IASB Meeting | Agenda reference **Paper 6A**

Staff Paper | Date **May 2009**

Project **Revenue Recognition**

Topic **Contract Boundaries**

Objective of the Paper

1. The objective of this paper is to help the boards reach a decision on the boundary of a contract in the proposed revenue recognition model. In many contracts, customers have options to renew or cancel goods or services promised in the contract. The staff has concluded that there are essentially three ways to account for these options:

   (a) ignore the option (see paragraphs 3-13)

   (b) account for the option as a separate performance obligation (see paragraphs 14-34), and

   (c) look through the option by including within the contract boundaries those optional goods and services the customer is likely to receive (see paragraphs 35-50)

2. This paper discusses each of these approaches. In this month's meeting, the staff will ask the boards to decide which of these approaches they prefer for the proposed revenue recognition model.

Ignore the Option

3. Some have suggested that goods and services that are subject to renewal or cancellation options should be ignored. To introduce and illustrate the logic behind this first approach, consider the following example:

CleanCo contracts with Customer to provide one year of cleaning services for a fixed price of CU20,000. CleanCo also promises to provide an additional year of cleaning services for the same fixed price of CU20,000, at Customer's option. Historically, 70% of CleanCo's customers have opted for the additional year at the price stated in the contract.

This paper has been prepared by the technical staff of the IASB for the purposes of discussion at a public meeting of the IASB.

The views expressed in this paper are those of the staff preparing the paper and do not purport to represent the views of any individual members of the Board or the IASB.

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4. In this example, CleanCo's promise to provide an additional year of cleaning services represents an option to the customer—an option to renew the cleaning service contract for a fixed amount of consideration. Some think that options like this should be ignored. This is because they see CleanCo's promise of one additional year of service as an offer that the customer has not yet accepted. Some also argue that CleanCo may offer the same terms to any potential customer one year in advance, even if that customer has not contracted for the first year of cleaning services. As a result, the standalone selling price of this option might be zero, so it should not be treated as a separate performance obligation in the proposed revenue recognition model.

5. Another argument some give for ignoring the option is that the price the customer would pay for the optional goods and services is sufficient to cover the entity's costs of providing the goods and services. In other words, because the optional goods and services would be provided at a profit, there is no reason to account for that option. Finally, some argue to ignore renewal options like that in CleanCo because estimating the price at which the option would sell separately would be overly complicated and it would not provide sufficient incremental information to justify the cost.

6. For conceptual reasons, the staff thinks it would be unwise to write a revenue recognition standard that ignores renewal options. This is because many renewal options have value to the customer and would not be sold separately for nothing. The fact that some options do not have significant value to the customer does not justify ignoring all options.[1]

7. That said, the staff is sympathetic to many of the arguments made in support of ignoring the renewal option. For example, it seems reasonable to ignore an option that has no value to the customer. However, rather than propose a standard that ignores options, the proposed model can deal with options of insignificant value by allocating no consideration to them. The proposed model already contemplates this possibility because the allocation process in that

[1] Although it is difficult sometimes to determine whether a customer implicitly pays for an option within a present transaction, the staff has chosen not to deal with this issue in the paper.

model is based on the relative standalone selling price of the identified performance obligations. If a renewal option is treated as a performance obligation (in concept) but would not sell separately for more than an insignificant amount, then no consideration would be allocated to that option.

8. The staff disagrees with the argument that renewal options should be ignored if the additional consideration to be received would cover the cost to provide the optional goods and services. If such an approach were taken, entities could easily structure the pricing of optional goods and services so that all of the profit in an arrangement is recognized on the first goods and services transferred to the customer. Although many renewal options would essentially be ignored in the proposed model because they would have no separate value, options to renew at significantly discounted prices are likely to sell separately for a significant amount of consideration. Rather than ignore these options, the boards could rely on the proposed model to determine whether a promised option would sell separately for a significant amount, which in turn would require some allocation of consideration to that option.

9. As a final point, the staff is sympathetic to the argument for ignoring renewal options based on the complexity of estimating the standalone selling price of an option. However, rather than ignore all options because of the difficulty of measuring some options (for allocation purposes), the staff thinks that the boards should consider the possibility of looking through an option. This approach is described in paragraphs 35-50.

10. Consider another example:

> MaintCo contracts with Customer for five years of maintenance services on Customer's factory engines for CU1,000 per year. Customer pays for the maintenance annually and can cancel the contract by not paying any further annual installments. MaintCo charges a level payment throughout the contract, and the level payments take into account all expected maintenance costs during the contract and the likelihood that a customer will cancel the contract. Because maintenance costs are significantly higher in later years of the contract, the payments received in later years do not fully cover the expected costs of those years.

11. Ignoring the implicit renewal option in this example would mean that consideration received for the first year of maintenance would be allocated entirely to the first year of service, which would result in the first years of the contract being much more profitable than the later years of the contract. In fact,

when a customer opts for an additional year of service, the additional consideration would ultimately be insufficient to cover the costs of those later periods. This would result in recognition of onerous performance obligations and losses in the later years while relatively large profits are recognized in the early years of the contract.

12. Of course, if an entity is in steady state, new contracts with highly profitable early years would offset the recognized losses and onerous contracts of older contracts, and the net effect on the financial statements would be negligible. But this would not be the case for growing or shrinking entities.

13. The staff does not support an approach that ignores options to renew goods and services in a contract with a customer. In concept, that option creates a performance obligation in that the entity has promised within a contract to transfer a service (i.e., price and availability guarantees) to the customer. Although many such options will have no significant consideration allocated to them in the proposed model, there are likely to be options to which consideration would be allocated because they would sell separately for significant consideration. Moreover, if an entity charges a level premium for services with renewal or cancellation options, and those services are more costly in later years, ignoring the options can mislead investors about the profitability of the entity and its services.

Recommendation and Question 1

For the reasons articulated in this section, the staff recommends that the boards not ignore renewal and cancellation options in the proposed revenue recognition model.

Do the boards agree?

In asking this question, the staff is not asking the boards whether options should be treated as performance obligations, but only whether options to renew or cancel services should be ignored. The next two sections of the paper discuss potential ways to account for optional services if the boards decide not to ignore options.

Account for the Option as a Performance Obligation

14. The staff now considers how to account for renewal options if they are not ignored. One approach is to treat renewal options within a contract as performance obligations. This section of the paper considers what the accounting would look like if the boards decide that renewal options for goods and services should be treated as performance obligations.

15. If renewal options are treated as performance obligations, the goods and services subject to the option would not themselves give rise to performance obligations. In other words, goods and services that the customer has not yet opted to take would not themselves be included within the contract boundaries for measurement and recognition purposes. Instead, the renewal option itself would be included within the contract boundaries and treated as a performance obligation.

16. In the CleanCo example, this means that in addition to the promise to provide the first year of cleaning services, the promise to provide an additional year of cleaning services at a fixed price and at the customer's option also would be treated as a performance obligation. The contract boundaries would encompass the customer consideration promised for the first year (CU20,000), the promise to provide cleaning services for that first year, and the renewal option to provide one additional year of cleaning services at the customer's option.

17. Having identified the contract boundaries as encompassing the CU20,000 of consideration, that consideration would be allocated to the identified performance obligations on a relative selling price basis. This means that CleanCo would determine the standalone selling prices for the first year of cleaning services and for the renewal option that promises an additional year of cleaning services for CU20,000 one year from now.

18. Determining the standalone selling price for the renewal option could be a relatively simple exercise in the CleanCo example. For example, if CleanCo gives a fixed-price option for similar services to potential customers one year in advance in exchange for no consideration (i.e., a promotional promise that is outside an existing contract with a customer), then CleanCo could argue that the renewal option has a standalone selling price of zero. Because the standalone

selling price of the option would be close to zero, none of the CU20,000 would be allocated to that option and it would effectively be ignored—not in concept, but because the option has a standalone selling price of zero.

19. However, in some cases, a renewal option may in fact have significant value to a customer, and the entity would not sell that option separately for zero consideration. For example, if the price of cleaning services has increased by 20% each year over the last four years, CleanCo may be unwilling to give away for free a renewal option to provide cleaning services at CU20,000 one year from now. If CleanCo neither sells the first year of cleaning services without a renewal option nor gives away for free a fixed price option for cleaning services one year from now, then CleanCo would have to determine the standalone selling prices of the first year of cleaning services and the option for the additional year of service. This is not likely to be a simple task.

20. To determine the standalone selling prices of these two performance obligations, the proposed revenue recognition model requires that CleanCo first look for observable prices for the identical services or goods. If CleanCo never sells the first year of services without the renewal option, it would have to look for any competitors that sell the identical cleaning services separately or estimate that price itself. Although CleanCo may be able to find a comparable price for cleaning services offered by its competitors, it is unlikely that it will be able to find an observable price for the renewal option. As a result, CleanCo would have to estimate the standalone price for this option.

21. To determine the standalone selling price of an option, CleanCo could use an option pricing model (such as a Black-Scholes model or a binomial model). There are probably other methods and models that could be used to estimate the selling price of an option, but just to give a flavor of the information that would typically be needed to estimate the price of such an option, consider the following:

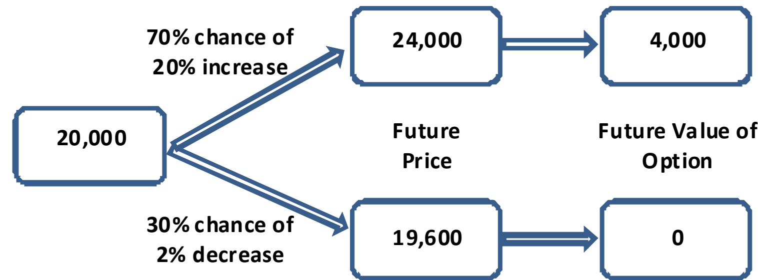
    (a) For the Black-Scholes model, CleanCo would need to determine the standard deviation of price changes for its cleaning services for a one year period of time. In other words, CleanCo would need to look at the price change over all one year periods for the past two or three years and calculate the standard deviation of these price changes. This

information, along with the current price of cleaning services (CU20,000), the exercise price for the additional year of service (CU20,000), the risk-free rate of interest, and the time until the option expires (1 year) would be used to estimate the option's standalone selling price.

(b) For the binomial model, CleanCo would need to determine the likelihood that prices for its cleaning services would increase in one year and by how much the price would increase. Similarly, CleanCo would need to determine the likelihood that prices for its cleaning services would decrease one year from now and by how much. This information, along with the current price of cleaning services (CU20,000), the exercise price for the year of service (CU20,000), and the risk-free rate of interest would be used to estimate the option's standalone selling price.

22. No matter how conceptually appealing it may be to think of a renewal option as a performance obligation, the practicality of estimating a standalone selling price for these options can be daunting. However, to ensure that we are all on the same page about the difficult of estimating selling prices for renewal options and its effect on financial statements, the next few paragraphs take the example a little bit further.

23. To estimate the standalone selling price of CleanCo's option, assume that in researching the inputs to this model, CleanCo determines that 70% of the time over the last four years, its selling prices for cleaning services have risen on average by 20% each year. Over that same four year period, when new contract prices have been flat or decreased, the price has decreased by 2% on average. This is depicted in the following binomial model (which ignores the time value of money):



24. With an estimate of the renewal option's price (CU2,800), CleanCo now needs to determine the standalone selling price of the first year of cleaning service. It observes that a comparable competitor sells a year of cleaning services to similar customers for CU18,500. CleanCo has no reason to think this price should be adjusted for differences between it and its competitor, so it concludes that the CU18,500 is an appropriate estimate of the standalone selling price of its own one year cleaning service. The CU20,000 would be allocated to each of the performance obligations as follows:

	Standalone Selling Price (A)	Percent of Total (B)	Package Discount (C)	Share of Discount (BxC)	Allocation (A) + (BxC)
Cleaning Services	18,500	86.9%	(1,300)	(1,129)	17,371
Option	2,800	13.1%	(1,300)	(171)	2,629
Total	21,300	100.0%		(1,300)	20,000

25. During the first year of service, revenue totaling CU17,371 would be recognized as the cleaning service performance obligation is satisfied. In contrast, the consideration allocated to the option would be recognized either when the customer forfeits the right to renew the contract or throughout the additional year of cleaning services. The statements of position and comprehensive income would reflect the following amounts in relation to this contract:

Assuming Customer Renews					
	Contract Inception	End of Year 1	At Contract Renewal	End of Year 2	
Rights	20,000	0	20,000	0	
Obligations	(20,000)	(2,629)	(22,629)	0	
Net Contract Position	0	(2,629)	(2,629)	0	
	Contract Inception	During Year 1	At Contract Renewal	During Year 2	Total
Recognized revenue	0	17,371	0	22,629	40,000

26. As can be seen in the figure above, the net position in the contract at inception is zero because the proposed model requires that the measure of the rights be fully allocated to all identified performance obligations. At the end of year 1, the option is still unexpired and remains so until the beginning of the additional year of service. Assuming that the customer renews, the measure of the new rights is equal to CU20,000 (immediately before the customer makes any payment) and this amount is allocated to the year of additional cleaning services. The CU2,629 originally allocated to the option is included in the net contract position, which causes revenue recognized during year 2 to be higher than the CU20,000 received upon renewal of the contract.

27. The next figure depicts the amounts that would be reflected in the statements of position and comprehensive income if the customer does not opt for the additional cleaning services.

Assuming Customer Does NOT Renew					
	Contract Inception	End of Year 1	At Forfeit of Option	End of Year 2	
Rights	20,000	0	0	0	
Obligations	(20,000)	(2,629)	0	0	
Net Contract Position	0	(2,629)	0	0	
	Contract Inception	During Year 1	At Forfeit of Option	During Year 2	Total
Recognized revenue	0	17,371	2,629	0	20,000

28. If the customer forfeits the option during the first year, the performance obligation associated with the option is immediately satisfied and recognized as revenue. The important point of these two figures is that some of the original CU20,000 consideration is allocated to the renewal option and recognized as revenue at a later point than the original cleaning services revenue.

29. At this point, the staff again highlights the difficulty of estimating a standalone selling price for a renewal option for nonfinancial goods and services. Even for this simple business scenario involving cleaning services, the application of a model that treats options as performance obligations is likely to be difficult.

30. As another example of this difficulty, consider how to account for the renewal option promised in the MaintCo example if the option is treated as a performance obligation. Estimating the standalone selling price of this option is much more difficult than for CleanCo because it is actually a series of renewal options spanning five years. The customer can cancel any future services at the end of each year, but to obtain the last year of service at the promised rate, the customer must continue to renew (and pay for) all periods before the last year.

31. Using a binomial or lattice model, a selling price for this series of renewal options can be estimated using expectations of the likelihood that customers will lapse, the expected price the MaintCo would charge for each individual year of service in the contract if sold on a standalone basis, and the likelihoods and direction that these prices might change over the contract period. As you can imagine, this would not be a simple exercise, so the staff omits this analysis and makes the following assumptions:

At contract inception and at the end of each year of the contract (when the customer chooses whether or not to cancel the contract), MaintCo determines the following standalone selling prices for the next year of service and the option for any remaining years of additional service at a fixed price of CU1,000:

	Next Year's Service	Option for Additional Years
At contract inception	200	800
End of Year 1	500	1,300
End of Year 2	800	1,500
End of Year 3	1,600	900
End of Year 4	1,900	0

32. Although these numbers make the allocation of each additional CU1,000 payment fairly straightforward, the point of this example is to compare the approach of ignoring the renewal option to the approach of treating the option as a separate performance obligation. If (instead of ignoring the option) the CU1,000 promised at the beginning of each year is allocated to the following year's maintenance service and the renewal option for any remaining years, the following amounts would be reflected in the financial statements of MaintCo.:

Assuming Customer Never Cancels

	Contract Inception	End of Year 1	End of Year 2	End of Year 3	End of Year 4	End of Year 5	
Rights	1,000	1,000	1,000	1,000	1,000	0	
Obligations	(1,000)	(1,800)	(2,300)	(2,500)	(1,900)	0	
Net Contract Position	0	(800)	(1,300)	(1,500)	(900)	0	
	Contract Inception	**Year 1**	**Year 2**	**Year 3**	**Year 4**	**Year 5**	**Total**
Recognized revenue	0	200	500	800	1,600	1,900	5,000

33. As this figure depicts, the rights at contract inception and at the end of any period reflect the promise of consideration only for the next year (the one that the customer has opted to receive). The performance obligations reflect an amount allocated to the next year's promised service and an amount allocated to the fixed price renewal option. This has the effect of allocating a significant amount of revenue to the later periods because the option is treated as its own performance obligation.

34. Given the practical difficulty of estimating the standalone selling price of most renewal options for additional goods and services, the staff now turns to an alternative treatment that neither ignores the option nor treats it as its own performance obligation. This alternative approach is described as "looking through" the option.

Look Through the Option

35. The boards have faced the issue of accounting for renewals and cancellations on other projects, particularly leases and insurance contracts. In the leases project, the boards initially considered accounting for a lessee's renewal option(s) as options. However, when the boards considered the practicality of measuring these options, they decided on a different approach, one that treated lease periods subject to renewal or cancellation as part of the lease term. In other words, the boards decided not to account for renewal periods as options, but instead to account for the right to a leased asset (whether before or during a renewal period) as a single asset and the obligation to pay for the leased asset as a single liability.

36. To look through a renewal option in the lease model, a lessee determines the most likely term of the lease contract. To do this, a lessee essentially looks through the renewal option(s) to determine what the lease term is likely to be based on its expectations and history with similar leases. Once the lessee determines the lease term, it then measures the lease asset and the lease liability by incorporating only the cash flows pertaining to the lease term. The boundaries of the lease contract encompass only the renewal periods within the expected term of the lease.

37. This same approach could be applied to the proposed revenue recognition model. For example, CleanCo could determine the most likely term of the cleaning contract to be two years, based on the likelihood that 70% of its customers opt for the additional year of service.[2] As a result, the promised consideration of CU40,000 for those two years would be the measure of the rights in the contract (ignoring any effect for the time value of money). This measure would then be allocated to the two years of cleaning service performance obligations on a relative selling price basis. If the standalone selling price for the first and second years of service are estimated at CU18,500 and CU24,000, then the promised CU40,000 would be allocated as follows:

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[2] The boards have not considered how a *lessor* would account for an option in a lease. Therefore, in analogizing from lessee accounting to sellers in revenue contracts, the staff does not mean to imply that the same approach would be taken by lessors.

	Standalone Selling Price (A)	Percent of Total (B)	Package Discount (C)	Share of Discount (BxC)	Allocation (A) + (BxC)
Year 1	18,500	43.5%	(2,500)	(1,088)	17,412
Year 2	24,000	56.5%	(2,500)	(1,412)	22,588
Total	42,500	100.0%		(2,500)	40,000

38. This allocation would result in the following amounts recognized in CleanCo's financial statements:

Assuming Customer Renews				
	Contract Inception	End of Year 1	End of Year 2	
Rights	40,000	20,000	0	
Obligations	(40,000)	(22,588)	0	
Net Contract Position	0	(2,588)	0	
	Contract Inception	During Year 1	During Year 2	Total
Recognized revenue	0	17,412	22,588	40,000

39. Although the numbers are not identical (nor would we expect them to be), the effect of looking through the option results in financial statements that are similar to those when the renewal option is treated as its own performance obligation. That is to say, some of the consideration received in the first period is allocated to the second period of cleaning services because the standalone selling price of the first year of service is lower than the standalone selling price of the second year of service. The key difference is that CleanCo would not have to estimate a standalone selling price for its renewal option at contract inception. Instead, CleanCo only has to determine the most likely term of the cleaning contract and incorporate the corresponding cash inflows into its measurement of the rights. (Of course, CleanCo would then need to estimate the standalone selling price of each year of cleaning service in order to allocate this measure of the rights to the performance obligations.)

40. It is important to note that the look-through approach does not take into account any consideration that might be received from the customer from future contracts. The only consideration considered pertains to the present contract, including any consideration that relates to those optional periods of service within the estimated term of the contract.

41. To see this, consider the MaintCo example. A look-through approach would require MaintCo to determine the most likely term of the maintenance agreement. Let's assume that MaintCo determines that 90 percent of its customers opt for all five years of the maintenance agreement while 10 percent opt for only one year. This means that the most likely term of the contract is five years, so MaintCo would include five years of consideration in its measure of the rights and allocate that amount to the separate years on a relative selling price basis. This would result in the following amounts being recognized in the financial statements (for a single contract in which the customer does not cancel):

Assuming Customer Never Cancels

	Contract Inception	End of Year 1	End of Year 2	End of Year 3	End of Year 4	End of Year 5	
Rights	5,000	4,000	3,000	2,000	1,000	0	
Obligations	(5,000)	(4,800)	(4,300)	(3,500)	(1,900)	0	
Net Contract Position	0	(800)	(1,300)	(1,500)	(900)	0	
	Contract Inception	Year 1	Year 2	Year 3	Year 4	Year 5	Total
Recognized revenue	0	200	500	800	1,600	1,900	5,000

42. Even though consideration from cancellable periods is included in the measurement of the rights, no consideration from future contracts is included in this measurement. Furthermore, including consideration from cancellable periods in the measurement of the rights does not affect the amount of revenue recognized at contract inception because the model precludes revenue recognition until a performance obligation is satisfied. This example illustrates that looking through an option by considering the likelihood of customer

renewal or cancellation does not lead to the recognition of a net asset at contract inception, nor does it lead to early recognition of revenue.

43. Given the practical and intuitive advantages of the look-through approach relative to treating renewal options as separate performance obligations, the staff recommends that the boards take a look-through approach for dealing with optional renewal periods in revenue contracts. This approach neither ignores the renewal options often included in customer contracts, nor treats the options as performance obligations (which would require difficult price estimation). At the same time, the look-through approach results in financial statements that are highly similar to those that would result from an options-as-performance-obligations approach. For all of these reasons, the staff recommends the look-through approach for renewal options.

Including Cash Flows that Cannot be Compelled

44. Although the look-through approach provides a practical and intuitive approach for dealing with optional renewal and cancellation periods, some have noted a potentially significant conceptual flaw in this approach. They question whether it is appropriate to incorporate cash inflows from renewal periods that the customer is neither obliged to renew nor standing ready to renew. They wonder how the measurement of the contract can include cash flows that an entity cannot compel.

45. This question is not new to renewal options and in fact manifests itself in many different accounting situations. Perhaps one of the most straightforward of these is the measurement of an equity security. Although the owner of that security cannot compel the payment of dividends on that security, any measurement of the value of that security will take into account the likelihood of dividend payments. For similar reasons, the staff thinks that it is appropriate that the measurement of the entity's net position in the contract take into account cash inflows that are considered likely to happen even though the customer is not obligated to make those payments unless it renews the contract. In addition, given that the inclusion of cash inflows from renewal periods does not result in the recognition of a net asset at contract inception, the staff sees no problem with using the practical and intuitive approach of looking through the option.

Recommendation and Question 2
For the reasons articulated in the previous two sections, the staff recommends that the boards not treat options to renew or cancel goods and services as a performance obligation. Instead, the staff recommends that the boards account for such options by looking through the option to determine the amount of optional goods or services the customer is likely to obtain and incorporating the cash inflows associated with that term into the measurement of the rights. The staff makes this recommendation even though the customer is contractually neither obliged to pay nor standing ready to pay for the goods and services subject to the renewal or cancellation option. Do the boards agree?

46. One of the primary reasons the staff recommends a look-through approach to account for renewal options is the difficulty of estimating a standalone selling price for such options. Rather than decide to account for all renewal options with a look-through approach, some may want to limit the look-through approach to those situations in which a standalone selling price for the option cannot be determined without undue cost. The staff would like to get a sense of whether there is any support for such an approach.

Question 3
Is there any support for an approach that requires renewal options to be accounted for as performance obligations if the standalone selling price of that option can be determined without undue cost? If there is no support for this approach, are the boards comfortable using a look-through approach for all renewal options, regardless of the ease with which the standalone selling price might be determined?

Most Likely Expectations vs. Probability Weighted Expectations

47. Before leaving this section of the paper, the staff notes that there are at least two ways to look through a renewal option. One of those has already been discussed—looking through the option by determining the amount of optional goods and services a customer is *most likely* to obtain. Another way to look through a renewal option is to determine a *probability weighted* expectation of the amount of optional goods or services a customer is likely to obtain. The advantage of this second approach is that an entity's portfolio of contracts is more likely to reflect the overall expectation of customer behavior.

48. To see this, consider that if 70% of CleanCo's customers renew for the second year of cleaning service, all of the contracts will be recognized and measured as if the most likely period of service is two years. CleanCo's own evidence suggests that 30% of its customers will opt for only one year. So at a portfolio level, a look-through approach based on a most likely service period will overstate the rights and obligations by 30% (ignoring the time value of money). Because of this shortcoming when using a most likely term, some have suggested that a probability weighted expectation of the goods or services the customer will obtain would produce a more faithful representation of the arrangement, both at the contract and portfolio level.

49. Some argue that this is not a significant issue for the proposed revenue recognition model because the rights and obligations in the contract are recognized net in the statement of position. Because revenue contracts are recognized net and revenue is only recognized when a performance obligation is satisfied, some think that a probability weighted expectation would not improve the information available to investors.

50. Others argue that a probability-weighted expectation should be used because the boards may yet decide that for some contracts (eg, specific performance contracts), the rights and obligations should be recognized separately as assets and liabilities. Moreover, using a probability-weighted expectation would be more consistent with the staff's proposal to measure uncertain consideration in a contract using a probability weighted expectation of the uncertain cash flows. (As a reminder, the context of that proposal relates to uncertain or contingent cash flows, not cash flows from optional goods or services that the customer have not yet decided to obtain.)

Recommendation and Question 4
Based on the arguments above, the staff recommends that the boards account for renewal options by looking through the option to determine the probability weighted expectation of optional goods or services that the customer will obtain. Do the boards agree?

Renewals of Services vs. Options for Additional Goods

51. In the CleanCo and MaintCo examples, the goods and services subject to renewal or cancellation are similar (some would even say identical) to the goods and services provided in the initial contract period. For example, the cleaning services provided in the first year of CleanCo's contract are the same as the cleaning services promised as an option in the second year. Similarly, the maintenance services provided in the first year of MaintCo's contract are the same as the maintenance services promised as an option in the next four years. The staff questions whether it matters that the optional goods and services be the same as the initial goods and services provided. Consider the following example:

> SongCo is a manufacturer of music players and an online retailer of music. As part of a seasonal promotion, SongCo gives each customer who buys a music player a discount card good for 100 online songs at a significant discount. Customers can pay CU0.50 for each song instead of the customary CU1 per song (but SongCo still makes a profit on the sale of each song). The customer pays CU300 in exchange for the music player and discount card. Historical evidence suggests that 30% of customers purchase 40 songs, 50% of customers purchase 80 songs, and 20% of customers purchase 100 songs.

52. The question with this example is whether the songs that the customer can purchase (at its option) are within the boundary of the contract. If the online songs are treated similarly to CleanCo's optional year of cleaning services or MaintCo's optional years of maintenance services, then the online songs would be included within the contract boundary. This option for online music would either be treated as its own performance obligation, or the option would be looked through to determine the most likely number of songs customers would purchase (the treatment recommended by the staff in the previous section).

53. Some would describe the promise of discounted online music as a sales promotion or incentive and they would ignore the promise unless it was onerous. However, in this regard, the staff sees no difference between the SongCo example and the earlier examples. The promise of an additional year of cleaning services at a discount could just as easily be described as a sales promotion or incentive. And yet ignoring all such options (whether thought of as a promotional promise or an option) would allow entities to time the recognition of revenue and profit through transaction structuring.

54. The primary difference the staff sees between the earlier examples and the SongCo example is that the online music is not a renewal or continuation of the initial promised good or service (ie, the music player).[3] Although in concept, the staff cannot explain why this difference should matter, some think that a promise to provide a different good or service at the customer's option is different from a promise to provide a renewal or extension of the same good or service at the customer's option. For options that would not extend or renew a previously provided service, they would either ignore the option or account for the option as a separate performance obligation.

55. Not all of the staff agree with this analysis. They think that ignoring an option for additional goods and services just because those goods and services are not the same as the non-optional goods and services would allow for opportunistic structuring of contracts (as explained previously). For example, SongCo could promise the online songs at an 80% discount even though the effective price of songs to customers who don't buy the music player is CU1 per song. In effect, SongCo would be able to recognize its normal profit on songs at the time that the music player is transferred to the customer if the option for online music is ignored.

56. Some staff also disagree with the idea of accounting for such options as performance obligations because of the difficulty of estimating the standalone selling price for some of these options. It is not likely to be any easier to estimate a standalone selling price for options for different goods and services than it would be for options that extend or renew the same goods and services.

57. Based on these arguments, the staff is considering a recommendation to account for options for additional goods and services within a contract by looking through those options, regardless of whether the optional goods and services are the same as the non-optional goods and services.

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[3] Another example in which an entity promises one good and an option for a different good in the future is a boat dealer that contracts to transfer a boat and promises the customer a fixed quantity of fuel at a fixed price if the customer chooses to buy it.

58. Consider briefly what this would mean for SongCo. In this example, SongCo would have to identify the number of online songs a customer is most likely to purchase. Because history suggests that customers purchase 80 songs most of the time, SongCo would conclude that 80 songs is the most likely number of goods. As a result, the promised consideration of CU340 (calculated as CU300 plus CU0.50 x 80 songs) would be included in the measurement of the rights in the contract.

59. This measure would then be allocated to the music player and the 80 expected songs, all on a relative selling price basis. If the music player sells separately for CU300 and each song sells separately for CU1, then CU268 would be allocated to the music player and CU72 would be allocated to the 80 songs (at 0.89 per song), as follows:

	Standalone Selling Price (A)	**Percent of Total (B)**	**Package Discount (C)**	**Share of Discount (BxC)**	**Allocation (A) + (BxC)**
Music Player	300	78.9%	(40)	(32)	268
Online Songs	80	21.1%	(40)	(8)	72
Total	380	100.0%		(40)	340

60. When the music player is transferred to the customer, CU268 is recognized as revenue. As each song is purchased by the customer, CU0.89 is recognized as revenue (based on the expectation that the customer will purchase 80 songs). Of course, this approach would require a significant number of adjustments at some point because the initial calculation of the most likely number of songs will be incorrect in most instances.

61. Because the staff has not completely settled on a recommendation for these types of options, and because the discussion paper poses an example very similar to this one, the staff is not making a recommendation here, but is asking only for comments on this particular issue.

Question 5

The staff is considering whether to recommend that the boards account for options for additional goods and services by looking through the option, regardless of whether the optional goods and services are the same as the non-optional goods and services.

What issues (if any) would the boards have with this recommendation? Is there another approach that the staff should consider in relation to options for non-similar goods and services? Is there any support for an approach that requires these options to be accounted for as performance obligations if the standalone selling price of that option can be determined without undue cost?

Issues Still to be Considered

62. This paper began as an effort to identify the boundaries of a contract in the proposed revenue recognition model. However, there are a number of related issues that the paper has not been able to address, including the following:

    (a) When should separate contracts be combined?

    (b) When should a single contract be segmented into multiple contracts?

    (c) Should the contract boundaries encompass all contractual options, including those that an entity can reprice at the individual contract level?

63. The staff intends to analyze these issues in the near future. Because of the time constraints on this project, the staff would like to emphasize the need to reach decisions on the issues discussed in this paper. To that end, the staff would like to ask the following questions, particularly in reference to questions 1-3. The answers to these questions will guide us in the event that we need to bring this topic back to the boards for additional discussion.

Question 6
If you are not prepared to make a decision on any one of the questions in this paper (particularly questions 1, 2, and 4), what additional analysis do you need to reach a decision? What is it about that additional analysis that you expect to help you reach a decision?