

STAFF PAPER

FASB | IASB Meeting

Week of 17 December 2012

FASB Education Session 12 December 2012
IASB Education Session 14 December 2012

Project	Revenue Recognition		
Paper topic	Constraining the cumulative amount of revenue recognised – Licenses		
CONTACT(S)	Gary Berchowitz	gberchowitz@ifrs.org	+44 20 7246 6914
	Brian Schilb	bjschilb@fasb.org	+1 203 956 3447
	Allison McManus	amcmanus@ifrs.org	+44 207 246 6462

This paper has been prepared by the staff of the IFRS Foundation and the FASB for discussion at a public meeting of the FASB or IASB. It does not purport to represent the views of any individual members of either board. Comments on the application of US GAAP or IFRSs do not purport to set out acceptable or unacceptable application of U.S. GAAP or IFRSs. The FASB and the IASB report their decisions made at public meetings in FASB Action Alert or in IASB Update.

Purpose of this paper

1. This paper considers whether to (a) retain paragraph 85 in the 2011 exposure draft *Revenue from Contracts with Customers* (“the 2011 ED”) and, if retained, whether to (b) revise the scope of that paragraph. Paragraph 85 in the 2011 ED constrains the amount of revenue that can be recognised from licenses of intellectual property that are subject to sales-based royalties, until the uncertainty related to those sales-based royalties is resolved (ie the customer’s subsequent sales occur).
2. This paper does not address the application of paragraph 85 of the 2011 ED or the general constraint guidance to the sale of non-financial assets that are not an output of an entity’s ordinary activities. This will be addressed in a future paper.

Staff recommendation

3. The staff recommend that:
 - (a) the Boards retain paragraph 85 in the final revenue standard;

The IASB is the independent standard-setting body of the IFRS Foundation, a not-for-profit corporation promoting the adoption of IFRSs. For more information visit www.ifrs.org

The Financial Accounting Standards Board (FASB), is the national standard-setter of the United States, responsible for establishing standards of financial accounting that govern the preparation of financial reports by nongovernmental entities. For more information visit www.fasb.org

- (b) the scope of paragraph 85 should continue to be limited to licenses of intellectual property where the consideration varies based on the customer's subsequent sales; and
- (c) paragraph 85 should also include licenses of intellectual property where the consideration varies based on the customer's *production* (eg production-based royalties, or some other form of customer usage of the licensed intellectual property).

Structure of the paper

6. This paper is organised as follows:

- (a) Background (paragraphs 7–12)
- (b) Feedback (paragraphs 13–15)
- (c) Should paragraph 85 of the 2011 ED be deleted? (paragraphs 16–29)
- (d) Should the scope of paragraph 85 be expanded? (paragraphs 30–48)
 - (i) Consideration that is contingent on the customer's future actions (paragraphs 31–37)
 - (ii) Maintain scope of paragraph 85 (ie licenses of intellectual property) but expand types of variable consideration (paragraphs 38–48)

Background

The 2011 ED requirements and explanation for paragraph 85

7. Paragraphs 81-84 of the 2011 ED set out the proposed requirements that an entity would follow to determine whether an amount of variable consideration can be recognised as revenue prior to the uncertainty associated with that variable consideration being resolved. Those proposed requirements would apply to all contracts with customers within the scope of the 2011 ED.

8. Notwithstanding the general requirements in paragraphs 81-84 of the 2011 ED, the Boards decided to include paragraph 85 in the 2011 ED to provide specific guidance related to revenue recognition for licenses:

Notwithstanding the requirements in paragraphs 81–83, if an entity licenses intellectual property (see paragraph B33/IG33) to a customer and the customer promises to pay an additional amount of consideration that varies on the basis of the customer’s subsequent sales of a good or service (for example, a sales-based royalty), the entity is not reasonably assured to be entitled to the additional amount of consideration until the uncertainty is resolved (ie when the customer’s subsequent sales occur).

9. The Boards included this specific requirement in response to concerns that the generally applicable constraint proposals (paragraphs 81 – 84 of the 2011 ED) might not always result in an appropriate application of the constraint for licenses of intellectual property where the consideration is based on a sales-based royalty. This is because a license of intellectual property (absent other performance obligations in the contract) would give “rise to a performance obligation that the entity satisfies at the point in time when the customer obtains control of the rights” (paragraph B33/IG33 in the 2011 ED). This would require an entity to estimate the total amount of consideration to which it expects to be entitled and recognise that amount as revenue when the customer obtains control of the rights (typically at the inception of the contract). In these cases, both users and preparers thought that it would not be useful for an entity to recognise revenue at the inception of the contract based on an estimate of the total amount of the consideration “because that approach inevitably would require the entity to report, throughout the life of the contract, significant adjustments to the amount of revenue recognised at inception of the contract as a result of changes in circumstances” (paragraph BC203 of the 2011 ED). Therefore, paragraph 85 of the 2011 ED explained that for licenses of intellectual property with a sales-based royalty, an entity should not recognise revenue until the customer’s subsequent sales occur. However, in paragraph BC203 the Boards emphasised that

paragraph 85 of the 2011 ED applied only to licenses of intellectual property and for other circumstances, an entity would consider the indicators in paragraph 82 of the 2011 ED to determine if the constraint applied.

The Boards' November 2012 tentative decisions

Licenses

10. As explained in paragraph 9 above, the 2011 ED proposed that a license contract (absent other performance obligations in the contract) represents a promise to transfer a right to a customer. However, at the November 2012 joint Board meeting, the Boards tentatively decided that an entity should assess the nature of the promise in the license contract before applying the other parts of the revenue model to the contract. Specifically, an entity should assess whether the nature of the promise in the license is (a) to transfer a right or (b) to provide access to the entity's underlying intellectual property.
11. This assessment of the nature of the promise is important because whether the license contract results in the transfer of a right or the provision of access over the license term will affect whether the license (absent other performance obligations in the contract) results in a performance obligation satisfied at a point in time or over time, respectively.

Constraint

12. At the November 2012 joint Board meeting the Boards also tentatively decided to clarify that the objective of the constraint is for an entity to recognise revenue at an amount that should not be subject to significant revenue reversals. The staff think that this objective, while modified, is consistent with the original intent of paragraphs 81-84 of the 2011 ED (ie the general constraint guidance). Therefore, the staff think that the feedback on paragraph 85 remains relevant in light of the Boards' November 2012 tentative decision and clarifications for the general constraint guidance.

Feedback

13. Most users agreed with the requirement in paragraph 85 of the 2011 ED because they think that recognising revenue for licenses subject to sales-based royalties only when the uncertainty is resolved provides more useful information. In addition, some preparers, primarily in the pharmaceutical, software and technology industries, appreciated the clarity that paragraph 85 of the 2011 ED provided them in accounting for their licenses of intellectual property.
14. However, respondents raised concerns with paragraph 85, although they had different views, namely:
 - (a) paragraph 85 of the 2011 ED is an unnecessary exception and should be deleted (and that an entity should rely on the principles of the constraint in paragraphs 81 – 84 of the 2011 ED);
 - (b) the scope of paragraph 85 of the 2011 ED should be:
 - (i) expanded to become a general principle that would always apply when the consideration is dependent on the customer's future actions; or
 - (ii) maintained to apply only to licenses of intellectual property, however the Boards should include other types of variable consideration such as royalties based on the customer's production.
15. However, irrespective of their different concerns related to paragraph 85 of the 2011 ED, almost all respondents requested the Boards clarify the rationale for that paragraph.

Should paragraph 85 of the 2011 ED be deleted?

16. Some respondents suggested removing paragraph 85 of the 2011 ED because they view it as an unnecessary rule. Those respondents think that instead, the general principles in paragraphs 81 – 84 of the 2011 ED should apply to *all* transactions because those principles are sufficient to achieve the appropriate accounting outcome.

17. However, as explained in the feedback section above, there was broad support from users of financial statements for paragraph 85 of the 2011 ED. This is because for licenses subject to sales-based royalties, recognising revenue when the uncertainty is resolved (ie when the customer's subsequent sales occur) would provide useful information because:
- (a) the amount recognised as revenue would not be subject to continuous adjustment; and
 - (b) there is a closer correlation between the timing of cash receipt and recognition of revenue that some think more appropriately depict the economics of these transactions.
18. Also, as mentioned above, some preparers appreciated the clarity that paragraph 85 of the 2011 ED provided them in accounting for their licenses of intellectual property (which, in the 2011 ED represented a transfer of a right and therefore a performance obligation satisfied at a point in time) when the consideration varies based on the customer's subsequent sales. In particular, those preparers appreciated that paragraph 85 of the 2011 ED eased the practical difficulties of estimating the total amount of consideration and applying paragraphs 81-84 of the constraint. In addition, paragraph 85 avoided the unhelpful pattern of revenue recognition that may result from estimating the total amount of consideration and applying those paragraphs of the general constraint guidance. (Although some of these practical difficulties may also be eased by the tentative decision of the Boards in November 2012 that some licenses represent a transfer of a right and some represent a promise to provide access to the entity's underlying intellectual property, the staff think that they will still be relevant for those licenses that represent the transfer of a right. The interaction of paragraph 85 of the 2011 ED and the November 2012 tentative decision on licenses is discussed further below.)

Practical difficulties

19. When the license represents the transfer of a right (that is a performance obligation satisfied at a point in time), paragraph 85 of the 2011 ED eliminates the

requirement for the entity to try to estimate the total amount of consideration that varies based on the customer's subsequent sales by requiring revenue to be recognised only when the uncertainty is resolved (ie when the customer's subsequent sales occur). This may be helpful because royalty arrangements may extend for a number of years and, in addition, the nature of many of these arrangements may mean that there is significant uncertainty about the value of the item transferred (ie the license of intellectual property). In addition, in some cases where the entity licenses intellectual property in exchange for a sales-based royalty, the entity might have very limited experience from which to estimate the total amount of consideration because the contract may be unique (for example, it might be the first time that the entity has licensed the intellectual property in that specific location).

20. By only requiring revenue to be recognised when the uncertainty is resolved (ie when the customer's subsequent sales occur), paragraph 85 also eliminates the need for an entity to assess (and reassess) the objective and indicators related to the general constraint guidance. This is helpful to preparers because, although the objective and indicators of the general constraint guidance may constrain an entity from recognising as revenue a significant amount of the estimated total amount of consideration at the time the entity performs (ie at the inception of the contract), it is likely that the entity could recognise a minimum amount of revenue when the entity performs because there may be a minimum amount that the entity expects will not be subject to significant revenue reversals. However, an entity would still be required to continually reassess the objective and indicators and revise its estimate of the minimum amount of revenue that could be recognised. Not only would this reassessment be complex and costly, but estimating a minimum amount and reassessing that minimum may result in a pattern of revenue recognition that may not be helpful to users. Consider the following example:

An entity licenses its intellectual property (IP) for a 10 year period in England. The entity will receive a percentage of the customer's sales as consideration (ie a sales-based royalty). There are no other performance obligations in the contract. The entity concludes that the license represents the transfer of a right which results in a performance obligation satisfied at a point in time.

The entity has experience in licensing the IP in similar countries and markets. The entity estimates the total amount of consideration it expects to be entitled over the 10 years will be CU500,000. Some of that amount might be subject to significant revenue reversal, however, at the time of satisfying its performance obligation, the entity does not expect the amount of revenue to be less than CU100,000. Consequently, the entity would recognise CU100,000 when it satisfies its performance obligation (ie at the inception of the contract).

At the end of year 1, based on sales to date, the entity revises its estimate of the amount of consideration that will not be subject to revenue reversal to be CU175,000. Consequently, the entity would recognise an additional CU75,000 of revenue at the end of year 1. This process would continue for the 10 year period and therefore may result in a revenue recognition pattern as follows:

Year 1: CU100,000

Year 2: CU 75,000

Year 3: CU 60,000

Year 4-9: CU265,000

Year 10: NIL

21. In the staff's view, the revenue recognition pattern in the above example that may result from applying the general principles of the constraint to sales-based royalties does not provide useful information. This is primarily because the revenue recognition pattern is based on continually revised estimates of minimum amounts and it does not correlate to either the entity's performance (which occurs at the inception of the contract) nor the timing of cash received. Therefore, when the license represents a transfer of a right, the staff think that paragraph 85 of the 2011 ED is helpful because it eases the practical difficulties of estimating the total consideration and applying the general principles of the constraint, but it also provides a useful pattern of revenue recognition that was supported by users.
22. However, in light of the Boards' tentative decision in November 2012 that some licenses represent a promise to provide access to the entity's underlying intellectual property, some may suggest that paragraph 85 of the 2011 ED will no longer be needed to provide a useful pattern of revenue recognition for those

license contracts. The next section considers the implications of the November 2012 tentative decision for licenses on whether paragraph 85 should be deleted.

Implications of November 2012 tentative decision for licenses

23. As explained above, the Boards tentatively decided in November 2012 that some licenses represent a promise to provide access to the entity's underlying intellectual property, which would result in a performance obligation satisfied over time. In these cases, because the performance obligation is satisfied over time, paragraph 85 of the 2011 ED will have little effect on an entity's process for recognising revenue (ie estimates of total consideration and application of the general constraint principles) and the ultimate pattern of revenue recognition. This is because the entity would most likely determine that recognising revenue as the customer's subsequent sales occur is an appropriate measure of progress for the performance obligation that is satisfied over time. Therefore, some may question whether, in light of the Boards' November tentative decision, paragraph 85 could be:

- (a) deleted, because the population of license contracts for which the advantages described in paragraphs 19-21 above are relevant (ie licenses where the promise is a transfer of a right) is smaller than it would have been under the 2011 ED (ie because some license contracts will represent a promise to provide access to the entity's underlying intellectual property and therefore result in a performance obligation satisfied over time); or
- (b) limited to licenses where the promise is to transfer a right; or
- (c) included as an indicator of the nature of the promise in the license (ie an indicator of whether the license represents a transfer of a right or a promise to provide access to the entity's underlying intellectual property).

Deleting paragraph 85 or limiting to licenses that transfer a right

24. In light of the November 2012 tentative decision for licenses, some may think that the population of license contracts for which the advantages from paragraph 85 of the 2011 ED described in paragraphs 19-21 above are relevant (ie licenses where the promise is a transfer of a right) is smaller than it would have been under the 2011 ED. (This is because, based on the November 2012 tentative decision of the Boards, some license contracts will represent a promise to provide access to an entity's underlying intellectual property and, therefore, result in a performance obligation satisfied over time.) Thus, some may suggest that paragraph 85 either be deleted or limited to licenses where the promise is to transfer a right.
25. However, in addition to the advantages of retaining paragraph 85 of the 2011 ED in paragraphs 19-21 above (ie eliminating the practical difficulties and providing a useful revenue recognition pattern), the staff think that paragraph 85 may also simplify the application of the revenue standard to many license contracts, regardless of whether the license represents a transfer of a right or a promise to provide access to the entity's underlying intellectual property. This is because, when the consideration is a sales-based royalty, an entity (practically) may not need to determine the nature of the promise in the license contract. This is because paragraph 85 would require revenue to be recognised when the uncertainty related to the sales-based royalty is resolved (ie when the customer's subsequent sales occur) regardless of whether the license represents a promise to transfer a right or to provide access to the entity's underlying intellectual property.

An indicator of the nature of the promise in a license

26. As part of the November 2012 tentative decision that some licenses represent a promise to transfer a right and others represent a promise to provide access to the entity's underlying intellectual property, the Boards tentatively decided that, to determine the nature of the promise in a license, an entity would consider the characteristics of the license. In light of this decision, the staff think that some may suggest that the Boards should consider deleting paragraph 85 and instead include the existence of a sales-based royalty as an indicator of when the nature of

a license represents a promise to provide access to the entity's underlying intellectual property.

27. The staff considered the possibility of including variable payment terms (eg a sales-based royalty) as an indicator of the nature of a promise in a license when developing November 2012 Agenda Paper 7F/164F *Implementation guidance: Licenses*. However, the staff rejected this idea because, although fixed or variable payment terms can change the economics of the transaction, those payment terms do not change the nature of the rights transferred in a license contract. Consequently, the fixed or variable payment terms will not help an entity determine the nature of the entity's performance. In addition, the staff observed that the existence of fixed and variable payment terms (ie a non-refundable fee and a sales-based royalty, which are common in license contracts) would add unnecessary complexity in the assessment of the nature of the entity's promise. Consider the following examples:

An entity licenses a movie to a customer for 15 years. The entity has no other performance obligations in the contract and deems the license to be a transfer of a right (satisfied at a point in time).

Example 1: Variable consideration (ie a sales-based royalty)

The customer promises to pay 5% of its quarterly sales related to the movie.

Example 2: Fixed consideration

The customer promises to pay an upfront non-refundable fixed amount of CU1,000,000.

Example 3: Fixed and variable consideration

The customer promises to pay an upfront non-refundable fixed amount of CU500,000 and 3% of its quarterly sales related to the movie.

28. In the examples above, the entity is exposed to different risks based on the payment structure. However, the nature of the rights transferred under the license and the nature of the entity's performance does not change depending on the payment terms. In addition, Example 3 highlights the difficulty of including payment terms as an indicator of the nature of the promise in the license. This is

because it is unclear if, in assessing the nature of the promise in the license, the entity should consider either the *fixed amount* (which some may suggest indicates a promise to transfer a right, ie a performance obligation satisfied at a point in time) or the *variable amount* (which some may suggest indicates a promise to provide access to an entity's underlying intellectual property, ie a performance obligation satisfied over time). Furthermore, if the variable portion was considered more important and resulted in the entity concluding the nature of the promise in the license represented a promise to provide access to its underlying intellectual property, should the entity also recognise the upfront non-refundable fee over time as the access is provided (ie as the performance obligation is satisfied)? This approach would not seem to reconcile with Example 2, where the nature of the entity's promise for the license appears the same, even though the payment terms are different. Given this, the staff think that the existence of a sales-based royalty is not an appropriate indicator of when the nature of a license represents a promise to provide access to the entity's underlying intellectual property.

Staff recommendation

29. The staff recommend retaining paragraph 85 of the 2011 ED because:

- (a) it eases the practical difficulties for preparers of estimating the total amount of consideration that varies based on the customer's subsequent sales and applying the general constraint paragraphs;
- (b) it eliminates the possibility of reporting a pattern of revenue recognition that may not be useful to users of financial statements for some licenses of intellectual property that represent a transfer of a right with consideration that varies based on the customer's subsequent sales; and
- (c) it may simplify the application of the revenue model to license contracts when the consideration in the contract varies based on the customer's subsequent sales (ie because, practically, an entity would not need to consider the nature of the promise in the license).

Should the scope of paragraph 85 of the 2011 ED be expanded?

30. Some respondents suggested that the scope of paragraph 85 of the 2011 ED should be expanded beyond licenses of intellectual property to include any contract with a customer where the consideration is contingent on the customer's future actions. Additionally, others suggested the Boards consider including in paragraph 85 other forms of variable consideration for licenses of intellectual property such as royalties that vary based on the customer's production.

Consideration that is contingent on the customer's future actions

31. Some may view expanding the scope of paragraph 85 of the 2011 ED to any consideration contingent on a customer's future actions as the more conceptually appropriate accounting result. They would argue that, if an entity's revenue is contingent on the customer's future actions (for example, advertisers that are compensated based on additional sales of the customer), the customer has no present obligation until it takes that action. Accordingly, they argue that the entity has no asset and corresponding revenue from its performance until those actions occur. However, others think that the customer has an obligation when the entity satisfies its performance obligation and any uncertainty surrounding the customer's obligation should be reflected in the measurement of the obligation.
32. The staff observe that some may think that expanding the scope of paragraph 85 of the 2011 ED would be beneficial because it will align the accounting for all types of consideration that are dependent on a customer's future actions. However, the staff think that it would not be appropriate to expand the scope of paragraph 85 of the 2011 ED because it may lead to unintended consequences, and also because:
- (a) it may not appropriately depict performance in a number of contracts, which may also be exacerbated by the recognition of costs when the entity performs; and

- (b) it would increase complexity because it would require the Boards to create an exception to the expanded scope for customer rights of return.

May not appropriately depict performance

33. The core principle of the revenue model is that an entity should recognise revenue to depict the transfer of goods or services to customers. Paragraphs 81-84 of the 2011 ED provide the principle for determining the amount of revenue that should be recognised when there is *measurement* uncertainty of the amount of revenue that an entity is entitled to for the transfer of those goods or services (ie the satisfaction of a performance obligation). In many cases, this may result in an entity recognising some, but not all of the consideration the entity expects to be entitled to for the satisfaction of a performance obligation. However, if the Boards expand the scope of paragraph 85 of the 2011 ED to apply to all contracts where the consideration is dependent on the customer's future actions, the result may be that the amount of revenue recognised would not depict the transfer of goods or services to a customer (ie it would not reflect the satisfaction of the entity's performance obligation). This is because the entity may be prevented from recognising revenue until the relevant customer future actions occur, rather than when the entity performs.
34. Expanding the scope of paragraph 85 and further constraining the amount of revenue recognised may also exacerbate the problem of depicting performance where an entity has recognised expenses arising from its performance. As a result, an entity may recognise a loss on a satisfied performance obligation. This is illustrated in the following example:

An entity agrees to build a customer's payroll system and process the transactions on the system for 10 years. The build and processing are determined to be separate performance obligations.

The agreement states that the entity's consideration will be based on a fixed fee for each payroll transaction processed over the 10 year period. The entity has significant experience with similar types of "build and run" contracts and does not expect a significant revenue reversal of its estimate of the transaction price.

The entity incurs significant costs to build the customer payroll system that are expensed upon transfer of the payroll system to the customer (in year 1).

An exception for customer returns

35. If the Boards decide to expand the scope of paragraph 85 of the 2011 ED to apply to all contracts with customers where the consideration is contingent on a customer's future actions, this may mean that an entity would be required to defer revenue in any transaction where the entity provides the customer a right of return, until that right of return expires. This may not be an acceptable outcome to many respondents who broadly agreed with the accounting for rights of return in the 2011 ED. Therefore, if the Boards decide to expand the scope of paragraph 85 of the 2011 ED to apply to all contracts with customer where the consideration is contingent on a customer's future actions, the Boards would also need to consider excluding rights of return from the scope of the revised paragraph 85. This could be justified because rights of return are different from other forms of variable consideration:
- (a) in the case of a right of return, there is uncertainty as to whether the entity has actually performed (ie the failed sale notion); however,
 - (b) in the case of other variable consideration, the entity has performed and there is uncertainty as to the amount of consideration that the entity is entitled to for that satisfied performance obligation.
36. As explained in paragraphs BC276 – BC277 of the 2011 ED, the Boards concluded that the existence of a right of return means that the entity has made an uncertain number of sales. However, the Boards decided that in determining the amount of revenue to recognise an entity should use the principles for recognising and measuring variable consideration. There is no effect on the outcome that is achieved by including customer return rights in the constraint guidance in the 2011 ED because the entity would recognise the same *amount* of revenue whether it viewed some transactions as failed sales (and thus recognised no revenue for those transactions and the full amount of the transaction price for the remaining transactions) or recognised a reduced amount of revenue for all transactions

(taking into account an estimate for the amount of goods or services that may be returned).

37. The staff think that although it would be appropriate to exclude rights of return from paragraph 85 if the Boards decide to expand its scope, doing so would add unnecessary complexity. Furthermore, the staff think that the need to add a scope exclusion for some transactions suggests that expanding the scope of paragraph 85 to apply to all contracts with customers where the consideration is contingent on a customer's future actions may create other unintended consequences.

Maintain scope of paragraph 85 (ie licenses of intellectual property) but expand the types of variable consideration

38. As noted above, many respondents did not disagree with the outcome that resulted from applying paragraph 85 of the 2011 ED. However, the majority of respondents requested the Boards provide more rationale for limiting the scope of paragraph 85 to licenses of intellectual property. Some respondents also requested the Boards consider whether paragraph 85 could be expanded to include other types of variable consideration related to licenses, such as royalties based on the customer's production (or some other form of customer usage of the licensed intellectual property).

Limiting the scope to licenses of intellectual property

39. The Boards' discussion and tentative decision in November 2012 acknowledged the diversity of license contracts and also the challenges that entities may face in applying the revenue model to licenses. As explained above, the staff think that paragraph 85 may ease some of the practical difficulties for license contracts when consideration varies based on a customer's subsequent sales, in particular because it will not require an entity to estimate the total amount of consideration in the contract and it will not require an assessment and reassessment of the general constraint principles. In addition, paragraph 85 may simplify the application of the revenue model to license contracts because an entity may not need to determine the nature of its promise in the license.

40. Although many of those practical difficulties described above are more relevant for licenses that transfer a right (ie that result in a performance obligation satisfied at a point in time), the staff think that these practical difficulties may not be so challenging for promises to transfer other goods or services at a point in time (even though the consideration may also vary based on the customer's subsequent sales). This is because it may be easier to estimate and constrain the transaction price for the promise to transfer other goods or services, because those goods or services are primarily tangible items with cost bases that could help in the determination and estimation of the transaction price.
41. Therefore, the staff think that the reason why a number of respondents accepted the outcome from applying paragraph 85 was because the nature of the asset underlying the license (ie the intellectual property) is an intangible asset. Generally, for intangible assets, many respondents prefer a more conservative revenue recognition pattern when the consideration varies based on the customer's subsequent sales. This may be because, even if the entity has entered into a license contract, there remains significant uncertainty about the possible inflow of economic benefits arising from the intangible asset. This may be due in part to the fact that often, intangible assets are not recognised in the financial statements.
42. As a result of those reasons for limiting the scope of paragraph 85 of the 2011 ED to licenses of intellectual property, the staff think that the guidance in paragraph 85 of the 2011 ED should not be applied by analogy to other contracts where the promise is not a license (for example, where the promise represents a good or a service). The staff note that this is already stated in paragraphs 85 and BC203 of the 2011 ED.

Expanding the types of variable consideration

43. As explained above, some respondents asked the Boards to consider expanding the types of variable consideration for licenses of intellectual property that may be captured by paragraph 85 of the 2011 ED. Specifically, those respondents suggested that the Boards include consideration that may vary based on the customer's usage of that intellectual property, such as the customer's production

(ie a production-based royalty). In their view, the economics of a production-based and a sales-based royalty are the same. This is because, in both cases, the promise relates to the use of an intangible asset and the consideration depends on the action of the customer. Thus, there may be significant uncertainty about the amount of the total consideration to which the entity expects to be entitled. In their view, it would be appropriate to capture both types of consideration in paragraph 85 of the 2011 ED for licenses of intellectual property to ensure consistent accounting for economically similar contracts.

44. The staff agree with those respondents and think that the Boards should expand the types of variable consideration within the scope of paragraph 85 to include consideration arising from licenses of intellectual property that may vary based on the customer's production or sales (ie production or sales-based royalties, or some other form of customer usage of the intellectual property). This will result in consistent revenue recognition patterns for economically similar licenses of intellectual property, which will be helpful to users.
45. In addition, the staff observe that this will further align the accounting for consideration that may vary based on the customer's production or sales (ie production or sales-based royalties, or some other form of customer usage of the intellectual property) for licenses of intellectual property with the Boards' tentative decision on the recognition of variable lease payments. This is because the Boards' tentatively decided that a lessor would only recognise variable lease payments that are contingent on the lessee's sales or usage when those sales or usage occurs.

Staff recommendation

46. The staff recommend that the scope of paragraph 85 of the 2011 ED should continue to be limited to licenses of intellectual property. This is because the underlying asset (ie the intellectual property) is an intangible asset and paragraph 85 of the 2011 ED is a helpful mechanism for entities to ensure they present useful information for licenses of intellectual property where the consideration varies based on the customer's sales.

47. The staff also recommend that the scope of paragraph 85 of the 2011 ED should not be expanded to include any contract with a customer where the consideration is contingent on the customer's future actions. This is because expanding the scope beyond licenses of intellectual property would:
- (a) not appropriately depict performance, which may be exacerbated by a requirement to recognise costs; and
 - (b) increase complexity because it would require the Boards to create an exception to the expanded scope for customer rights of return.
48. In addition, the staff recommend that the Boards expand the types of variable consideration for licenses of intellectual property in paragraph 85 to also include consideration such as royalties based on the customer's production (or some other form of customer usage of the licensed intellectual property).

Questions for the Boards

Do the Boards agree with the staff recommendation that:

- (a) paragraph 85 should be retained in the final revenue standard;
- (b) the scope of paragraph 85 should continue to be limited to licenses of intellectual property where the consideration varies based on the customer's subsequent sales; and
- (c) paragraph 85 should also include licenses of intellectual property where the consideration varies based on the customer's *production* (eg production-based royalties, or some other form of customer usage of the licensed intellectual property)?

Appendix A

A1. The following table includes paragraph 85 of the 2011 ED and identifies how that paragraph might change as a result of the staff recommendations in this paper.

Proposals from the 2011 Exposure Draft	Anticipated change?
<p>18 Notwithstanding the requirements in paragraphs 81–83, if an entity licences intellectual property (see paragraph B33) to a customer and the customer promises to pay an additional amount of consideration that varies on the basis of the customer’s subsequent sales of a good or service (for example, a sales-based royalty), the entity is not reasonably assured to be entitled to the additional amount of consideration until the uncertainty is resolved (ie when the customer’s subsequent sales occur).</p>	<p>The staff recommend that the Boards expand the types of variable consideration for licenses of intellectual property in paragraph 85 to also include consideration such as royalties based on the customer’s production (or some other form of customer usage of the licensed intellectual property).</p>