Project **Revenue Recognition**

Topic **Accounting for options for additional goods and services in contracts with customers**

Introduction and purpose

1. Entities regularly grant options to customers in the ordinary course of business. Some options are given as part of an entity's marketing efforts—i.e. those efforts to obtain *future* contracts with customers. Other options are purchased by customers as part of a *present* contract and give customers the right to acquire additional goods and services at a discount. The Boards have not yet decided:

   (a) how an entity would determine whether options to acquire additional goods and services are granted in a present contract with a customer; and, if so,

   (b) how the entity would account for them in the proposed model.

2. Therefore, the purpose of this paper is to help the Boards reach tentative decisions on those issues.

3. This paper recommends that:

   (a) An entity should account for an option to acquire additional goods and services granted in a contract with a customer as a performance obligation in that contract if that option provides a material right to the customer that the customer would not receive without entering into that contract. An entity should account for that performance obligation by allocating to it a portion of the transaction price relative to the standalone selling price of the option.

(b) If the standalone selling price of an option is not directly observable, an entity may estimate it using an intrinsic value method.

(c) If the optional additional goods and services are:

(i) similar in nature to the other goods and services in the contract; and

(ii) provided in accordance with terms and conditions (including pricing) in the contract

the entity should include the expected optional goods and services (and corresponding customer consideration) in the measurement of the contract.

4. This paper is organized as follows:

(a) background (paragraphs 5–9)

(b) distinguishing between an option and an offer (paragraphs 10–24)

(c) determining the price of an option (paragraphs 25–33)

(d) renewal options (paragraphs 34–56)

(e) cancellation options (paragraphs 57–62).

Background

5. In their Discussion Paper, the Boards suggest that some options for additional goods and services should be accounted for as performance obligations in a contract with a customer. For instance:

> TuneCo is a manufacturer of music players and is an online music retailer. As part of a seasonal promotion, TuneCo gives each customer a CU40 gift card with the purchase of a music player. The customer can redeem the gift card on TuneCo's Website by downloading music. [DP, paragraph 3.27]

6. In this example, the Boards decided that the customer's option to obtain online music at a discount is a performance obligation in the contract. Hence, some of

the consideration from the sale of the music player would be allocated to the gift card and recognized as revenue when the customer redeems the gift card.

7. But the Boards did not agree that all options for additional goods and services are performance obligations. For instance, the Board did not reach a preliminary view on the following example:

> SongCo also manufactures music players and retails music online. As part of a seasonal promotion, SongCo gives each customer a 40 per cent discount on its online music (for purchases up to CU100) with the purchase of a music player. [DP, paragraph 3.27]

8. Some Board members thought that SongCo's promised discount in the example above relates only to a *future* contract, and therefore is not a performance obligation in the present contract. Under that view, all of the consideration in the contract is recognized as revenue when the music player is transferred to the customer. Any discount exercised on a future purchase would affect the amount of revenue (and margin) recognized for that future contract.

9. The mixed views of Board members on these two examples were also reflected in the responses to the Discussion Paper. Appendix A to this paper contains a summary of those responses.

Distinguishing between an option and an offer

10. The staff thinks that the mixed views on accounting for a customer's option to acquire additional goods and services are because of the difficulty in distinguishing between:

    (a) an option that the customer pays for (but often implicitly) as part of a present contract, and

    (b) a marketing or promotional offer that the customer did not pay for and, although made at the time of entering into a contract, is not part of the contract.

11. In the case of the former, most think it is appropriate to allocate some of the consideration to the option, because it is an asset promised in the contract (i.e. a deliverable in the contract) and results in performance obligations for the entity. It is therefore part of the exchange between the entity and the customer. In the case of the latter, none of the consideration needs to be allocated to the option, because the offer is no different from an offer made outside of a contract with a customer. It exists independently of the contract.

12. The staff observes that the problem of distinguishing between an option and an offer is not new. It has been a practice issue in the software industry for many years. In US GAAP, the software industry has guidance related specifically to the topic. Accounting Standards Codification 985-605-15-3d states the following:

> d. More-than-insignificant discounts on future purchases that are offered by a vendor in a software arrangement. More-than-insignificant discounts have all of the following characteristics:
>
> 1. Incremental to the range of discounts reflected in the pricing of the other elements of the arrangement
>
> 2. Incremental to the range of discounts typically given in comparable transactions
>
> 3. Significant.
>
> If the discount or other concessions in an arrangement are more than insignificant, a presumption is created that an additional element or elements (as defined in paragraph 985-605-25-5) are being offered in the arrangement.
>
> Judgment is required when assessing whether an incremental discount is significant.

13. Moreover, Accounting Standards Codification 985-605-15-4c states the following:

> c. Marketing and promotional activities not unique to software transactions, such as the following:
>
> 1. Insignificant discounts on future purchases that are offered by a vendor in a software arrangement. For example, a vendor may offer a small discount (a coupon or other form of offer for 5 percent off)

> on additional licenses of the licensed product or other products that exist at the time of the offer but are not part of the arrangement.
>
> 2. Discounts that are not incremental to discounts typically given in comparable transactions (for example, volume purchase discounts comparable to those generally provided in comparable transactions).

14. Many respondents to the Discussion Paper note that they think that the above guidance is useful and could be applied more broadly than to software contracts. In effect, it distinguishes between options that are performance obligations and those that are marketing and promotional activities, by presuming that the offer of a discount or other concession is a performance obligation in the contract if it is "significant" and "incremental".

Significant

15. The significant notion is relatively straightforward. It filters out immaterial options. If an entity were to account for immaterial options as performance obligations, it likely would conclude that the standalone selling price of the option was very small. Hence, very little of the transaction price would be allocated to the performance obligation. There would therefore be little benefit to users in accounting for such options as performance obligations.

16. The staff thinks it is not necessary to introduce an additional materiality constraint by using the term "significant" for options: the usual constraint of materiality can apply. Although materiality applies to all aspects of financial reporting, the staff thinks that in this context it might be helpful to state that immaterial options do not need to be accounted for as performance obligations.

Incremental

17. The incremental notion establishes that the option is part of a present contract rather than a marketing offer for a future contract. In other words, an incremental option provides a right that the customer obtains only as a result of entering into a contract rather than independently of that contract. Therefore, it is something for which the customer pays (explicitly or implicitly) and so it

should be accounted for as a performance obligation in the contract with the customer.

18. For instance, consider the following:

> Suppose a customer enters into a contract with Entity for Product A and is given the right to acquire Product B in the next three months at a discount of 20 per cent.
>
> Entity routinely provides 20 per cent discounts on Product B.

19. In the example above, the customer (and other customers) could also obtain the 20 per cent discount and the discount is not incremental. Hence, the option is not part of the contract for the sale of Product A. Although Entity has promised to provide additional goods and services at a discount, the customer could have obtained those additional goods and services on similar terms without entering into the contract.

20. The guidance in ASC 985-605-15-3d(1) (quoted above in paragraph 12) suggests that the discount must be incremental to other discounts in the contract. For instance, suppose Entity gives the customer a 20 per cent discount on Product A. The first criterion would suggest that to be treated as a performance obligation in the contract for Product A, the discount on Product B would need to be greater than 20 per cent. The staff does not think that that conclusion applies in all cases. The staff thinks that if the customer could not otherwise obtain the 20 per cent discount on Product B, then that discount results in a performance obligation in the contract for Product A, regardless of the discount on Product A. (Nonetheless the fact that the customer received a 20 per cent discount on Product A (and any other goods and services in the contract) might suggest that the customer would otherwise be entitled to the 20 per cent discount on Product B. If so, there would not be a performance obligation with respect to the discount on Product B.)

Proposed principle

21. The staff thinks that the existing significant and incremental notions (and related guidance) can be used as the basis for a principle in the Boards' proposed model to distinguish between options in a contract and offers. The staff therefore recommends that an entity should account for an option to acquire additional goods and services granted in a contract with a customer as a performance obligation in that contract if that option provides a material right to the customer that the customer would not receive without entering into that contract.

22. Indicators that an option for additional goods and services is part of the contract include:

    (a) the option is promised at the same time as the other goods and services in the contract

    (b) the option is promised explicitly in the contract

    (c) the option is sold on a standalone basis by the entity or by any other entity

    (d) the additional goods and services will be provided at a discount that is outside the range of discounts typically given to the customer or other customers in standalone transactions for those goods and services.

23. Options that are not part of the contract would not be in the scope of the proposed model.

24. Options that are performance obligations would be accounted for as other performance obligations. Hence, an entity would allocate part of the transaction price to it relative to the standalone selling price of the option. That part of the transaction price is subsequently recognized as revenue as the entity satisfies its obligations.[1]

[1] Conceptually part of the option performance obligation may be satisfied over the period to exercise or expiry of the option—see paragraph 29. However, that would be possible only if the time value

Recommendation and Question 1
The staff recommends that an entity should account for an option to acquire additional goods and services granted in a contract with a customer as a performance obligation in that contract if that option provides a material right to the customer that the customer would not receive without entering into that contract (for example, a material discount on additional goods and services that the customer would not otherwise receive). Hence, an entity should account for that performance obligation by allocating to it a portion of the transaction price relative to the standalone selling price of the option. Do the Boards agree? If not, how should an entity distinguish between an option in a contract and an offer?

Determining the price of an option

25. If an option to acquire additional goods and services is a performance obligation in a contract, the entity must determine its standalone selling price in order to allocate part of the transaction price to it.

26. In some cases, the standalone selling price of the option may be directly observable.[2] Sometimes, it may be indirectly observable, because there are prices for a bundle of the goods and services with and without the option. For instance, customers often pay additional consideration for the option to cancel an airline ticket. In many cases, though, the standalone selling price of the option would need to be estimated.

27. In the Discussion Paper, the Boards do not preclude or prescribe any particular method of estimating a standalone selling price. The staff notes that various

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component has been separately identified. Otherwise, the performance obligation is satisfied as the customer exercises its option to acquire additional goods and services or on expiry of the option.

[2] In some cases there may be an observable price for an option, but because it is a price in another market, it does not represent the standalone selling price to the entity's customer. Nonetheless, the entity might be able to adjust that price to arrive at an estimated standalone selling price. For instance, airline frequent flier miles may be sold to hotel and credit card companies. That price is a wholesale price and may not be the price at which the miles could be sold to the airline's retail customers.

option pricing models exist and some of these models have been explored in previous papers.[3]

28. Option pricing models use various inputs to arrive at a price for the option, but generally the price of an option includes two components: the intrinsic value of the option and its time value.

    (a) *The intrinsic value* component is the value of the option if it were exercised today. That value depends on the difference between the current price of the underlying goods and services and the price the customer would pay for those goods and services (i.e. the exercise price). In the context of revenue recognition, the intrinsic value can be viewed as the amount the customer has prepaid towards the additional goods and services—in effect, it is a prepayment. Like any other prepayment, that amount should not be recognized as revenue until the entity provides the goods and services to which that prepayment relates.

    (b) *The time value* component is the value of an option that depends on the time until expiry and the volatility of the price of the underlying goods and services.

29. The staff thinks that conceptually the time value component of the option provides a service to the customer—i.e. the customer continuously receives the benefits of the price and flexibility guarantees. Nonetheless, existing revenue recognition standards ignore such services, which are implicit in many contracts. The Boards have also already decided to ignore some of those services. For example, if an entity enters into a contract on 1 January to provide a widget on 30 June at a fixed price, the entity is providing price and availability guarantees services to the customer over the period *to* 30 June. Nonetheless, the proposed model (and existing standards) would require no accounting until either the entity provides the widget, the customer pays or the contract becomes onerous. Many people think that is a reasonable approach because in the absence of

[3] IASB Agenda Paper 6A on Contract Boundaries (May 2009).

observable prices, any benefits to users of allocating some of the transaction price to the price and availability guarantees would probably not justify the costs and difficulties of doing so.

30. Consequently, the staff thinks that the time value component of an option price could be ignored for allocating the transaction price to performance obligations. Hence, an entity could focus only on the intrinsic value component of the option when determining a standalone selling price.

31. To determine the standalone selling price of the option, the entity could estimate its intrinsic value by reference to the discount the customer would obtain when exercising the option, adjusted for:

    (a) the discount that the customer could receive without exercising the option; and

    (b) the likelihood that the option would be exercised.

32. For instance, consider the following:

SongCo enters into 100 contracts for the sale of a music player for CU100. As part of each contract it gives the customer a 40% discount voucher for online music (for purchases up to CU100 over a six month period) that cannot be used in conjunction with any other offer. SongCo often gives 10% promotional offers.

Suppose SongCo concludes that the discount voucher is part of the contract for the sale of the music player. How could it estimate the standalone selling price?

SongCo estimates that there is an 80% likelihood that a customer will exercise the option and that each customer exercising the option will on average purchase CU50 of online music. Because SongCo often gives 10% promotional offers, the 40% discount the customer would obtain when exercising the option needs to be reduced by 10% to 30% (i.e. to reflect the incremental value to the customer of the discount).

Hence, SongCo estimates the standalone selling price of each option as CU12 (i.e. CU50 x 30% x 80%).

If the standalone selling price of the music player is CU100, SongCo allocates CU10.7 (i.e. CU100 x (12 ÷ (12 + 100))) of the transaction price of CU100 to the option.

(This example assumes the time value of money is immaterial).

33. The inputs required for the measurement approach in paragraph 31 should be readily obtainable by an entity and the calculations would be relatively straightforward and intuitive. The measurement approach above is also consistent with the measurement application guidance in IFRIC 13 *Customer Loyalty Programmes*.[4] The staff thinks it should be mentioned specifically as an acceptable method for estimating the standalone selling price of an option.

Recommendation and Question 2

The staff recommends that if the standalone selling price of an option is not directly observable, an entity may estimate it using an intrinsic value method.

Do the Boards agree?

[4] See AG2, IFRIC 13.

Renewal options

34. A renewal option also gives a customer the right to acquire additional goods and services. Therefore, it could be viewed similarly to other options to provide additional goods and services. Hence, if it provides the customer with a material right that the customer could not otherwise obtain without entering into the present contract, it could be accounted for as a performance obligation in the contract. Part of the transaction price would then be allocated to it by determining its standalone selling price.

35. If the option were to renew for only one additional period, then the accounting would be similar to the accounting for other options such as sales incentives. But, in cases in which a renewal option provides the customer with a material right, there typically is a series of options. In other words, to exercise any option in the contract, the customer must have exercised all the previous options in the contract. The staff thinks that determining the standalone selling price of a series of options can be complex.

36. Consider the following example.

Vendor enters into contracts to provide maintenance services over a three-year term. The customer pays annually in advance but has the option to not renew each year. The expected cost of the services provided over a three year contract is CU2,451, with 25%, 30% and 45% incurred in the first, second and third years, respectively. However, 10% of customers are expected to not renew at the end of the first year and 10% of the remaining customer are expected to not renew at the end of the second year. Taking this lapse rate into account and a requirement for a 20% margin, Vendor charges its customers CU1,000 per year.[5]

So for any contract that runs for its full term:

	Yr 1	**Yr 2**	**Yr 3**
Revenues	1,000	1,000	1,000
Costs	613 [2451 x 25%]	735 [2451 x 30%]	1,103 [2451 x 45%]

But following the sale of 100 contracts, Vendor expects revenues and costs as follows:

Yr	**No of contracts**	**Revenues**		**Costs**	
1	100	100,000	[100 x 1000]	61,275	[100 x 2451 x 25%]
2	90 [100 x 90%]	90,000	[90 x 1000]	66,177	[90 x 2451 x 30%]
3	81 [90 x 90%]	81,000	[81 x 1000]	89,339	[81 x 2451 x 45%]
Total		271,000		216,791	
Margin		54,209	(20%)		

37. In this example, even if the customer could gain access to the third year's maintenance services on a standalone basis, the customer would not be able to acquire those services for CU1,000. The customer can acquire those services at that price only by having first acquired the first (and second year) services. Therefore under the principle established in paragraph 21, at contract inception, Vendor is providing a right to the customer that the customer could not receive without entering into the contract for the first year's services. Consequently, Vendor could be viewed as having two performance obligations: an obligation to

[5] Note that in this example the possibility that a customer will not renew is reflected in the pricing of the contract. In other words, customers that renew benefit from customers that lapse.

provide maintenance services for a year and another obligation related to the customer's option to continue services for two additional years.

38. To allocate some of the transaction price to the renewal option, Vendor needs to estimate the standalone selling price of that option. Using an intrinsic value method, that estimate would reflect:

    (a) Value of the discount provided in the third year 379

    [Vendor needs to estimate the standalone price of the services to be provided in the third year. Suppose it estimates that amount to be CU1,379 on the basis of its costs of CU1,103(i.e. 2451 x 45%) and required margin of 20% (i.e. 1103 ÷ 80% = 1,379). The value of the discount is therefore 379 (i.e. CU1,379 less exercise price of CU1,000).]

    (b) Less: the proportion of that discount that will not be provided to customers because of lapses (72)

    [10% of customer lapse each year, so the likelihood of a customer exercising the option for year 3 is 81% (i.e. 100 x 90% x 90%), and therefore the adjustment for lapse is 72 (i.e. 379 x 19%).

    (c) Less: the benefit that will be obtained from customers renewing in the second year (73)

    [90% of customers will renew in the second year and pay in excess of the (estimated) standalone price of the service provided in that year (which on the basis of the costs of CU735 (i.e. 2451 x 30%) and required margin of 20% is CU919 (i.e. 735 ÷ 80%)). They will do that so as to be able to be in a position to exercise the option for the third year. Hence, the benefit obtained from customers renewing in the second year is (1000 – 919) x 90% = CU73).]

39. Consequently, the estimated standalone selling price of the renewal option for the purposes of allocating the transaction price is CU234 (i.e. 379 – 72 – 73). If the standalone selling price of the first year service is CU766 (i.e. (2451 x 25%) ÷ 80%), Vendor recognizes revenue of CU766 in the first year. (For simplicity, in this example there is no discount to allocate to the performance obligations.)

40. Note that in determining that estimate, Vendor would have had to identify various inputs, such as the standalone selling prices for each of the year's services and the likelihoods of customers renewing each year. In other words,

Vendor would have had to consider the entire potential term of three years in order to determine the amount of the first year transaction price that should be deferred until later years.

41. Because an entity would need to consider the entire contract term anyway, the staff thinks it might be simpler for the entity to view the contract as a three-year contract rather than as a one-year contract with a series of options. Consequently, the entity would include the optional goods and services (and corresponding customer consideration) in the initial measurement of the contract. (That approach is also known as a 'look through approach'.)

Accounting for optional goods and services in the contract

42. If optional goods and services are included in the measurement of the contract, the entity has a contract with an *uncertain quantity* of goods and services to be provided to the customer and, hence, an *uncertain amount* of consideration.

43. The Boards have reached tentative decisions on uncertain consideration: the proposed model requires an entity to allocate the probability-weighted estimate of total consideration to the performance obligations (if that amount can be reasonably estimated).

44. Accordingly, the staff thinks that if optional services are included in the measurement of the contract, that contract can be accounted for similarly to a contract with contingent consideration. For instance, consider again the example in paragraph 36.

Suppose Vendor has written 100 contracts to provide maintenance services for three years at CU1,000 per year. 10% of customers are expected not to renew at the end of the first year and 10% of the remaining 90 customers are expected not to renew at the end of the second year.

Vendor sells the maintenance services only as three-year contracts. However, it estimates that the standalone selling price of the maintenance services for each of the three years is as follows:

Yr 1	CU766 (on the basis of expected costs of CU613 and required 20% margin)
Yr 2	CU919 (costs of CU735, etc)
Yr 3	CU1,379 (costs of CU1,103, etc)

45. The probability-weighted consideration per contract is CU2,710 (i.e. CU1,000 + (90% x CU,1000) + (90% x 90% x CU1,000)). This amount could be allocated to the years of the contract on the basis of the relative standalone selling prices of those years as follows:

Year	Standalone selling price	Adjustment for probability that service will be provided	Revised standalone selling price
1	766	100%	766
2	919	90%	827
3	1,379	81%	1,117
	3,064		2,710

Note that there is no discount in this example for buying three years' services together. Any discount would simply complicate the example without adding to the illustration.

46. Therefore, assuming that there are no changes in circumstances and renewals are in line with expectations, revenue, expenses and the contract liability for the contracts would be as follows:

	Yr 1	Yr 2	Yr 3	Total
Revenue[1]	76,600	82,700	111,700	271,000
Expenses[2]	(61,275)	(66,177)	(89,339)	(216,791)
Margin	15,325	16,523	22,361	54,209
Contract liability[3]	23,400	30,700	-	

1 Pattern of revenue recognition derived from the table in paragraph 45.
2 Expenses derived from the table in paragraph 36.
3 The contract liability represents the amount customers have prepaid for services to be provided in future periods. At the end of Year 1, customers have paid CU100,000 of which CU76,600 has been recognized as revenue. At the end of Year 2, customer have paid CU190,000 of which CU159,300 has been recognized as revenue.

47. The staff notes that this method of allocating revenue to reporting periods in a continuous delivery contract is the method implied by the Discussion Paper. The staff plans to discuss how to account for such contracts in future meetings. Hence, there may be other techniques that could be used to allocate revenue in this example.

Uncertainty addressed through measurement

48. The Boards will observe that in the example above, uncertainty about the term of the contract (i.e. the quantity of goods and services and the amount of consideration) is addressed through measurement of the contract—i.e. Vendor determined the probability-weighted amount of consideration. In contrast, in the Discussion Paper *Leases Preliminary Views*, the Boards proposed that a *lessee* (i.e. a customer) should account for a lease contract with term options on the basis of its most likely term. (The Boards have not yet considered how a lessor should account for such a lease.)

49. The staff thinks that for the purposes of revenue recognition, capturing uncertainty in the measurement of the contract is preferable because it better reflects the uncertainty of the entity's contract, i.e. the existence of the option. For instance, in the above example, the proposed approach does not ignore the

possibility that the total consideration under the contract could be less than the most likely amount to be received (which is CU3,000). Furthermore, although each individual contract in the example above will run for either two or three years, using a probability weighted approach more appropriately reflects the economics when there is a portfolio of contracts. That is likely to be the case in the context of revenue recognition because the Boards are specifying the accounting of the selling entity. In contrast, the Boards' decision in leasing applies only to the lessee, who may have only one lease contract.

Advantages and disadvantages of including the optional goods and services in the initial measurement of the contract

50. In support of including the optional goods and services (and corresponding customer consideration) in the initial measurement of the contract, it could be argued that:

    (a) it would be more intuitive than treating the renewal option itself as a performance obligation. For instance, the staff doubts that entities would view the example above as a contract for a year's service plus a series of options. Rather, the staff thinks that companies would devise, price, market and manage the contract as a contract with the obligation to provide maintenance services over three years.

    (b) it would be more consistent with how most view a cancellation option. For instance, consider a similar contract to the above but in which the customer prepays for three years and has the ability to cancel at the end of the each year for a pro rata refund. In such an example, most are likely to view the contract as a three-year contract which the customer has the ability to cancel. Yet that example is economically the same as the example above (the only difference being that customer prepayments may result in a higher likelihood of the contract running full term compared with the contract in which the customer renews each year). Cancellation options are discussed further below.

(c) accounting for the contract as a series of options places great emphasis on a contractually-stated ability of the customer to cancel the contract. However, customers arguably can cancel almost all contracts (although not without a termination penalty as appropriate).

(d) the pricing of the present contract is affected by (and affects) the pricing of the optional goods and services. Hence, the contracts are interdependent.

(e) the effect in profit or loss and on the carrying amount of the *net* contract position is similar to accounting for the option itself as a performance obligation (see paragraph 52).

51. Against that approach, it could be argued that:

(a) in determining the amount of revenue to allocate to performance obligations in the present contract, the entity would be taking into account cash flows for which it does not have enforceable rights.

(b) options for additional goods and services would not all be treated consistently. In some cases, the allocation of revenue would be based on the goods and services in the present contract and the option itself, whereas in other cases the allocation would be based on goods and services in the present contract and the expected amount of optional goods and services.

52. In the staff's view, including the optional goods and services (and corresponding customer consideration) in the measurement of the contract rather than just the option itself (as described in paragraphs 10-33 above) is not a fundamentally different way of accounting for the contract in the proposed revenue recognition model. That is particularly so if the contract (i.e. the remaining rights and obligations) is accounted for net on the statement of financial position (as proposed in the Discussion Paper). Both approaches reflect the likelihood of the exercise of the option in the measurement of the net contract position. The difference between the two relates to the allocation methodology. In one approach, the consideration from the present contract is allocated to the goods

and services in that contract and the option itself. In the other, the consideration from the present contract together with the expected consideration from the optional goods and services is allocated to the goods and services in the present contract together with the expected optional goods and services. Put simply, the "gross" components of the allocation process might differ, but the "net" outcome does not.

When should an entity include the optional goods and services in the measurement of the contract?

53. The staff thinks that two criteria distinguish renewal options from other options to acquire additional goods and services.

Same nature

54. First, the additional goods and services underlying the renewal options are of the same nature as those provided under the initial contract: the entity continues to provide what it was already providing. That feature explains why it is more intuitive to view the goods and services underlying such options as part of the initial contract, in comparison to examples such as customer loyalty points and many discount vouchers. In the latter two cases, most view the options as another separate deliverable in the contract because the underlying goods and services may be of a different nature.

Provided under the existing terms and conditions in the contract

55. Second, all of the terms and conditions relating to the provision of the additional goods and services (i.e. of the subsequent contracts) are established on entering into the initial contract. The entity's position is therefore constrained: it cannot change those terms and conditions. In particular, it cannot change the pricing of the additional goods and services. The only thing that would preclude the series of options being exercised and the contract not continuing until "full term" is the customer's behaviour.

56. That is different from examples such as customer loyalty points and discount vouchers. For instance, if an airline frequent flier programme offers "free" flights to customers, the airline is not fully constrained, because it subsequently can determine the number of points that are required to be redeemed for any particular 'free' flight. Similarly, when an entity grants discount vouchers, it has not constrained itself with respect to the price of the subsequent goods and services against which the discount vouchers will be redeemed.

Staff recommendation and question for the boards

Recommendation and Question 3

The staff recommends that if the optional additional goods and services are:

(i) similar in nature to the other goods and services in the contract; and

(ii) provided in accordance with terms and conditions (including pricing) in the contract

the entity should include the expected optional goods and services (and corresponding customer consideration) in the measurement of the contract.

Do the Boards agree?

(i) If not, how should an entity determine how much revenue to recognize in cases in which there is a series of options?

(ii) If yes, do you agree with the criteria to determine when an entity should include the optional goods and services in the measurement of the contract? If not, what criteria should be used?

Cancellation options

57. Similar issues to those discussed above arise in contracts in which the customer prepays but has a cancellation option. For instance, suppose a customer prepays for three years' services, but has the right to cancel the contract at the end of the first and second years for a pro rata refund. Services for years two and three are

therefore optional: they will be provided only if the customer chooses not to cancel the contract. Should those goods and services be included in the measurement of the contract?

58. The staff thinks that the accounting for renewal and cancellation options should be symmetrical. Economically a contract in which the customer has prepaid in full, but can cancel and obtain a refund, is the same as a contract in which the customer has the option to renew at an agreed price. Arguably the only difference relates to the possible different likelihoods of cancellation and renewal.

59. Accordingly, for contracts satisfying the criteria discussed in paragraphs 53-56 and containing cancellation options, the staff proposes that the measurement of the contract include the expected optional goods and services and corresponding customer consideration. Because the customer has prepaid, that means that the entity also recognizes a refund obligation.

> Suppose Vendor has written 100 contracts to provide maintenance services for three years at CU3,000. 10% of customers are expected to cancel at the end of the first year for a refund of CU2,000 and 10% of the remaining 90 customers are expected to cancel at the end of the second year for a refund of CU1,000.
>
> The estimated standalone selling of the maintenance services for each of the three years is as above in the table in paragraph 44, i.e.:
>
> Yr 1 CU766
> Yr 2 CU919
> Yr 3 CU1,379

60. The probability-weighted consideration per contract is CU2,710 (i.e. (81% x CU3,000) + (9% x 2,000) + (10% x 1,000)). Similarly the probability-weighted amount of the refund obligation is CU290 (i.e. (10% x CU2,000) + (9% x CU1,000)). Hence, at inception of the 100 contracts, Vendor has a performance obligation to provide maintenance services of CU271,000 and a refund obligation of CU29,000.

61. The probability-weighted customer consideration amount could be allocated to the expected maintenance services as in the table in paragraph 45 above. Therefore, assuming that there are no changes in circumstances and that cancellations are in line with expectations, revenue, expenses, the contract liability and refund obligation for the contracts are as follows:

	Inception	Yr 1	Yr 2	Yr 3	Total
Revenue		76,600	82,700	111,700	271,000
Expenses		(61,275)	(66,177)	(89,339)	(216,791)
Margin		15,325	16,523	22,361	54,209
Contract liability	271,000	194,400	111,700	-	
Refund obligation	29,000	9,000[1]	-	-	

1 The refund obligation at the end of Year 1 has reduced by CU20,000, being the 10 customers that cancel at that point for a refund of CU2,000 each.

62. Appendix B illustrates how a change in the likelihood of cancellation could be accounted for.

Appendix A Responses to the Discussion Paper

A1. This appendix summarizes the feedback received from comment letters with respect to the boundaries of a contract, with an emphasis on renewal and cancellation options, contingent obligations, offers and sales incentives.

Renewal and cancellation options, contingent obligations, and offers

A2. Contract renewal and cancellation options (besides the rights of return) were not addressed in the Discussion Paper. Consequently, only a few respondents commented on those types of contract options. The few that did comment, raised the following issues.

(a) Enforceability—Respondents often questioned how enforceability would apply with cancellation and renewal options. Cancellation options may be enforceable by either party, whereas renewal options are enforceable by the entity upon exercise by the customer. Many respondents noted that though many contracts can be renewed or extended, the entity has no *legally enforceable* rights before the customer agrees to that renewal or extension, and respondents questioned the notion of enforceability in such contracts.

(b) Contingent obligations/offers—Respondents asked whether other types of contingent obligations would be considered part of a contract; for example, a pharmaceutical company might promise to continue to provide research services if a product reaches a specific phase of development. Respondents also asked whether offers to existing or prospective customers extend the boundaries of a contract or create new contracts. The staff notes that respondents often thought that the accounting for contingent obligations and offers should be the same as discounts on future goods or services, as discussed below.

Sales incentives

A3. With respect to overall views on sales incentives, many respondents noted that for recognition purposes, it is typically self-evident that the promise of a 95 per cent discount on a future good or service should be treated as a performance obligation in a contract and that a 5 per cent discount can be ignored. They noted that the difficulty is determining the line between these clear cut scenarios and therefore noted that it will be necessary for the Board to provide further guidance. Additionally, respondents noted that measuring the standalone value of sales incentives would often be difficult, and that the Boards should consider how to ensure consistent and practical application of the proposed model. Along the same lines, some respondents noted that although all types of sales incentives should be considered performance obligations, those performance obligations that have small or immaterial standalone values should be measured at nil.

A4. However, respondents' views were mixed as to whether all types of sales incentives are performance obligations. Respondents often commented only on specific types of sales incentives, and noted that the accounting for those types of incentives is unique. The proposed accounting for sales incentives can be divided into the following four types of sales incentives:

(a) discounts on future purchases of goods /services;

(b) free goods or services;

(c) loyalty and award programs; and

(d) discounts on current items.

Discounts on future goods or services

A5. Respondents often noted that the accounting for contingent obligations, offers, and discounts on future goods or services should be treated the same. Many respondents noted that these types of incentives should be accounted for as separate performance obligations only to the extent that such offers: (a) are in a

current contract with a customer, and (b) would result in an onerous contract if accounted for on a standalone basis; or if goods or services are offered at a significant, material and incremental discount as compared with existing customer contracts. Further, for such performance obligations it should be expected that the customer will exercise the discount/offer/contingent obligation.

A6. Respondents noted that criterion (b) is necessary, so as not to impose onerous bookkeeping on entities for simple coupons or options offered to customers at market price.

A7. Some respondents noted that the accounting methodology prescribed in SOP 97-2 *Software Revenue Recognition*, to account for significant and incremental discounts may be applicable outside the software industry.

A8. A few respondents asked how contingent obligations, offers, and discounts on future goods and services related to the decisions made at the May 2009 meeting to require the recognition of expected consideration.

A9. Cash Rebates—A few respondents noted that in accounting for cash rebates, the rebates should not be treated as performance obligations, but rather as reductions to the transaction price.

Free goods or services as incentives

A10. Respondent noted that free goods or services offered as sales incentives are different from contractual requirements to provide future discounts on goods and services, in that the customer does not have to provide future consideration for free goods. Because a seller does not have any additional rights a new contract is not created, and by default the free goods or services are part of the present contract.

Loyalty and award programmes

A11. Respondents agree that loyalty or award programmes should be accounted for as separate performance obligations, consistently with IFRIC 13 *Customer Loyalty*

Programmes. As they did for free goods or services to be provided in the future, respondents noted that the seller does not have any additional rights, that a new contract is not created, and therefore the loyalty points and award programs are separate performance obligations of the current contract.

Appendix B Changes in expected probability of renewal or cancellation

Change in expected probability of cancellation

B1. This Appendix illustrates how an entity would account for a change in the expected probability of renewals or cancellations. To illustrate, the Appendix continues the example with a cancellation option in paragraph 59.

> Suppose that at the end of Year 1, Vendor revises its estimates of expected cancellations at the end of Year 2 from 10% to 20%. How should the change of circumstances be accounted for?

B3. In accordance with the Boards' tentative decision on uncertain consideration, the staff thinks that Vendor would update its measurement of the customer consideration and also the refund obligation. In effect, there would be a reallocation of the amount the customer paid (i.e. CU3,000) between the amount for the services and the amount for cancellation refunds. Vendor would then reallocate the revised customer consideration over the three years' services and adjust revenue on a cumulative basis for any portion of the change in the customer consideration that was allocated to satisfied performance obligations.

B4. Accordingly the revised customer consideration per contract is CU2,620 (i.e. (72% x CU3,000) + (18% x 2,000) + (10% x 1,000)). The revised allocation of this amount is:

Year	Standalone selling price	Adjustment for prob. that service will be provided	Revised standalone selling price	Allocation %	Allocated selling price
1	766	100%	766	29.6	776
2	919	90%	827	32.0	838
3	1,379	72%	993	38.4	1,006
	3,064		2,586	100.0	2,620

B5. Hence, at the end of Year 1:

(e) the revised amount of the performance obligation for the contracts is CU184,400 (i.e. (CU838 + CU1006) x 100) (compared to CU194,400 before adjustment).

(f) the revised amount of the consideration to be allocated to the first year of services is CU77,600 (compared to CU76,600 before adjustment)

(g) the revised refund obligation is CU18,000 (i.e. 18% x CU1,000 x 100) per contract (compared to CU9,000 before adjustment).

B6. Therefore, assuming that there are no further changes in circumstances and that cancellations at the end of Year 2 are in line with revised expectations, revenue, expenses, the contract liability and refund obligation for the contracts are as follows:

	Inception	Yr 1	Yr 2	Yr 3	Total
Revenue[1]		77,600	83,800	100,600	261,000
Expenses[2]		(61,275)	(66,177)	(79,412)	(206,864)
Margin		16,325	17,623	21,188	55,136
Contract liability	271,000	184,400	100,600	-	
Refund obligation	29,000	18,000[3]	-	-	

1 Pattern of revenue recognition derived from the table in paragraph B4.
2 Expenses for Year 1 and 2 derived from the table in paragraph 36. The expenses for Year 3 are 72 contracts x CU1,103 (rounding difference).
3 The refund obligation reduces by CU20,000 for the 10 customers that cancel at the end of Year 1. However, it is increased by CU9,000 for the change in circumstances (as calculated in B5.(g)).