STAFF PAPER

January 26, 2015

Project	**FASB/IASB Joint Transition Resource Group for Revenue Recognition**
Paper topic	Material Right

CONTACT(S)	Mary Mazzella	msmazzella@fasb.org	+1 203 956 3434
	Kristin Floyd	knfloyd@fasb.org	+1 203 956 5384
	Stuart Leadill	sleadill@ifrs.org	+44 207 246 6410

The following implementation questions and potential interpretations were submitted to the TRG by a stakeholder.

Issue 1: Accounting for a Customer's Exercise of a Material Right

1. Per paragraph 606-10-25-10 (IFRS 15 paragraph 18), a contract modification is a change in the scope or price (or both) of a contract. A contract modification exists when the parties to a contract approve a modification that either creates new or changes existing enforceable rights and obligations.
2. When a contract with a customer includes a "material right" how should an entity account for the customer's exercise of the right (option)?

   (a) View A – A continuation of the contract (an entity would include the amount allocated to the material right in the transaction price for the performance obligation (or obligations) underlying such right). Proponents of this view note that the scope and pricing of the original contract included the option and that the contract does not need to be modified or changed in order for the customer to exercise the option. Therefore the exercise of the option by the customer does not represent a modification because it is not "a change in scope or price (or both) of the contract" per paragraph 606-10-25-10 (IFRS 15 paragraph 18).

   (b) View B – A contract modification (an entity would apply the modification guidance when a customer exercises a material right). Proponents of this view believe the exercise of the option by the customer changes the scope or price of the contract and should therefore be viewed as a modification per paragraph 606-10-25-10 (IFRS 15 paragraph 18).

(c) View C – As variable consideration (any potential addition consideration upon exercise of the option should be treated as variable consideration subject to the constraint). Proponents of this view believe the option in the contract creates variable quantities and pricing subject to the guidance in paragraphs 606-10-32-5 to 32-9 (IFRS 15 paragraphs 50-54).

3. Example

An entity enters into a contract with a customer to sell 2 years of Service A for $100 (its standalone selling price) with an option to purchase 2 years of Service B for $300 (25% off the $400 standalone selling price of Service B). The entity concludes the option to purchase Service B provides the customers with a material right (and a separate performance obligation) and estimates the standalone selling price of such right is $33. As a result, the entity allocates the $100 transaction price to each performance obligation on the basis of each performance obligations' standalone selling price as follows:

$75	Service A
$25	Option to purchase Service B

Upon executing the contract, the customer pays the $100 and the entity immediately begins transferring Service A to the customer. The entity recognizes the $75 allocated to Service A over the 2 year service period and defers recognition of the $25 allocated to the option. Six months later the customer exercises its option to purchase 2 years of Service B for $300.

4. How should the entity account for the customer's exercise of the option?

(a) View A - A continuation of the original contract. The additional $300 of consideration to be received would be added to the $25 of deferred consideration (the amount allocated to the option) and recognized as Service B transfers to the customer (total transaction price of $400 with $75 allocated to Product A and $325 allocated to Service B).

(b) View B – A contract modification. The addition of Service B would be evaluated in accordance with the contract modification guidance. Service B would not be accounted for as a separate contract since the price of the contract did not increase by an amount of consideration that reflects the entity's standalone selling price of the service. Therefore, the entity would evaluate the modification in accordance with paragraph 606-10-25-13 (IFRS 15 paragraph 21). Since Service A is still being transferred to the customer, paragraph 606-10-25-13 (c) (IFRS 15 paragraph 21 (c)) would seemingly apply such that the entity would reallocate the consideration in the arrangement (including both the unrecognized consideration from the original contract and the additional consideration) to the remaining performance obligations. The amount allocated to Service A would adjust revenue on a prospective basis and the amount allocated to Service B would be recognized as the service transfers to the customer.

(c) View C – As variable consideration. The potential $300 additional consideration should be treated as variable consideration subject to the constraint. That is, when it is probable that including the $300 in the transaction price would not result in a significant reversal of cumulative revenue recognized under the contract (that is, it is probable the customer will exercise the option), the entity would include such amount in the transaction price and reallocate consideration between Service A and Service B. At such time, the entity would reallocate the transaction price to Service A and Service B on the basis of the original standalone selling price ($80 allocated to Service A and $320 allocated to Service B).

Issue 2: Material Rights and Significant Financing Components

5. Topic 606 (IFRS 15), *Revenue from Contracts with Customers*, states that when the receipt of consideration does not match the timing of the transfer of goods or services to the customer, then the entity is either receiving or providing financing. The transaction price would be adjusted for the time value of money if the financing component is significant.
6. If an option creates a material right that is accounted for as a performance obligation (i.e., 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), would an entity need to consider if a significant financing component exists for that option?

Issue 3: Determining When a Material Right Exists[1]

7. An entity charges a one-time upfront activation fee and provides service on a month-to-month basis. Customers are under no obligation to continue to purchase the monthly service and the entity has not committed to any pricing levels for the service in future months. The activation fee approximates one-half of a month of service revenue. Since the activity of signing up the customer does not result in the transfer of a good or service to the customer, it does not represent a separate performance obligation. The activation fee should therefore be deferred and recognized as the future service is provided. How should the entity account for the upfront fee?

   (a) View A - When compared to one month of service (the contract period), the activation fee is material. Therefore, the option to purchase the monthly service in the future without paying the activation fee is a material right. As a result, the recognition period for the upfront fee should extend beyond the initial contractual period of one month and take into account the expected period of benefit (paragraph 606-10-55-51) (IFRS 15 paragraph B49).

   (b) View B - The arrangement does not contain a material right because the upfront fee is not material when compared to the service fee for the expected period of benefit. This view takes into account expected future transactions with the customer (similar to the issue discussed by the TRG). Consider the following example:

      Activation fee = $50

      Monthly service fee = $100

      Average customer life = 2 years

[1] This issue was discussed at the October 31, 2014 TRG meeting. Refer to Agenda Ref No. 6

When comparing the activation fee to two years of service fees ($2,400), the activation fee is not quantitatively material (2%). Thus, the activation fee should only be recognized over the initial contractual period of one month.