

STAFF PAPER

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Purpose

1. Some stakeholders informed the staff that there are different interpretations of the guidance in Accounting Standards Update No. 2014-09, *Revenue from Contracts with Customers*, and IFRS 15 *Revenue from Contracts with Customers* (collectively referred to as the “new revenue standard”)¹, for determining whether customer options to acquire additional goods and services should be accounted for as a material right or as a separate contract, or whether there are situations in which the goods or services underlying the option are included as a part of the accounting contract. Furthermore, at the July 13, 2015 FASB-IASB Joint Transition Resource Group for Revenue Recognition (TRG) meeting, the TRG discussed the applicability of the series provision² to long-term service contracts and the accounting for variable consideration included in those contracts (refer to TRG Agenda Ref No. 39). Some TRG members questioned whether the consideration in those contracts would be more appropriately characterized as consideration received upon the exercise of an optional purchase and, therefore, not included in the accounting for the initial

¹ References to IFRS 15 are included in “[XX]” throughout this paper.

² Paragraph 606-10-25-14(b) [22(b)]

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contract. This paper summarizes those potential issues and the staff's views. The staff will seek input from members of the TRG on those matters.

Background

2. Some contracts include an option for the customer to purchase additional goods or services. Although the customer is not obligated under the contract to purchase additional goods or services, there may be various reasons why the customer is economically compelled to exercise its option. Some examples in which the customer may be economically compelled include contracts where the seller is the sole provider of the goods or services or contracts that include an exclusivity clause that requires the customer to only purchase goods and services from that entity.
3. The staff understands stakeholders have questions about when, if ever, the goods or services underlying options in the contract (and the related consideration for those goods or services) should be considered a part of the contract for which the entity is evaluating under the new revenue standard. *If* the goods or services underlying the option (rather than the option itself) are considered part of the contract, then (a) the goods or services would be evaluated for separation in Step 2, *Identify the Performance Obligations in the Contract*, and (b) the consideration for those goods or services would be included in Step 3, *Determine the Transaction Price*.
4. Fact patterns where this evaluation sometimes becomes complex include some or all of the following characteristics:
 - (a) The contract includes an initial purchase and then purchases of additional, goods or services. Those additional purchases could result from an option in the contract for the initial purchase or a separate contract.
 - (b) Past practice suggests that customers acquire the optional goods or services. For example, an initial contract is for 6 months and the customer has an option to renew the contract for up to 6 years. The average period for similar contracts is 4 years. Often the contracts include provisions that require some form of compensation if the contract is not renewed or is cancelled.

- (c) The legal contract(s) include both (1) a master service agreement which outlines contractual terms, such as pricing and overall terms and conditions and (2) individual purchase orders which provide the quantities of the goods or services.
- (d) The purchase of additional goods or services is at the discretion of the customer, but the entity is obligated to provide those items if the customer requests them. That is, the entity has an obligation to stand ready to deliver those additional goods or services at the customer's discretion. The optionality exists solely from the customer's perspective, rather than from either (1) the entity's perspective or (2) from both parties' perspective.
- (e) The initial goods or services are not provided at the standalone selling price (sometimes at a discount, sometimes at a premium).

Accounting Guidance

5. Step 1 of the new revenue standard defines the term *contract* (paragraph 606-10-25-2 [10]) and includes criteria for a contract to be accounted for under the core principle in the new revenue standard (paragraph 606-10-25-1 [9]). Paragraph 606-10-25-2 [10] states:

A contract is an agreement between two or more parties that creates enforceable rights and obligations. Enforceability of the rights and obligations in a contract is a matter of law. Contracts can be written, oral, or implied by an entity's customary business practices. The practices and processes for establishing contracts with customers vary across legal jurisdictions, industries, and entities. In addition, they may vary within an entity (for example, they may depend on the class of customer or the nature of the promised goods or services). An entity shall consider those practices and processes in determining whether and when an agreement with a customer creates enforceable rights and obligations.

6. BC50 discusses wholly unperformed contracts and states the following about contracts that allow the parties to terminate the contract without penalty:

The Boards decided that Topic 606 [IFRS 15] should not apply to wholly unperformed contracts if each party to the contract has the unilateral enforceable right to terminate the contract without penalty. Those contracts would not affect an entity's financial position or performance until either party performs. In contrast, there could be an effect on an entity's financial position and performance if only one party could terminate a wholly unperformed contract without penalty. For instance, if only the customer could terminate the wholly unperformed contract without penalty, the entity is obliged to stand ready to perform at the discretion of the customer. Similarly, if only the entity could terminate the wholly unperformed contract without penalty, it has an enforceable right to payment from the customer if it chooses to perform.

7. Step 2 of the new revenue standard requires an entity to identify the performance obligations in the contract. An entity assesses the goods or services promised in the contract to identify the performance obligations. Paragraph 606-10-25-18 [26] includes examples of promised goods or services that may be included in a contract with a customer. Example (j) in that paragraph is:

Granting options to purchase additional goods or services (when those options provide a customer with a material right, as described in paragraphs 606-10-55-41 through 55-45 [B39-B43])

8. Entities regularly grant options for additional goods and services to customers in the ordinary course of business. Some options are given as part of an entity's marketing efforts, while others are purchased by customers (often implicitly) as part of a *present* contract and give customers a right to acquire additional goods and services at a discount. Paragraphs 606-10-55-42 through 55-43 [B40-B41] include specific

guidance on determining whether a customer option for additional goods or services gives rise to a material right and, thus, a performance obligation. BC386 further explains that if there is no material right, then the option is a marketing or promotional offer and is not considered part of the contract.

606-10-55-42 [B40] If, in a contract, an entity grants a customer the option to acquire additional goods or services, *that option gives rise to a performance obligation in the contract only if the option provides a material right to the customer* that it would not receive without entering into that contract (for example, a discount that is incremental to the range of discounts typically given for those goods or services to that class of customer in that geographical area or market). If the option provides a material right to the customer, the customer in effect pays the entity in advance for future goods or services, and the entity recognizes revenue when those future goods or services are transferred or when the option expires.

606-10-55-43 [B41] If a customer has the option to acquire an additional good or service at a price that would reflect the standalone selling price for that good or service, that option does not provide the customer with a material right even if the option can be exercised only by entering into a previous contract. *In those cases, the entity has made a marketing offer that it should account for in accordance with the guidance in this Topic only when the customer exercises the option to purchase the additional goods or services. [Emphasis added.]*

9. BC391 discusses renewal options and states that a right to renew (or cancel) is similar to other types of optional purchases.

A renewal option gives a customer the right to acquire additional goods or services of the same type as those

supplied under an existing contract. This type of option could be described as a renewal option within a relatively short contract (for example, a one-year contract with an option to renew that contract for a further year at the end of the first and second years) *or a cancellation option* within a longer contract (for example, a three-year contract that allows the customer to discontinue the contract at the end of each year). *A renewal option could be viewed similarly to other options to provide additional goods or services. In other words, the renewal option could be a performance obligation in the contract if it provides the customer with a material right that it otherwise could not obtain without entering into that contract. [Emphasis added.]*

10. Step 3 of the new revenue standard requires an entity to estimate the total transaction price, which includes variable consideration. Paragraph 606-10-32-4 [49] states:

For the purpose of determining the transaction price, an entity shall assume that the goods or services will be transferred to the customer as promised in accordance with the existing contract and that the contract will not be cancelled, renewed or modified.

11. Because a customer option to purchase additional goods or services is either a material right that is paid for by the customer as part of the existing contract or a marketing offer that is not part of the contract, the additional consideration that would result from the customer exercising its option would not be included in the transaction price.
12. BC417 and BC418 explain that some types of variable consideration that are included in the transaction price are dependent upon the customer's actions:

BC417 The Boards considered whether to expand the restriction for a sales-based or usage-based royalty on a license of intellectual property, whereby revenue recognition would be constrained to zero for any performance obligation

when the amount that an entity is entitled to is based on a customer's future actions. However, the Boards decided not to introduce this principle into Topic 606. This is because it would have prevented an entity from recognizing any revenue when the goods and services were transferred in cases in which the entity could estimate the variable consideration and meet the objective of constraining estimates of variable consideration. *[Emphasis added.]*

BC418 The Boards also observed that expanding the scope to constrain revenue when consideration is based on the customer's future actions also would have increased complexity. It would have required the Boards to create another exception to maintain the guidance for accounting for customer rights of return, which also results in consideration that is dependent on the customer's future actions.

Issue 1 – Optional Purchases versus Variable Consideration

13. Some stakeholders have questions about how to distinguish between a contract that contains an option to purchase additional goods and services and a contract that includes variable consideration based on a variable quantity (such as a usage-based fee). As noted in TRG Agenda Ref No. 39, the staff's view is that variable quantities can give rise to variable consideration in some contracts.
14. Contracts that contain options to purchase additional goods or services could result in variable quantities of goods or services being purchased by the customer. That variability is caused by the customer's ability to exercise its option. Paragraph 606-10-55-42 [B40] notes that a customer option is accounted for *only* if it provides a material right to the customer. In that case, the option (material right), but not the underlying goods or services, is the performance obligation.
15. Some stakeholders think there is an inconsistency between BC50 and BC391 (both included above). Those stakeholders think that BC50 indicates that any time a vendor

has a stand-ready obligation, any future purchases under that contract (optional or not) should be considered a part of the initial contract and should be estimated to determine the transaction price. That is because the vendor is obligated to stand ready and that contract has created enforceable rights and obligations between the parties. However, other stakeholders think that BC50 and BC391 should be considered together. That is, if the customer has the option to terminate a contract, the customer's right is in effect an option to purchase additional goods or services that would be a performance obligation only if it provides the customer with a material right.

16. Accounting for a contract that contains an option to purchase additional goods and services and a contract that includes variable consideration sometimes would result in minimal differences in the timing and measurement of revenue recognized in a reporting period. For example, the accounting for a contract that requires an entity to process transactions for a constant amount of consideration per transaction over a specified period would likely result in revenue recognized as each transaction is processed. This would be the case regardless of whether each transaction processed was considered an optional purchase or, instead, variable consideration for the entity's service of processing transactions over the specified period.
17. However, there could be a difference in required disclosures. If each transaction was considered an optional purchase, an entity would *not* be required to disclose an estimate of the consideration received from the exercise of future options. In contrast, if each transaction processed was considered variable consideration, the entity would be required to estimate the remaining transactions to be processed in order to disclose the transaction price allocated to the remaining performance obligations in paragraphs 606-10-50-13 through 50-16 [120-122] unless it qualifies for one of the practical expedients in paragraph 606-10-50-14 [121].
18. In addition to disclosure differences, the distinction between optional purchases and variable consideration can have a significant effect on contracts with multiple performance obligations. Consider the following example:

Example 1: Company X agrees to sell Customer Y equipment and a service of processing transactions. The equipment and service are both distinct. The equipment is transferred to the customer at the beginning of the service period and the service is performed over the following year. The only consideration in the contract is based on the number of

transactions processed. The number of transactions to be processed are unknown and there are no contractual minimums.

If each transaction was considered to be an optional purchase and there is no material right, then the entity would not allocate any of the contingent-based consideration to the transferred equipment because each transaction would be the performance obligation in an independent contract accounted for separately.

In contrast, if the transaction processing is considered to give rise to variable consideration, then the transaction price would include an estimate of the variable consideration (subject to the constraint) and the transaction price would be allocated to the equipment and service (unless the variable consideration were allocated to only the equipment or the service in accordance with paragraph 606-10-32-40 [85]).

19. The staff think sometimes judgement will be needed to distinguish between contracts with an option to purchase additional goods or services and contracts that have variable consideration (in particular, distinguishing between optional purchases and usage-based fees). The staff think the first step (which is a critical step) is to appropriately identify the nature of the promises in the contract as well as the rights and obligations of the parties. In the staff's view, the following are some differences between optional purchases and variable consideration that may be helpful when evaluating a contract under the new revenue standard:
- a. Options for additional goods or services: The customer has a present contractual right that allows it to choose the amount of *additional* distinct goods or services (or change the goods or services to be delivered) that are purchased (that is, a separate purchasing decision). Prior to the customer's exercise of that right, the vendor is not presently obligated to provide (and does not have a right to consideration for delivering) those goods or services.
 - b. Variable consideration: The customer previously has entered into a contract that obligates the vendor to transfer the promised goods or services. The future events (including the customer's own actions) that result in additional consideration occur after (or as) control of the goods or services have (or are) transferred. The customer's actions do not obligate the vendor to provide *additional distinct* goods or services (or change the goods or services to be transferred).

What are Optional Purchases?

20. The new revenue standard does not define the term *customer option*. However, the new revenue standard discusses *customer options* to acquire *additional goods or services*. BC386 states that if the option is deemed to be a marketing offer, then it is not part of the contract and paragraph 606-10-55-42 [B40] states that in those cases the marketing offer is only accounted for when the customer exercises its option. Because an option that is a marketing offer is considered a new contract if it is exercised, the staff think that an analogy to the contract modification guidance in paragraphs 606-10-25-12 through 25-13 [20-21] could be helpful when an entity is distinguishing between optional purchases and variable consideration. This is because the modification guidance provides an example of the customer changing the amount of goods or services provided. In order for a modification to be considered a separate contract, one of the criteria is that the modification results in the *addition of* promised goods or services *that are distinct*. Similarly, the staff thinks the exercise of a customer option for additional goods and services would typically result in the addition of promised goods or services that are distinct.
21. The staff does not think BC50 implies that any time a vendor is obligated to stand ready to perform that the contract always contains a single performance obligation of standing ready to provide goods or services (and, therefore, that the entity must include an estimate of expected purchases in the transaction price). The staff thinks that BC50 and BC391 should be considered together and that an entity should consider the *present* legally enforceable rights in the contract when identifying the performance obligation(s). In some contracts, the present legally enforceable rights merely give the customer a *right* to purchase additional goods or services.
22. The staff also considered the guidance in paragraphs 606-10-55-340 through 342 [IE254-IE256], which states:

**> > Example 50—Option That Does Not Provide
the Customer with a Material Right (Additional
Goods or Services)**

606-10-55-340 [IE254] An entity in the telecommunications industry enters into a contract with

a customer to provide a handset and monthly network service for two years. The network service includes up to 1,000 call minutes and 1,500 text messages each month for a fixed monthly fee. The contract specifies the price for any additional call minutes or texts that the customer may choose to purchase in any month. The prices for those services are equal to their standalone selling prices.

606-10-55-341 [IE255] The entity determines that the promises to provide the handset and network service are each separate performance obligations. This is because the customer can benefit from the handset and network service either on their own or together with other resources that are readily available to the customer in accordance with the criterion in paragraph 606-10-25-19(a) [27(a)]. In addition, the handset and network service are separately identifiable in accordance with the criterion in paragraph 606-10-25-19(b) [27(b)] (on the basis of the factors in paragraph 606-10-25-21 [29]).

606-10-55-342 [IE256] The entity determines that the option to purchase the additional call minutes and texts does not provide a material right that the customer would not receive without entering into the contract (see paragraph 606-10-55-43 [B41]). This is because the prices of the additional call minutes and texts reflect the standalone selling prices for those services. Because the option for additional call minutes and texts does not grant the customer a material right, the entity concludes it is not a performance obligation in the contract. Consequently, the entity does not allocate any of the transaction price to the option for additional

call minutes or texts. The entity will recognize revenue for the additional call minutes or texts if and when the entity provides those services.

23. In this example, the contract includes a present right (the option) for the customer to purchase additional minutes or text messages, which when purchased are distinct. Furthermore, the customer controls the ability to purchase the minutes or texts.
24. Based on the guidance above, the staff view an optional purchase as providing the customer with a present right to choose the amount of *additional* distinct goods or services (or change the current goods or services) it will purchase. In other words, prior to the exercise of that right, the vendor is not presently obligated to provide the additional distinct goods or services. In the staff's view, the following is an example of optional purchases:

Example of Optional Purchases: Entity B enters into a contract to provide 100 widgets to Customer Y at CU 10 per widget. Each widget is a distinct good transferred at a point in time. The contract also provides Customer Y the right to purchase additional widgets at the standalone selling price of CU 10 per widget. Therefore, the quantity that may be purchased by Customer Y is variable.

Although the quantity that may be purchased is variable, the transaction price for the existing contract is fixed at CU 1,000. That is, the transaction price includes only the consideration for the 100 widgets specified in the contract and any exercise of an option is accounted for as an independent contract (because there is no material right given the pricing of the option to acquire additional widgets in this contract). The contract provides a right that allows the customer to choose the number of additional widgets which are distinct goods. In addition, while Entity B may have an obligation to stand ready to deliver additional widgets, Entity B is not legally obligated to provide the widgets until Customer Y exercises the option.

Why are optional purchases different from variable consideration?

25. As discussed above, when contracts contain an optional purchase, the customer's actions (of exercising the option) result in the vendor's obligation to provide additional distinct goods or services. However, BC417 makes clear that a customer's future actions can also result in variable consideration. As such, to distinguish between an optional purchase and variable consideration based on the customer's

actions, the staff think it is important to determine the vendor’s rights and obligations that arise from the customer’s actions.

26. Some stakeholders question whether a customer’s action that obligates it to pay the vendor would be indicative of an optional purchase. Those stakeholders also might consider the customer’s ability to avoid payment similar to a right to exercise an option. BC148(c) discusses how the Boards considered the right to payment in the new revenue standard and states “In cases in which the customer clearly receives benefits as the entity performs, as in many service contracts, the possibility that the entity ultimately will not retain the payment for its performance is addressed in the measurement of revenue.”
27. The staff think BC148(c) makes it clear that when an entity transfers goods or services, the possibility it will not be entitled to consideration for its services is addressed in measurement of revenue (that is, Step 3). As such, when BC148 is taken together with BC417 through BC418 (both included above), the staff think that customer actions or events that result in additional payment *after* (or as) control of the goods or services has transferred would be indicative of variable consideration. In contrast, the customer’s action in an optional purchase results in a new obligation for the vendor to transfer additional distinct goods or services.
28. Consider the example of a franchise license with a sales-based royalty. The customer’s actions (the use of the license) result in a payment for the service that is already being provided (the right to access the license transferred over time) and the customer actions (use of the license) do not result in additional goods or services to be provided. In the staff’s view, the following are examples of variable consideration:

VC Example 1 -- Goods: Entity A enters into a contract to provide equipment to Customer X. The equipment is a single performance obligation transferred at a point in time. Entity A charges the customer based upon usage of the equipment at a fixed rate per unit of consumption. The contract has no minimum payment guarantees. The customer is not contractually obligated to use the equipment; however, Entity A is contractually obligated to transfer the equipment to Customer X.

The usage of the equipment by the customer is a variable quantity that affects the amount of consideration owed to the entity. It does not affect the entity’s performance obligation, which is to transfer the piece of equipment. In other words, the vendor has previously

performed by transferring the distinct good, and the customer's actions that result in additional payment occur after the goods have been transferred and do not require the vendor to provide additional goods or services.

VC Example 2 -- Services: D, a nightclub, hires Company S to provide security services, which includes checking identification of each customer at the door and collecting the entrance fee on the behalf of D. S receives CU 1 for each customer that comes through the door. That is, S will get paid CU 1 each time it checks identification and collects the cover charge. If no customers come into D, then S will not get paid, but it is still obligated to perform each night.

The performance obligation in the contract is the security service for a night. The variability in the contract that affects the amount S is paid does not affect the amount of services to be provided. That is, S is required to perform by watching the door regardless of the number of customers. The events that result in payment occur as S performs the service and are not a result of a choice made by the customer. The amount S ultimately is paid is factored into the measurement of the transaction price.

Examples of Optional Purchases versus Variable Consideration

29. At the July 9, 2014 TRG meeting, the TRG members discussed some fact patterns in TRG Agenda Ref No. 39. The staff want to emphasize that the staff's views in Issue 2 of that paper are linked to the conclusion that there is a single performance obligation. The examples in in TRG Agenda Ref No. 39 include:

IT Outsourcing: IT Seller and IT Buyer execute a 10 year IT Outsourcing arrangement in which IT Seller provides continuous delivery of different outsourced activities over the contract term. For example, the vendor will provide server capacity and manage the customer's software portfolio, along with other activities. The total monthly invoice is calculated based on different units consumed. For example, the billings might be based on millions of instructions per second of computing power (MIPs), number of software applications used, or number of employees supported. Price per unit differs for each type of activity provided. IT Seller charges the IT Buyer a non-refundable upfront fee related to the transition activities.

Transaction Processing: Transaction Processor (TP) enters into a 10 year agreement with a customer. Over the 10 year period, TP will provide continuous access to its system and process all transactions on behalf of the customer. The customer is obligated to use TP's system to process all of its transactions; however, the ultimate quantity of transactions is not known and is outside the control of the TP and its customer. TP concludes that the customer simultaneously receives and consumes the benefit of providing the network as it

performs. TP charges the customer on a per transaction basis. TP also charges the customer a fixed upfront fee at contract inception.

30. The staff understands that stakeholders have questions regarding contracts that have a stand ready element. The staff did not intend at the last TRG meeting to imply that all contracts with a stand ready element to them include a single performance obligation that is satisfied over time. Therefore, the staff think it is important to contrast the above examples from the previous TRG meeting with another example.

Supply Agreement: Supplier enters into a 5 year exclusive master supply agreement with a customer which obligates the supplier to produce and sell parts for a particular product the customer manufactures to the customer as requested. The customer is not obligated to purchase any parts, however, it is highly likely it will purchase parts because the part is required to manufacture the product and it is not practical to get parts from multiple suppliers. Each part is a distinct good that transfers to the customer at a point in time.

IT Outsourcing

31. The staff (and many stakeholders in this industry) view the type of arrangement above as being a single performance obligation (each of the underlying activities are not distinct) for the entire contract term. The staff and those stakeholders think that the nature of the promise is to provide a single continuous integrated service for the contract term.
32. In the IT outsourcing fact pattern contemplated above, the customer's actions do not obligate the vendor to transfer *additional distinct goods or services*. The customer previously made the choice (by entering into the contract) that obligated the vendor to provide services and the customer to only use that vendor's services for that population of the customer's IT needs. The customer's subsequent actions utilize the service to which IT Seller is already committed and performing.
33. The staff view the nature of the promise (and the rights and obligations) in the IT contracts contemplated above as being different from Example 50 in the new revenue standard (the optional purchases of additional calls or text messages). This is because in the telecom example (Example 50) the customer has the choice to acquire additional distinct services (the minute or the message) that obligates the provider to deliver the *additional* services. In contrast, in the IT outsourcing scenario, the

customer's subsequent action (the usage of the service) does not obligate the vendor to provide additional distinct goods or services because the nature of the promise is the overall service and not the individual activities. That is, the staff (and many stakeholders in this industry) view the quantity of units used to determine the payments as a measure of usage (that is, computing power consumed) of the *service* being performed (that is, the overall outsourcing service) rather than distinct services purchased by the customer. Finally, the staff view a typical customer option in the outsourcing scenario to be a right to extend the contract term (because the overall daily services are the additional distinct services).

34. Finally, the type of arrangements the staff are considering would have enforceable rights and obligations in the contract. Under the contract, the vendor is presently obligated to make the IT outsourcing service continuously available to the customer throughout the non-cancellable contract term. The vendor's performance creates a right to payment, the variability of which is reflected in the measurement of revenue.

Transaction Processing

35. The staff view this type of transaction processing service as a single performance obligation (that may be a series of distinct services) that spans the contract period. The staff think the nature of the promise is to provide the customer with continuous access to the processing platform so that when the customer's customer submits a transaction it is processed for the customer.
36. In the fact patterns contemplated above, the customer does not control the number of transactions processed and is contracting for access to the processing platform. Because the customer does not control the number of transactions processed, entering into the initial contract is the purchasing decision after which the customer does not have the ability to choose quantities processed. As such, because the vendor is already obligated to provide continuous access to the platform (and receive consideration for that service), the events that result in payment occur after (or as) the vendor transfers the service and do not result in an obligation for the vendor to transfer additional goods or services.
37. Finally, the type of arrangements the staff are considering would have enforceable rights and obligations in the contract. Under the contract, the vendor is presently

obligated to make the service continuously available throughout the contract term on the customer's behalf and the customer has the right to those services. The vendor's performance creates a right to payment, the variability of which is reflected in the measurement of revenue.

Supply Agreement

38. Some stakeholders think that the nature of the promise in this example is a service of standing ready to perform with a single performance obligation. Under that view, the entity would estimate the number of purchases to be made throughout the contract term and continually adjust the transaction price and reallocate the consideration among the transferred goods or services. Stakeholders that view this arrangement as a single performance obligation do not see a difference between this example and the outsourcing or transaction processing examples. They would view the nature of *any* contract (or most contracts) with a stand ready obligation and an undefined quantity of items that will be provided or activities performed as a single service rather than the delivery of the underlying goods or services.
39. The staff view the nature of the promise in this example as the delivery of the parts, rather than (or in addition to) a service of standing ready. The staff think an important distinction between this fact pattern and transaction processing or outsourcing arrangements is that the contract provides a right to choose the quantity of *additional distinct goods* versus a right to use the services for which control to the customer has (or is currently being) transferred. Similarly, the supplier is not obligated to transfer any parts until the customer submits the purchase order, while in the other fact patterns the vendor is obligated to make the promised services available to the customer without any additional decisions made by the customer.
40. TRG Agenda Ref No. 16 on stand ready obligations notes that, in some contracts, the nature of the entity's promise is primarily that of "standing ready", or making available a scarce resource to the customer when-and-as it is needed (for example, the service of making the entity's health club available for the customer's use when the customer decides to use it). In contrast, in other cases, the nature of the promise is to transfer specified goods or services. For example, a contract to deliver 100 widgets over the next five years when the customer requests the widgets generally

would not be a “stand-ready obligation”, nor would a contract that simply sets out terms and conditions for future orders, but requires purchase orders of a specified quantity at a later date to obligate the vendor to perform (and customer to pay). Paragraph 606-10-55-185 [IE93], which describes a stand ready obligation, may also help distinguish the differences:

606-10-55-185 [IE93] The entity determines that its promise to the customer is to provide a service of making the health clubs available for the customer to use as and when the customer wishes. ***This is because the extent to which the customer uses the health clubs does not affect the amount of the remaining goods and services to which the customer is entitled.*** The entity concludes that the customer simultaneously receives and consumes the benefits of the entity’s performance as it performs by making the health clubs available. Consequently, the entity’s performance obligation is satisfied over time in accordance with paragraph 606-10-25-27(a) [35(a)]. ***[Emphasis added.]***

41. The staff do not view customer purchases under a master supply agreement to be similar to a customer’s use of a health club (or the other examples determined to be stand ready obligations in TRG Agenda Ref 16). When the customer submits a purchase order, it is contracting for a specific number of distinct goods and creates new performance obligations for the supplier. In contrast, in the health club example, the customer is using services that the health club has made available and no new obligations arise from the usage of the service.

Summary

42. The staff think the determination of whether a contract has variable consideration or an optional purchase is highly dependent upon the evaluation of the nature of the promise in the contract. Consequently, not all outsourcing, transaction processing, and supply agreements automatically would be accounted for consistently with the

staff view of the examples in this paper. An entity will need to evaluate the facts and circumstances of its contracts to determine the nature of its promise to the customer. Similar to previous U.S. GAAP and IFRS, this sometimes will require the use of judgement.

43. The staff suggest that when an entity is evaluating the nature of its promises, the entity also should be mindful of the disclosure requirements in the new revenue standard. Those disclosure requirements include, but are not limited to, a description of the *nature* of the goods and services that the entity has promised to transfer and *significant judgements*, and changes in the judgements, made in applying the new revenue standard that significantly affect the determination of the amount and timing of revenue. For many entities, the disclosure requirements in the new revenue standard are incremental to those required under previous U.S. GAAP and IFRS.

Issue 2 – Customer Termination Rights and Penalties

44. At the October 31, 2014 TRG meeting (Agenda Ref No. 10), the TRG discussed the accounting for termination clauses in a contract and TRG members supported the view that the legally enforceable contract period should be considered the contract period. The discussion in that paper focused on the accounting for termination clauses in contracts when *each* party has the unilateral enforceable right to terminate the contract at any time during the specified period by *compensating the other party*. That discussion indicated that a contract exists throughout the period covered by the termination penalties because the penalties are evidence of enforceable rights and obligations throughout that term. The TRG members also discussed that the existence of a termination penalty by itself does not mean that the duration of a contract includes periods covered by the termination penalties. An entity would also consider whether the termination penalty is substantive.
45. Since that TRG meeting, the staff has become aware of further questions regarding customer termination rights and the effect of termination penalties. More specifically, the questions relate to how to evaluate the contract term when only the customer has the right to cancel without cause the contract and how termination penalties effect that analysis.

46. Some stakeholders think there is an inconsistency between BC50 and BC391 in how customer termination rights should be evaluated. Some stakeholders think that BC50 suggests that a contract exists for the entire term (and the entity should account for all of the potential goods or services in that term) when only the customer can cancel but there is cancellation penalty. In contrast, others think BC50 and BC391 should be considered together and that BC391 indicates that a cancellation option or termination right is akin to a renewal option and, therefore, that option should only be accounted for if it provides the customer with a material right. Consider the following example in a service contract:

Contract 1:

Entity A enters into a four year service contract with Customer X with a right to cancel the contract at the end of each year. Contract 1 requires Customer X to pay an annual fee of CU 100, which is the standalone selling price for renewals after year 3. Customer X can terminate the contract prior to year four without cause but would incur a termination penalty. The penalty decreases annually throughout the contract term. Assume the penalty is substantive in each period. The following table illustrates the payments under the contract.

	<u>Year 1</u>	<u>Year 2</u>	<u>Year 3</u>	<u>Year 4</u>
Annual Fee	100	100	100	100
Termination Penalty	<u>30</u>	<u>20</u>	<u>10</u>	<u>-</u>
Cumulative fee if customer cancels in this year	130	220	310	400

47. The staff understands stakeholders have the following views on Contract 1:
- a. *View A:* Contract 1 is a four-year contract. The substantive termination penalty is evidence of enforceable rights and obligations throughout the contract term. The termination penalty is ignored until the contract is terminated at which point it will be accounted for as a modification.
 - b. *View B:* Contract 1 is a one-year contract with three renewal options and the penalty creates a material right. The premium the entity would have to pay in years 1 through 3 if the entity does not renew is akin to an upfront fee for the future goods or services that is waived upon each renewal. The entity would allocate consideration to the material right or apply the practical alternative

described in paragraph 606-10-55-45 [B43], which allows the entity to include the expected services in the measurement of the transaction price. Any uncertainty around the renewals would be factored into the standalone selling price of the material right or the calculation of expected term.

48. The question about customer options and termination penalties is not limited to service contracts. Consider the following example:

Contract 2: An entity sells equipment and consumable parts for the equipment (both the equipment and parts are distinct goods that do not meet the overtime criteria). The standalone selling price of the equipment and parts is CU 10,000 and CU100, respectively. The entity sells the equipment for CU 6,000 (a 40% discount from standalone selling price) and provides an option to purchase each part for CU 100. If the customer does not purchase at least 200 parts, it is required to pay a penalty to repay some or all of the CU 4,000 discount provided on the equipment. The penalty decreases as each part is purchased at a rate of CU 20 per part. A discount of CU 10 would be viewed as a material right to the customer.

49. Stakeholders have the following views about the accounting for Contract 2, which are similar to the views for Contract 1:
- a. *View A:* The penalty (or foregoing the upfront discount) is substantive and in effect creates a minimum purchase obligation such that the entity would conclude that the minimum number of parts required to avoid the penalty would be evidence of enforceable rights and obligations. As a result, the contract includes both the equipment and the minimum parts (200) required to not incur the penalty. Therefore, the transaction price is CU 26,000 [(200 x 100) + 6,000], which should be allocated to the multiple performance obligations (CU 8,667 [26,000 * (10,000/30,000)] to the equipment and CU 17,333 [26,000 * (20,000/30,000)] to the parts [86.67 per part]). The entity would account for the failure to purchase additional parts and the resulting penalty as a contract modification.
 - b. *View B:* The part purchases are a contract option. However, the transaction price at contract inception is CU 10,000 [6,000 + 4,000 penalty], and there are two performance obligations at inception, the equipment and a material right. If the customer purchases no parts, it would, in effect, pay CU 10,000

for the equipment and the penalty could be viewed as a discount on the future purchases. That is, the customer can realize a discount on the equipment by purchasing parts, which is similar to making the contractual price of the parts CU 80. Consequently, the penalty (or avoidance of paying a penalty) should be evaluated as giving rise to a material right. The entity estimates the standalone selling price of the material right to be CU 4,000. The entity would then allocate CU 7,143 $[(10,000/14,000) * 10,000]$ of the transaction price to the equipment and CU 2,857 $[(4,000/14,000) * 10,000]$ to the material right based on their relative standalone selling prices.

Staff Analysis

50. The staff think View A is appropriate view under new revenue standard for Contracts 1 and 2. View A is consistent with the discussion in TRG Agenda Ref No. 10 and that a penalty that compensates the other party is evidence of the enforceable rights and obligations for both parties throughout the entire term. While TRG Agenda Ref No. 10 was specific to contracts in which both parties have the unilateral ability to terminate the contract, the staff do not view a customer only right to terminate to be a significant enough difference to warrant another acceptable view. Furthermore, the staff do not think that an entity should have different results (even if many times the results would be similar) by calling the penalty (or foregoing a discount) a material right versus concluding there is a longer contractual term.
51. The staff think that BC391 makes clear that customer cancellation rights can be similar to a renewal option. The staff think that this would typically be the case when there are no contractual penalties that compensate the other party upon cancellation (refer to TRG Agenda Ref No. 10 for further discussion on penalties that compensate the other party) and when the customer has the unilateral right to terminate the contract for other than cause or contingent events outside the customer's control.

Issue 3 – When Should an Optional Purchase be Considered a Separate Performance Obligation

52. Issue 2 is about situations in which it may be appropriate to include the goods or services underlying customer options as part of the contract when the contract

contains penalties that *compensate the other party* upon cancellation. However, there are differing views on when, if ever, the goods or services underlying the option to purchase additional goods or services should be a performance obligation when there are *no* contractual penalties that compensate the other party. There are various reasons why an entity might think it is virtually certain (or highly probable/probable) that the customer will exercise its option for additional goods or services. This might be the case, for example, in cases in which the entity is the sole provider of the goods or services and/or the contract includes an exclusivity clause that requires the customer to acquire those goods and services only from the entity. Below is a summary of the two primary views for this issue when there are no contractual penalties that compensate the other party:

View A – Goods or services must be legally enforceable

53. Items that as a “matter of law” (606-10-25-2 [10]) are ‘optional’ from the customer’s perspective should not be identified as goods or services promised in the contract and, therefore, not identified as performance obligations. The options should instead be assessed to determine whether the customer has a material right. As a result, consideration that would be received for ‘optional’ goods or services if the customer exercises its right *should not* be included when determining the transaction price for the existing contract.
54. Stakeholders that support View A think that the option for the customer to purchase additional goods or services represents a right that should be evaluated in accordance with paragraphs 606-10-55-41 through 55-45 [B39-B43] to determine whether it represents a material right (and if so, a portion of the consideration would be allocated to the right). Paragraph 606-10-55-42 [B40] states that an option to acquire additional goods or services “gives rise to a performance obligation in the contract *only if* the option provides a material right to the customer.” Those stakeholders further think their view is consistent with the Boards’ clarification in BC186 that the transaction price should only include amounts to which the entity has rights under the present contract and should “not include estimates of consideration from the future exercise of options for additional goods or services.”

View B – Judgment is required to determine if the legal options represent in substance promised goods or services in the contract

55. Stakeholders that support View B think that in certain facts and circumstances the substance of the contract implies that a contractual option could be considered a part of the contract. Under this view, the entity would estimate the in-substance minimum in order to determine the transaction price and allocate the arrangement consideration among the performance obligations (that would reflect that minimum). Purchases above and beyond the estimated minimum would be considered optional purchases and accounted for as separate contracts.
56. Those stakeholders take a broader view of a penalty that creates enforceable rights and obligations and would consider economic penalties to the customer outside of the contractual arrangement with the vendor. For example, they would consider economic penalties that compel the customer to exercise the option(s) even if that penalty did not result in compensation to the other party in the contract. They would also consider factors such as whether the contract creates an exclusive relationship between the parties, practical restrictions (for example, the entity is the only provider of the goods or services), governmental regulations, and other economic losses the customer might incur if the option was not exercised. Furthermore, those stakeholders might consider the history with the customer and whether there are any implied promises from the customer.
57. Those stakeholders acknowledge that the new revenue standard does not explicitly require entities to estimate the number of options the customer will exercise; however, they think that a facts and circumstances approach to each contract is necessary to appropriately apply the principle of the new revenue standard. Those stakeholders think this view is supported by the following:
 - (a) Not all performance obligations are required to be legally enforceable. That is, paragraph 606-10-25-16 [24] states that a contract can include promises that are implied by the entity's customary business practices. BC87 clarifies that implied promises do not need to be enforceable by law.
 - (b) Current revenue recognition guidance in U.S. GAAP considers significant economic penalties to exist outside of the contractual arrangement. For

example, the guidance in 985-605-55-122, which was superseded by the new revenue standard, discussed the concepts of significant economic penalties to determine the scope of the software guidance. This guidance states:

For purposes of item (a) in the preceding paragraph, the term significant penalty contains two distinct concepts

a. The ability to take delivery of the software without incurring significant cost

b. The ability to use the software separately without a significant diminution in utility or value.

(c) The lease guidance considers external factors outside of the contract when determining the lease term. The current guidance in U.S. GAAP (which the staff understands is consistent with the Board's decisions in the leases project) requires the following:

(i) To determine the lease term, an entity is required to consider all periods for which failure to renew the lease imposes a penalty on the lessee in such amount that a renewal appears, at lease inception, to be reasonably assured.

(ii) Furthermore, the definition of penalty includes factors outside of the contract that may cause an economic detriment or an entity to forgo an economic benefit.

58. Supporters of View B think that by following the legal form, contracts with similar economics may have different financial reporting outcomes in an individual reporting period. Consider the following examples:

Examples

Example 1: An entity sells equipment and a consumable part for the equipment (both the equipment and the part are distinct goods based on the guidance in paragraphs 606-10-25-19 through 25-22 [27-30] that do not meet the over time recognition criteria in paragraph 606-10-25-27 [35]). The equipment does not function without the consumable part, but the customer could resell the equipment. The standalone selling price of the equipment is CU 10,000 and the standalone selling price of each part is CU 100. The costs of the equipment and each part are CU 8,000 and CU 60, respectively.

Scenario A: The entity sells the equipment for CU 6,000 (40% discount from standalone selling price) with a contractual option to purchase each part for CU 100. There are no contractual minimums; however, the entity estimates the customer will purchase 200 parts over the 2 years. Assume, that the seller and customer have an exclusive contract where the customer cannot purchase the goods from other vendors during the contract term.

59. *View A:* The parts underlying each option would *not* be considered a part of the contract and there is no material right. The transaction price is CU 6,000, which is entirely attributable to the equipment, and the entity would have a loss of CU 2,000 when it transfers control of the equipment to the customer.
60. *View B:* If there was a significant economic penalty to the customer for not purchasing the parts because the equipment would not function without the parts and the entity is contractually restricted from purchasing parts from other vendors, the entity would estimate the minimum purchases and include that amount in the transaction price. Therefore, the transaction price would be CU 26,000 (6,000 for equipment + [200 * 100] for the parts). The transaction price would be allocated as follows: CU 8,667 to the equipment ($10,000/30,000 * 26,000$) and CU 17,333 to the parts ($20,000/30,000 * 26,000$). The entity would have profit of CU 667 (8,667-8,000) when it transfers control of the equipment and profit of CU 26.67 (86.67-60) per part.

Scenario B: The entity sells the equipment for CU 10,000 and each part for CU 80 (the entity concludes the 20% discount on parts is material). The customer is not required to purchase any parts; however, the option to purchase parts represents a material right. Assume the entity estimates 200 parts would be purchased and the standalone selling price of the material right is CU 4,000.

61. *View A:* The discount on the option to purchase each part would give rise to a material right and the contract would have two performance obligations, the equipment and the material right. The transaction price (CU 10,000) would be allocated to the performance obligations based on the stand-alone selling price (4,000 [200 estimated purchases * 20 discount] for the material right and 10,000 for the equipment) of each performance obligation (CU 7,143 [$10,000/14,000 * 10,000$] allocated to the equipment and CU 2,857 [$4,000/14,000 * 10,000$] to the material right). The allocated transaction price would be recognized as each performance obligation is satisfied.

The entity would recognize a loss on the sale of the equipment and some of the transaction price is deferred until parts are transferred.

62. *View B:* If there was a significant economic penalty (for example, if the customer is contractually restricted from purchasing goods from other parties or it is impractical because of various factors), the entity would estimate the minimum purchases and include that amount in the transaction price. The contract includes multiple performance obligations (the equipment and each part the entity expects the customer to purchase). The transaction price is CU 26,000 and CU 8,667 ($26,000 * [10,000/30,000]$) is allocated to the equipment and CU 86.67 allocated to each of the 200 parts expected to be purchased. The outcome would be the entity recognizes margin on the equipment and each part.

Example 2: A vendor enters into a five-year contract to provide a service to a customer with payments due monthly (assume collection is probable and pricing reflects standalone selling price throughout the contract term). To secure the contract, the *vendor* makes an upfront payment *to the customer*. Contractually, the customer has the right to terminate the contract at any time with 30 days of notice without penalty. The vendor does not have the right to terminate the contract. Most customers do not terminate the contract, in part because of the time and effort required for set-up on the vendor's system and the cost that would be incurred to change vendors.

63. *View A:* The contract is a month to month contract because the termination clause is akin to a renewal right. Because the prices charged for each month are at the standalone selling price there is no material right. The upfront payment made to the customer by the vendor does not impact the analysis of the material right because in contrast to the examples in Issue 2 (and upfront fees *received from the customer* discussed in TRG Agenda Papers 6 and 32) the failure to renew does not impact the customer's ability to retain the payment from the vendor and, therefore, would not be considered a penalty. As such, only the future options are considered and paragraph 606-10-55-43 [B41] makes clear that even if the contract provides a right to exercise an option because of a present contract, that option is considered a marketing offer if there is not a material right.
64. *View B:* There is a significant economic penalty to the customer in the form of the cost and effort required to switch vendors which is further evidenced by the past

history of renewals. The entity would estimate the minimum contract term and include all of the payments over that term in the transaction price.

Staff View

65. The staff think View A is appropriate in Examples 1 and 2. The staff do not think the new revenue standard requires estimating future contracts the customer will enter into with the vendor. This is different from Issue 2 because in Issue 2 the penalty compensated the other party and is evidence of enforceable rights and obligations throughout the contract term. The staff think that options are only a performance obligation if the option provides the customer with a material right (that is, the underlying goods or services are not the performance obligation). Furthermore, the staff think paragraph 606-10-55-43 [B41] makes clear that even if the contract provides a right to exercise an option because of a present contract, that option is considered a marketing offer if it does not represent a material right. Finally, if the upfront deliverable in the arrangement is considered a distinct good or service, the staff think it is counterintuitive to conclude that the entity is economically compelled to purchase additional items solely because they are utilized with the upfront good. That is because if the good or service is distinct, then the customer can benefit from that good or service on its own without any additional goods or services and the promise is separately identifiable from the other promises in the contract.
66. The staff also do not view optional purchases of additional goods or services to be similar to implied promises in a contract. The staff think the guidance in paragraph 606-10-25-16 [24] is specific to promises made by the vendor that creates an expectation of the customer. In other words, the consideration in the current contract relates to those promises implied by the vendor rather than pulling forward consideration from future contracts.
67. The staff note that there is often judgment required to determine the extent of the contract and entities also should consider the guidance in paragraph 606-10-25-9 [17] on contract combination. The staff's view on options to purchase additional goods or services does not preclude an entity from making judgments about the extent of the legal contracts (which is a determination that requires consideration of the terms

and conditions of the contract together with the legal framework in the relevant jurisdiction) and when those contracts should be combined with other contracts.

Question for the TRG Members

1. What are the TRG members' views about the issues and the staff analysis in this paper?