

Example 1

Extending Contractual Terms and Providing Free Services

Pepper's Fit Friends ("Pepper"), the owner and operator of a health and fitness club in Chicago, enters into contracts with customers to provide one year of access to its club. Each customer has unlimited use of the club during the club's hours of operations and, in exchange, pays $1,200 at contract inception. The customer is not obligated to pay an ongoing monthly fee. Pepper determines that the nature of its performance obligation is to stand ready to provide the customer with access to its club on an as-needed basis throughout the year. Further, Pepper determines that its performance obligation is satisfied over time because the customer simultaneously receives and consumes the benefits of Pepper's performance as Pepper provides access to its club. Because Pepper's obligation is the same throughout the one-year contract, Pepper concludes that its performance obligation meets the criteria to be accounted for as a series under ASC 606-10-25-15. Pepper recognizes revenue on a straight-line basis over the one-year contract term (i.e., $100 per month).

Example 1 (continued)

Case A — Club Temporarily Closes Because of Unforeseen Circumstances

On January 1, 20X8, Pepper enters into a contract with Customer A to provide one year of access to its club in exchange for $1,200, an amount that is payable at contract inception. On April 1, 20X8, as a result of damage from a flood, Pepper is required to temporarily close its club to perform repairs. During this time, customers are unable to access or use the club. On July 1, 20X8, Pepper reopens its club. As a result of closing its club for three months, Pepper offers existing customers three additional months of access to its club (to be added to the end of the customers' current contracts) for no additional charge. Consequently, A's current membership is active through March 31, 20X9.

The extension of A's membership represents a contract modification because it changes the parties' enforceable rights and obligations under the contract. The contract modification is not accounted for as a separate contract in accordance with ASC 606-10-25-12 because the modification does not grant additional distinct goods or services at their stand-alone selling prices. Because Pepper's performance obligation is a series, the months of service remaining under the contract are distinct from the months of service already provided to the customer. Therefore, Pepper accounts for its contract modification prospectively in accordance with ASC 606-10-25-13(a).

Before closing its club on April 1, 20X8, Pepper recognized $300 of revenue for A's contract ($100 per month × 3 months). Because A is unable to access Pepper's club during the three months in which the club is closed, Pepper is not standing ready to provide access to its club during those three months. Consequently, Pepper is not performing under the contract during those three months and therefore should not recognize revenue from April 1, 20X8, through June 30, 20X8. The remaining $900 of revenue for A's contract should be recognized on a straight-line basis for the remainder of the contract beginning with Pepper's reopening of the club on July 1, 20X8. As a result, Pepper recognizes $100 of revenue per month from July 1, 20X8, through March 31, 20X9.

Case B — Club Remains Open, but Customer Elects Not to Use the Club

On January 1, 20X8, Pepper enters into a contract with Customer B to provide one year of access to its club in exchange for $1,200, an amount payable at contract inception. As a result of personal health and safety concerns, B chooses not to use the club from April 1, 20X8, through June 30, 20X8, and B notifies Pepper that it will not use the club over this period. During this time, the club remains open. Customer B's account is not frozen during this time (i.e., B is still contractually permitted to access the club). However, to maintain its relationship with B, Pepper offers B an additional three months of access to its club (to be added at the end of B's current contract) for no additional charge. This extension is negotiated and agreed to on June 1, 20X8. As a result, B's current membership is active through March 31, 20X9.

Like the membership extension in Case A, the extension of B's membership should not be accounted for as a separate contract in accordance with ASC 606-10-25-12 because the modification does not grant additional distinct goods or services at their stand-alone selling prices. Rather, the extension of B's membership represents a contract modification that should be accounted for prospectively in accordance with ASC 606-10-25-13(a). Before being notified that B would not be using the club for three months, Pepper recognized $300 of revenue for B's contract ($100 per month × 3 months). Although B is not using the club from April 1, 20X8, through June 30, 20X8, Pepper is still standing ready to provide B with access to its club during this time (i.e., Pepper's performance obligation for this period is unchanged). Because Pepper is still performing under the contract with B, it should continue to recognize revenue under the original contract until the modification (i.e., $100 per month). As a result of the June 1, 20X8, contract modification extending B's contract term by three months, Pepper should recognize $70 of revenue per month from June 1, 20X8, through March 31, 20X9 ($700 of revenue remaining ÷ 10 months of service remaining). In addition, Pepper may need to consider whether it has established a business practice of providing contract extensions that creates a valid expectation on the part of Pepper's other customers that they are entitled to an additional three months of access to the club. This could result in the provision of additional implied goods or services in other customer contracts and, therefore, additional contract modifications.

Example 2

Extending Payment Terms

Cherry Co. ("Cherry") sells kitchen appliances to customers. Control of each appliance is transferred to the customer at the point of shipment. Consequently, Cherry recognizes revenue at the point of shipment. Cherry's standard payment terms require customers to pay within 30 days of an appliance's shipment. Cherry elects the practical expedient in ASC 606-10-32-18, concluding that its contracts do not include a significant financing component because the timing between payment and performance (i.e., shipping the appliance) is one year or less. Therefore, Cherry is not required to adjust its transaction price, and thus revenue, for the time value of money.

As a result of an economic downturn, some of Cherry's customers are experiencing difficulty paying for appliances within 30 days as required under the standard payment terms. To help its customers, Cherry agrees to extend its standard payment terms from 30 days to 90 days for the foreseeable future. While this represents a form of a concession, Cherry is not conceding on the amount of consideration to which it expects to be entitled; rather, it is conceding on the timing of receiving the consideration.

Cherry concludes that it is still probable that Cherry will collect the consideration to which it is entitled for shipments to its customers. Although Cherry is providing customers with extended payment terms, Cherry determines that doing so does not create a significant financing component since the timing between payment and performance is still one year or less. Accordingly, Cherry does not adjust the amount of revenue recognized as a result of extending its payment terms from 30 days to 90 days.

However, Cherry should continue to monitor the timing of its customers' payments to ensure that payments are being received within 90 days of shipment. If a customer does not pay within the required 90-day period, Cherry should consider whether it is implicitly providing financing to its customer (which would require adjustment to the transaction price if Cherry expects to receive payment more than one year after shipment) or whether the contract consideration is not collectible.

Example 3

Granting Price Concessions

Albus Inc. ("Albus") provides lawn and gardening services to customers in Connecticut. Customers can choose from various packages, which require each customer to select the level of services it would like to receive over the six-month period from April 15 through October 15. The price paid will vary depending on the package the customer selects.

On March 26, Albus enters into a contract with Customer C to provide weekly lawn and gardening services from April 15 through October 15 (26 weeks) in exchange for $50 per week ($1,300 total). Because the number of services is predetermined in the contract, Albus determines that the nature of its obligation is to provide distinct weekly lawn and gardening services, as opposed to standing ready to provide the services throughout the contract term. Further, Albus determines that each of its performance obligations is satisfied over time because the customer simultaneously receives and consumes the benefits of Albus's performance as Albus performs by providing the lawn and gardening services. However, because each service is completed within a day, Albus elects to recognize the $50 weekly fee as revenue at the end of the day upon completion of the services.

Case A — Service-Level Issues

On July 15 (halfway through the contract), C issues a complaint to Albus about the services that Albus has provided to date. Specifically, C states that the fertilizer that Albus has been using harmed C's plants and did not stop the spread of the weeds. As a result of the complaint and to maintain its customer relationship with C, Albus agrees to reduce the weekly amount paid for the entire contract by $10 per week so that the services are priced at $40 per week ($1,040 total). The parties agree that Albus will continue to provide the same level of service for the remainder of the contract term (i.e., C acknowledges the Albus will continue to provide a lower level of services than what C originally expected). Albus concludes that the stand-alone selling price of the lower level of services is $40 per week. Although Albus is reducing the weekly service fee for the entire contract term, the parties agree that Albus will not refund C any amounts previously paid. Rather, the parties agree that C will pay a reduced weekly fee of $30 for the remainder of the contract term. The difference between the original transaction price of $1,300 and the amended transaction price of $1,040 ($260) represents a price concession.

Example 3 (continued)

Because of the prior service issues, Albus concludes that it did not perform as promised under the original contract. Accordingly, Albus concludes that the change in the transaction price does not result from a change in the enforceable rights and obligations under the contract. This is because Albus concludes that it could not enforce its right to $50 per week because of the service issues. The price concession does not represent a change in the parties' enforceable rights and obligations; rather, it represents a change in the transaction price. Thus, Albus should account for the price concession as a change in the transaction price in accordance with ASC 606-10-32-43 and 32-44 rather than as a contract modification in accordance with ASC 606-10-25-12 and 25-13.

Albus recalculates its total transaction price and recognizes a cumulative adjustment to revenue on the date of the price concession, which is calculated as follows:

Updated total transaction price:	$	1,040
Updated weekly revenue:	$	40
Updated revenue as of July 15:	$	520*
Revenue recognized before July 15:	$	650**
Cumulative adjustment recognized on July 15:	$	(130)***

* $40 per week × 13 weeks.

** $50 per week × 13 weeks.

*** $520 − $650.

Because the parties agree that Albus is not required to refund amounts previously paid (rather, C will pay $30 per week for the remaining contract term), the $130 reversal of revenue will result in the recording of a contract liability. The contract liability will be reduced as Albus transfers services to C over the remaining contract term. As a result, Albus will recognize revenue of $40 per week.

Case B — Goodwill Concession

On August 15, C requests a price concession from Albus on the grounds of financial hardship. To maintain its relationship with C, Albus agrees to accept a reduced weekly fee of $25 from C for the remainder of the contract term. Unlike the price concession in Case A, Albus's concession in this case represents a contract modification because it changes the enforceable rights and obligations of the parties to the contract (i.e., instead of being related to variability that existed at contract inception, the concession was negotiated as a result of changes in facts and circumstances related to Albus's customer after contract inception). Accordingly, Albus considers the guidance in ASC 606-10-25-12 and 25-13 to account for the modification. Because the modification is only a change in the transaction price, it should not be accounted for as a separate contract under ASC 606-10-25-12 (i.e., the modification does not add any promised goods or services). Therefore, Albus applies the guidance in ASC 606-10-25-13 to account for the modification. Since the lawn and gardening services remaining are distinct from the services already provided to C, Albus accounts for the modification prospectively in accordance with ASC 606-10-25-13(a). As a result, Albus does not adjust revenue previously recognized; rather, it recognizes the reduced $25 per week fee as revenue on a prospective basis.

Where to Find Additional Information

For more in-depth discussion and analysis of the contract modification guidance, as well as discussions of other topics related to the new revenue standard, refer to Deloitte's *A Roadmap to Applying the New Revenue Recognition Standard*. If you have questions about the new revenue standard or need assistance with interpreting its requirements, please contact any of the following Deloitte professionals:

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