Purpose

1. This paper seeks the Boards' views on the identification and satisfaction of performance obligations (and, hence, the pattern of revenue recognition) in contracts in which an entity grants a license to a customer.

Summary of recommendations

2. The staff recommends the following:

   (a) In a contract in which an entity grants an exclusive license to a customer, the promised asset is the continuing access to the entity's intellectual property. That access is transferred continuously and, hence, represents a series of performance obligations that are satisfied over time.

   (b) In a contract in which an entity grants a non-exclusive license to a customer, the promised asset is the license and the promise to grant that license represents a single performance obligation that the entity satisfies when the customer is able to use and benefit from the license.

Background

3. In general, a license is an official or legal permission granted to do or own a specified thing. In the context of software, licensing is defined in the FASB

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Accounting Standards Codification Glossary as 'granting the right to use but not own software through lease or licenses'.

4. If a customer obtains control of the entity's intellectual property, the contract would be considered a sale, rather than a license or lease, of the intellectual property. That would be the case if the entity grants a customer the right to use its intellectual property for the duration of its economic life.

5. It is common for entities to grant licenses in contracts with customers. For example:
   - Software licenses
   - Franchise agreements, such as right to operate a business using the franchise name or right-to-use the franchise process
   - Rights to music, film, and video games.

6. The Discussion Paper did not specifically address the accounting for contracts in which the entity grants a license to a customer. Hence, many respondents to the Discussion Paper questioned how an entity would apply the proposed model to those contracts.

Structure of paper

7. This paper is organized as follows:
   (a) The nature of a performance obligation to grant a license
   (b) Existing standards and current practice
   (c) Potential differences between a license and a lease
   (d) Appendix A: Applying the proposed revenue recognition model to non-exclusive licenses.

The nature of a performance obligation to grant a license

8. To account for a contract in which an entity grants a license to a customer, it is necessary to identify the performance obligations in the contract. The staff

thinks that there are two main views on the nature of the performance obligations in licensing agreements. Both of those views could be consistent with the proposed model.

(a) *View A*—The promised asset is the license and is separate, or separable, from the entity's intellectual property. Hence, the promise to grant a license represents a single performance obligation that the entity satisfies when the customer is able to use and benefit from the license.

(b) *View B*—The promised asset is the continuing access, authorized by the license, to the entity's intellectual property. That access is transferred continuously and, hence, represents a series of performance obligations that the entity satisfies over time.

View A – The promised asset is the license

9. Proponents of View A view a license as an asset that is separate, or separable, from the entity's intellectual property. They think that:

   (a) The license represents a product that is based on, but separate from, the entity's intellectual property. That could be viewed as similar to any product that contains an entity's intellectual property. For example, a payroll processing software product contains intellectual property, but the customer's asset is the use and benefit of payroll processing and not access to the entity's intellectual property (source code). Similarly, when a customer purchases a dress, that dress contains intellectual property for its design. But the customer's asset is the use and benefit of the dress.

   (b) The entity's intellectual property comprises a bundle of rights which can be componentized and sold separately. The license represents a separable component of the entity's intellectual property that can be transferred at a point in time.

10. If a license is separate, or separable, from the entity's intellectual property for either of the reasons above, then the promised asset is something that the entity can transfer at a point in time when the customer obtains control of that asset. A

customer would obtain control of a license at the earliest point at which the customer can obtain the use and benefit of the license.

11. Additionally, proponents of View A note that licensing intellectual property is the only way an entity can distribute its product and retain its intellectual property. The license protects the entity from the unauthorized duplication of its products. Those proponents think that the asset transferred with a license is, in principle, similar in nature to the promised asset in a sale of any product.

View B – The promised asset is the continuing access to the entity's intellectual property

12. Proponents of View B think that an entity cannot componentize its intellectual property. Hence, a portion of that intellectual property cannot be transferred at a point in time. If the entity retains ownership of all of its intellectual property, then a license merely grants the customer the ability to continuously access that intellectual property for a period of time less than its expected useful life. That access can be transferred, and revenue recognized, only over time.

13. View B proponents think that an entity has performance obligations to provide the customer access to the intellectual property over the license period. That is because an infringement by the licensor could impair the licensee's ability to use the licensed software. As such, proponents of View B think that the entity has a series of performance obligations that are satisfied over the license period.

14. View B is consistent with the Boards' decision on lessor accounting at their joint meeting in October 2009.

Existing standards and current practice

15. Having considered the alternative views on the nature of performance obligations in licensing agreements, this section now considers the view of existing standards and current practice.

16. Existing standards and current practice for accounting for license agreements generally are consistent with View A—i.e. licenses often give rise to revenue

recognition at a point in time. Examples include existing standards on software, motion pictures, music, and franchises. For instance, the appendix to IAS 18 *Revenue* states the following:

> An assignment of rights for a fixed fee or non-refundable guarantee under a non-cancellable contract which permits the licensee to exploit those rights freely and the licensor has no remaining obligations to perform is, in substance, a sale. An example is a licensing agreement for the use of software when the licensor has no obligations subsequent to delivery. Another example is the granting of rights to exhibit a motion picture film in markets where the licensor has no control over the distributor and expects to receive no further revenues from the box office receipts. In such cases, revenue is recognised at the time of sale.

17. However, in some instances in current practice an entity recognizes revenue over a license period (similar to View B). That typically occurs either because:

    (a) *the consideration in the contract is uncertain in amount*, which could result in revenue being recognized only as the payments from the customer become due and payable. For example, in U.S. GAAP a contract in which an entity licenses software for a five-year period with equal monthly payments typically would result in revenue recognition as each monthly payment becomes due and payable.

    (b) *the license cannot be separated from other performance obligations* in the contract, which could result in licensing revenue being recognized concurrently with revenue for other goods and services in the contract. That could occur because either (a) there is no vendor-specific objective evidence[1] of the selling price of the undelivered elements in software transactions or (b) the license does not have standalone value. For example, for many biotechnology intellectual property licenses it is common for an entity to conclude that the license does not have standalone value because the customer cannot use the license for its intended purpose without the undelivered research and development services to be provided by the entity. In those situations, revenue

[1] VSOE was discussed in the October 2009 Board memo (IASB Memo 3C/ FASB 122C).

generally is recognized over the period of the research and development services.

Potential differences between a license and a lease

18. As noted above, existing standards on accounting for licenses are consistent with View A (i.e. revenue upfront) except when a consideration amount is uncertain or when a license cannot be separated from other performance obligations in the contract.

19. In contrast, the Boards decided in October 2009 that a lessor should recognize revenue in a way that is consistent with View B. Under that approach the lessor would recognize revenue over the lease term as it satisfies its performance obligations to permit the lessee to use its asset.

20. Leases and licenses seem to be very similar. That is, they both grant a customer the right to use an asset of the entity. However, because licenses often are accounted for in current practice consistently with View A, and the Boards have decided that lessor accounting should be consistent with View B, it is important to consider potential differences between a license and a lease.

21. The following are the some of the characteristics to consider when comparing a lease to a license:

    (a) Tangible versus intangible

    (b) Exclusive versus non-exclusive

    (c) Duration of the agreement.

Tangible versus intangible

22. Leasing typically is associated with contracts in which an entity grants a customer the right to use a *tangible* asset. Licensing typically refers to contracts in which a customer obtains the right to use an *intangible* asset. Tangible assets are easier to identify specifically, and typically cannot be used by more than one customer concurrently.

23. As noted in paragraph 9(a), it can be argued that an entity licensing intellectual property is distributing products just as a product manufacturer distributes products using its intellectual property. However, because the customers can duplicate the entity's intangible products more easily than with tangible products, the entity licenses products to protect it from such unauthorized distribution.

24. In a right to use a tangible asset, the asset often is physically returned to the entity at the end of the term, similar to the case of a car rental agreement in which the customer returns the car to the rental agency. However, in the case of an intangible asset it is not always the case that the customer returns the asset to the entity. For example, a customer can use licensed off-the-shelf software or a DVD of a motion picture in perpetuity.

25. Despite those slight distinctions between tangible and intangible assets, the staff thinks it is difficult to argue why the accounting for a promised asset should differ depending on whether the asset is tangible or intangible. The FASB's Conceptual Framework in its discussion on the nature of assets deemphasizes the physical nature of assets:

> The definition of assets focuses primarily on the future economic benefit to which an entity has access and only secondarily on the physical things and other agents that provide access to the benefits. Many physical things and other agents are in effect bundles of future economic benefits that can be unbundled in various ways and two or more entities may have different future economic benefits from the same agent at the same time or the same continuing economic benefit at different times. [*Statement of Financial Accounting Concepts No. 6*, paragraph 25 and 185]

Exclusive versus non-exclusive

26. As noted above, tangible assets typically cannot be used by more than one entity concurrently. Hence, leases by nature are exclusive because the lessee obtains the exclusive right to use a specific tangible asset for a specified term.

27. Conversely, licenses typically are non-exclusive—i.e. the entity can grant similar licenses to other customers and those license periods can be concurrent.

Of course, some licenses are exclusive. And when they are, entities in current practice often analogize to leases when accounting for them[2].

28. The staff thinks that analogizing to a lease is appropriate for exclusive licenses because they are similar in nature. Both grant the customer an exclusive right to use a specified asset for a period of time. The only distinction seems to be that the one grants the right to use a tangible product and the other an intangible product. As discussed in the previous section, the staff thinks that tangible assets should be accounted for similarly to intangible assets.

Duration of the agreement

29. Both leases and licenses have durations that can vary widely. The staff thinks that leases and licenses, by definition, grant a customer the right to use an asset for less than its economic life. If the duration of a contract is at least equal to the economic life of the intellectual property, then the arrangement is similar to the outright sale of that intellectual property. That is, the customer obtains control of the entity's intellectual property. The entity would not have access to its intellectual property during the contract so long as the customer pays and there would be no residual value for the entity to exploit at the end of the contract. In evaluating the duration of the contract the staff thinks that an entity would need to carefully consider all facts and circumstances (e.g. the effects of contract extensions and renewals).

Staff recommendation and question for the Boards

30. The staff thinks that leases and licenses are very similar. Both grant a customer the rights to use an asset in exchange for consideration. However, in accordance with the analysis above, the staff thinks that they differ mostly in that a lease is exclusive and licenses often are non-exclusive. If a license is non-exclusive, the staff thinks that it should be accounted for in accordance with View A. That is

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[2] In U.S. GAAP, an entity would not analogize to leases if the transaction is in the scope of industry-specific guidance (e.g. software and motion pictures).

because a non-exclusive license is separate, or separable from the entity's intellectual property and the promise to grant a license represents a single performance obligation to deliver an intangible product (similar to the sale of other products). However, an entity still might not recognize revenue when the customer obtains control of a non-exclusive license because of other aspects of the proposed revenue recognition model (i.e. constraints on uncertain consideration and application of the segmentation principle). Those aspects are explained in Appendix A.

31. If a license is exclusive, the staff thinks it should be accounted for consistently with the Boards' decision on lessor accounting—View B. The staff thinks that the nature of an exclusive right justifies a different pattern of revenue recognition. The granting of an exclusive right restricts an entity's interest in its property. That restriction remains in effect throughout the license period. The staff thinks that the restriction over time could be viewed as the entity's performance obligations to allow the customer to use the entity's property during the period. Non-exclusive licenses lack that restriction and therefore do not give rise to remaining performance obligations once the customer obtains control of the license.

Question 1 Exclusive and non-exclusive licenses

The staff recommends that:

(a) In a contract in which an entity grants an *exclusive* license to a customer, the promised asset is the continuing access to the entity's intellectual property. That access is transferred continuously and, hence, represents a series of performance obligations that are satisfied over time.

(b) In a contract in which an entity grants a *non-exclusive* license to a customer, the promised asset is the license and the promise to grant a license represents a single performance obligation that the entity satisfies when the customer is able to use and benefit from the license.

Do the Boards agree with the staff recommendations?

Appendix A

Applying the proposed revenue recognition model to non-exclusive licenses

Introduction and purpose

A1. This appendix analyzes the staff recommendations for non-exclusive licenses (View A) in accordance with the proposed revenue recognition model. In those transactions, an entity often will recognize revenue over time when applying the proposed revenue recognition model. The main reasons for recognizing revenue over time for a non-exclusive license are an entity's:

(a) inability to separate the license from other performance obligations, and

(b) lack of a verifiable estimate of uncertain consideration.

Contract segmentation

A2. The segmentation principle decided by the Boards in the October 2009 meeting requires an entity to allocate the transaction price to segments of a contract rather than to individual performance obligations. A segment includes one or more performance obligations for which the entity has evidence of a market—that is, evidence that a segment of the contract could be sold separately.

A3. If a contract includes performance obligations for goods and services other than the license, then an entity must be able to conclude that the license could be sold separately in order to recognize revenue upfront for the license. If the entity concludes that the license could not be sold separately, then the entity would combine the license with other performance obligations when allocating the transaction price. The entity then would select a single method of recognizing revenue for the segment in a manner that best depicts the transfer of goods and services to the customer (e.g. passage of time).

A4. The staff notes that it is common for licenses to be sold with other services. In many of those situations, the entity might always sell the license with the other

services but the entity might sell the other services separately (e.g. a software license sold with renewable post-contract support services). If an entity sells the other services on a standalone basis, the staff thinks the entity might conclude that it could sell the license separately (even if it actually does not).

Uncertain consideration

A5. In many contracts in which an entity grants a license to a customer, the customer promises a variable or uncertain amount of consideration. Payments often are in the form of future royalties that can extend over significant time periods. The staff notes that the entity would not recognize revenue for a license unless an estimate of the amount of consideration can be verified.