



**IASB/FASB Meeting**  
**April 12-14, 2011**

IASB Agenda  
reference **2C**

**Staff  
Paper**

**FASB Education Session**  
**April 7, 2011**

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Project

**Revenue Recognition**

Topic

**Licenses and rights to use intangible assets**

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### **Purpose and staff recommendation**

1. This paper considers improvements to the proposed requirements in the Exposure Draft, *Revenue from Contracts with Customers*, 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.
2. The staff recommends that:
  - (a) The revenue standard should not distinguish between types of licenses; and
  - (b) In a contract in which an entity grants a 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 at the point in time when the customer obtains control of the license.
3. This paper is organized as follows:
  - (a) Background information (paragraphs 4-12)
  - (b) Distinguishing between licenses (paragraphs 13-15)
  - (c) The nature of the performance obligation (paragraphs 16-23)
  - (d) Appendix A Summary of existing requirements on licenses and rights to use (paragraphs A1-A4)

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## Background information

### *Proposals in the Exposure Draft*

4. In the Exposure Draft, the Boards provided implementation guidance on how an entity would account for a contract in which the entity licenses its intellectual property. A contract would be considered a sale, rather than a license, if the customer obtains control of substantially all the rights associated with the entity's intellectual property.
5. If the customer does not obtain control of substantially all the rights to use the entity's intellectual property, then the entity would determine whether the promised customer rights are exclusive. An entity might determine the rights are exclusive based on time, geography, or distribution channel or medium.
6. If the licensor has granted exclusive rights of use to the licensee, the licensor would be unable to grant a similar right to any other party at the same time, indicating that the licensor's ability to control the intellectual property is constrained during the contract period. The Boards concluded that this constraint suggests that the licensor has an ongoing performance obligation that is not fully satisfied until the end of the contract period. The licensor's performance obligation, therefore, would be satisfied continuously over the contract period.
7. If the rights are not exclusive, the Boards proposed that the entity satisfies its performance obligation when the customer is able to use and benefit from the promised rights (i.e. at a point in time when the customer obtains control).
8. The Boards proposed a distinction between licenses in order to account for some licenses consistently with leases. The staff notes that at the time of this decision, the Boards had not decided whether to scope out intangibles in the leases project. Subsequently, the Boards have scoped out intangibles from the leases project. Paragraphs BC 223 and BC 224 of the Exposure Draft states:

When developing implementation guidance, the Boards observed that licensing arrangements that are not sales of intellectual property often have characteristics similar to those of a lease. In both cases, a customer purchases the right to use an asset of the entity. The Boards decided tentatively in the Leases project that a lessor should recognize revenue during the term of the lease as the

lessor permits the lessee to use its asset. However, the Boards thought that this pattern of revenue recognition would not be appropriate for all licenses of intangible assets....

Consequently, the Boards decided that an entity should account for a promise to grant an exclusive right to use intellectual property (which is not a sale of that intellectual property) consistently with their tentative decisions on how a lessor would account for the promise to grant a right to use a tangible asset....

***Feedback on the Exposure Draft***

9. Most respondents disagreed that an entity should distinguish between an exclusive and a non-exclusive license. Those respondents think that exclusivity does not affect the nature of an entity's performance obligation, and therefore it is counterintuitive to have different patterns of revenue recognition depending on whether a license is exclusive. Those respondents commented similar to the following:

We do not believe that the proposal to recognise revenue depending on whether the licence is exclusive is in accordance with the control model. We do not see that the transfer of control to the customer is determined by whether or not the licence is exclusive. Applying different recognition criteria for exclusive rights (allocated over the license term) or nonexclusive (recognition at inception) might result in a different accounting treatment for similar transactions across industries and undermine comparability. (CL #419 Ernst & Young Global Limited)

10. In addition, most respondents thought the accounting for exclusive licenses is inconsistent with the control principle and in effect introduces an additional model (one that focuses on the customer's point of view) to determine when control has transferred. As such, for both types of licenses, those respondents thought that the entity should recognize revenue based on when the customer is able to use and benefit from the license. Concerns were consistent with the following comments:

DWA commonly enters into agreements to license its intellectual property (IP), such as the right to exploit characters from its animated feature films or the right to exploit the actual film itself. These license arrangements generally include exclusivity clauses for either a stated period of time, market or territory. In the vast majority of the Company's licensing arrangements, once the license period begins and the creative elements have been delivered to the other party, control has been transferred and DWA has no further performance obligations. The Company does not believe that the mere existence of the passage of time in an

exclusive license is representative of continuous transfer of control as it does not represent the transfer of goods or services to the customer... Accordingly, DWA believes control has transferred at that distinct point in time when it has delivered its creative elements to the third party and the license period has commenced and, therefore, recognition of revenue should occur at this point. Furthermore, DWA believes that recognition of revenue upon the commencement of the license term and delivery of creative elements would be consistent with how the ED has defined when a performance obligation is satisfied (ED paragraphs 25 to 33 including the Implementation Guidance for these paragraphs). (CL #355 DreamWorks Animation SKG, Inc.)

The ED notes the similarities between exclusive licenses to intellectual property and leases of tangible assets. While we acknowledge these similarities, we note that the FASB Exposure Draft, Leases, describes the lessors recognition of lease income under the performance obligation approach as being based on “the pattern of use of the underlying asset by the lessee.” This is a very different principle for determining when a performance obligation is satisfied than “transfer of control to the customer.” .... We believe the Board should reconsider the guidance on licenses of intellectual property to ensure that the guidance is consistent with the “transfer of control” notion. (CL#414 Financial Reporting Advisors)

11. The staff conducted additional outreach with a few preparers within the Entertainment and Media industry who seem to support a distinction. Those preparers think that, for some licenses, revenue should be recognized on a continuous basis if the licensed intellectual property has significant economic value at the end of the license period such that the entity can exploit or redeploy those rights at the end of the contract. In those cases, they think that the entity’s performance obligation is to allow access to the intellectual property for a period of time, resulting in revenue being recognized over the license period. In other cases, they think revenue should be recognized at the point in time when the customer obtains substantially all the risks and rewards of ownership associated with the intellectual property.
12. A few respondents thought that the Boards should address licenses as part of the leases project if the Boards think that a different model is required for some licenses (i.e., license revenue is recognized over sometime). Concerns were consistent with the following comments:

We assume that the boards are seeking to minimise any incompatibility between the proposed Standards on revenue and leasing. We do not think it is helpful to achieve this by

undermining the meaning of a performance obligation. If the boards believe it is necessary to recognise income over time where an exclusive licence is granted for only part of the life of intellectual property, we believe this would be better achieved by scoping such arrangements out of the proposed revenue Standard and into the proposed leasing Standard. (CL#393 Deloitte Touche Tohmatsu Limited)

### **Distinguishing between licenses**

13. On the basis of feedback received, the staff thinks that the line between exclusive and nonexclusive licenses is not operational. The staff considered whether another line would be appropriate, but could not identify one that addresses respondents' concerns. The feedback highlights that any type of line (for example, exclusive vs. non-exclusive) that distinguishes between licenses would not be operational because of the many ways an entity can grant rights to intellectual property.
14. In addition, any line would be arbitrary and not necessarily consistent with the core principle of the proposed revenue guidance. For example, an entity granting an operating system software license to a customer is exclusive to that particular customers' computer because others do not have access to that particular software. The staff thinks it is clear in that type of licensing arrangement that the entity satisfies its performance obligation when the customer obtains the ability to use and benefit from the software.
15. In addition, the staff notes that in the Exposure Draft of Statement of Position No. 00-2, *Accounting for Producers or Distributors of Film*, the AcSEC attempted to draw a line based on whether the license is exclusive or non-exclusive. However, AcSEC ultimately concluded that approach was not operational. The basis for conclusion from that guidance is as follows:

A licensing arrangement should transfer substantially all of the benefits and risks incident to ownership of a film on an exclusive basis for an individual market and territory in order for an entity to account for the transaction as a sale, and thus recognize revenue immediately. AcSEC based that concept on FASB Statement No. 13, *Accounting for Leases*, as it relates to the timing of revenue recognition when distinguishing between sales-type leases and operating leases. Therefore, under paragraph 7 of the exposure draft, an entity would have recognized revenue from a

nonexclusive arrangement in a manner similar to an operating lease.

Based on the arguments presented in the comment letters to the exposure draft, AcSEC decided that exclusivity should not be one of the conditions for revenue recognition in the film industry. AcSEC acknowledges that, under an exclusivity arrangement, the value of a film license to a customer has two major components: (a) the customer's right to use the film (in accordance with the license arrangement) and (b) the customer's right to use the film exclusively in a particular market and territory (which thereby restricts the entity's right to license the film to other customers). Therefore, for an exclusive license arrangement, AcSEC considered requiring bifurcation of the total license fee between the two major components. Under that scenario, an entity would recognize revenue from the fees allocated to the first component in accordance with the conditions of paragraph 6 of the exposure draft and it would recognize revenue on the fees allocated to the second component ratably over the license period.

AcSEC rejected the bifurcation approach primarily because it believes that the approach is not operational. Also, AcSEC agrees with many of the respondents to the exposure draft who noted that the "substantially all" condition of paragraph 7 was subjective and, if kept as a revenue recognition condition, could lead to diversity in practice. AcSEC concluded that the approach proposed in the exposure draft was not operational.

#### Question 1

The staff recommends that the revenue standard should not distinguish between types of licenses. Do the Boards agree? If not, how should the standard distinguish between types of licenses?

### The nature of the performance obligation

16. If no distinction is made between licenses, the Boards have two alternatives to account for a contract in which the entity grants a license to a customer. The decision depends on the nature of a performance obligation to grant a license:
  - (a) A license represents a single performance obligation that the entity satisfies at the point in time when the customer obtains control of the license (i.e., use and benefit of the license).
  - (b) A license represents access to the entity's intellectual property that the entity satisfies continuously over the pattern of use of the underlying rights to use the entity's intellectual property by the customer.

***Alternative A: A license represents a single performance obligation***

17. Under this alternative, an entity would apply the overall revenue model when accounting for a contract in which the entity grants the customer rights to use the entity's intellectual property. Proponents of Alternative A think that the entity's intellectual property comprises a bundle of rights which can be componentized and sold separately. As such, in accordance with that proposed guidance, an entity satisfies its performance obligation (and therefore, recognizes revenue) when the customer is able to use and benefit from the promised rights (i.e., when the customer obtains control).
18. In addition, proponents of Alternative A think that this alternative is consistent with the core principle of the proposed revenue guidance that focuses on the transfer of control and one model across all transactions. In addition, this alternative is generally consistent with existing standards and current practice for accounting for licenses, which are included in Appendix A – i.e., licenses often give rise to revenue recognition at a point in time for various transactions, including:
  - Licensing intellectual property (software, technology, medical compounds, know-how, etc).
  - 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.
19. In some circumstances, the entity would recognize license revenue continuously under this alternative because either:
  - (a) The license is not separable from other performance obligations in the contract. In accordance with the Boards' recent decisions on identifying separate performance obligations, that would be the case when either (1) the entity is providing a significant service of integrating a bundle of promised goods or services or (2) the license does not have distinct function. Consider the following example:

An entity licenses customer relationship management software to a customer. In addition, the entity will provide consulting services to
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significantly customize the software to the customer's information technology environment for a total consideration of CU600,000.

In this example, the entity is providing a significant service of integrating a bundle of promised goods or services. As such, the entity would account for the license and consulting services together as one performance obligation. Revenue for that performance obligation would be recognized continuously (if the conditions for continuous revenue recognition are met).

- (b) The contract includes an amount of the transaction price allocated to the performance obligation that is not reasonably assured to be received (i.e. uncertain consideration).

An entity enters into a license agreement with a customer for five years. Under the agreement, the customer agrees to pay CU1 for each product it manufactures and sells using the entity's intellectual property.

When the entity satisfies its performance obligation by transferring the licensed intellectual property, it does not recognize revenue relating to the future royalty payments until the uncertainty is resolved because the amount of the transaction price allocated to the performance obligation is not reasonably assured to be received. That is because the customer can avoid paying an additional amount of consideration. Hence, the entity would recognize revenue for the CU1 royalty payment as the customer sells its products and the uncertainty is resolved.

***Alternative B: A license represents access to the entity's intellectual property***

20. Under this alternative, an entity satisfies its performance obligation and recognizes revenue over the period in which the customer has the right to use the underlying asset. A few respondents think that the Boards should address accounting for intangibles in the leasing project because they view the right to use intellectual property as being similar to a lease. This alternative is consistent with the leases performance obligation approach for the lessor to recognize lease income based on the period over which the entity grants the lessee the right to use the underlying asset.
21. This alternative would significantly change current practice for accounting for various licensing transactions (see Appendix A for discussion on current practice). In addition, the entity may need to evaluate customer usage of the



underlying asset to determine the appropriate pattern of revenue recognition.

Consider the following example:

An entity enters into a license agreement with a customer to provide a single license of educational software for a fixed fee of CU5,000. The customer is expected to use those rights to intellectual property for a period of 5 years. The entity has no other performance obligations.

Under this alternative, the entity would recognize revenue continuously over a 5 period. That is, the pattern of use of the underlying asset by the customer.

22. In addition, if the Boards choose this alternative, the FASB would need to address accounting for film costs in Subtopic 926-20 because revenue that exceeds 10 years following the date of the film's initial release would be excluded in determining the amortization for film costs. That guidance is as follows:

An entity shall amortize film costs using the individual-film-forecast-computation method, which amortizes such costs in the same ratio that current period actual revenue (numerator) bears to estimated remaining unrecognized ultimate revenue as of the beginning of the current fiscal year (denominator). ...

... For films other than episodic television series, ultimate revenue shall include estimates over a period not to exceed 10 years following the date of the film's initial release.

**Staff recommendation**

23. In accordance with the analysis above, the staff recommends that in a contract in which an entity grants a 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 (Alternative A).

**Question 2**

Do the Boards agree with the staff recommendation?

## Appendix A Summary of existing requirements on licenses and rights to use

- A1. Existing US GAAP on accounting for licenses and rights to use includes the following:
- (a) franchise fees revenue recognition in Subtopic 952-605,
  - (b) software revenue recognition in Subtopic 985-605, and
  - (c) recognition of revenue from the licensing of films in Subtopic 926-605.
- A2. Those standards require license revenue to be recognized at a point in time. In addition, for transactions that are not specifically in the scope of the above noted Subtopics, the staff thinks that the predominant current practice for accounting for those license agreements is at a point in time (if there are no other performance obligations and the transaction price is fixed or determinable). Consider the following example:

Entity A had previously filed a claim of patent infringement against Entity B, and they have recently reached a signed settlement agreement. As a result of the settlement, Entity A received a payment of CU1 million. The settlement agreement also contains a patent license agreement that grants Entity B the right to use the licensed patents. Under the settlement agreement and the patent license agreement, Entity A has no future performance requirements of any kind.

The CU1 million settlement is recognized by Entity A in the income statement upon the execution of the settlement agreement because all of the criteria in SAB 104 for recognition of revenue have been met. That is (a) an executed arrangement exists, (b) Entity A has no future performance requirements under the settlement agreement (i.e. Entity A has no future obligations in connection with the patents), (c) the settlement price is fixed and legally enforceable, and (d) payment of the settlement amount is reasonably assured (and was in fact paid during the period).

- A3. In addition, IFRS is broadly consistent with existing US GAAP standards and current practice. 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.

A4. However, in some instances in current practice an entity recognizes revenue over a license period. That typically occurs either because:

(a) *the consideration in the contract is not considered to be fixed or determinable*, either because

- (i) a significant portion of the consideration is not due until more than the vendor's standard payment terms for similar products. In those cases, revenue would be 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.
- (ii) Consideration is not due until a contingency is resolved. For example, royalty payments.

(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<sup>1</sup> 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

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<sup>1</sup> VSOE is limited to the following: (a) the price charged when the same element is sold separately or (b) for an element not yet being sold separately, the price established by management having the relevant authority; it must be probable that the price, once established, will not change before the separate introduction of the element into the marketplace (Subtopic 985-605 definition).

development services to be provided by the entity. In those situations, revenue generally is recognized over the period of the research and development services.