STAFF PAPER

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Project	**Revenue Recognition**		
Paper topic	Implementation guidance: licenses – illustrative examples		
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Purpose of this paper

1. The objective of this paper is to illustrate the application of the potential improvements to the implementation guidance for licenses in the 2011 Exposure Draft *Revenue from Contracts with Customers* ("2011 ED") as outlined in Agenda Paper 7F/164F. That paper outlines three alternative views of the nature of the promise to grant a license, as well as how the rest of the model will be applied. The three views of the nature of the entity's promise applied to examples in this paper are as follows:

   (a) View A: a right (the 2011 ED's proposals);

   (b) View B: a right (if specified criteria are met) or access to the entity's intellectual property; and

   (c) View C: access to the entity's underlying intellectual property *unless* the terms of the license give the customer control of the underlying intellectual property, such that the entity has in effect sold that intellectual property.

2. Agenda Paper 7F/164F also explains that identifying the nature of a promise to grant a license is an important starting point, however, the application of other parts of the revenue model must also be considered and will ultimately affect the amount and timing of revenue recognized for a license arrangement. The following examples from the pharmaceutical, software, media and entertainment and franchise industries highlight the importance of such

a complete evaluation of all of the steps of the revenue model. In fact, upon applying all of the steps of the 2011 ED, the ultimate pattern of revenue recognition for most of the examples would be the same, regardless of whether the starting point was View A, B or C. Also of note is that in many license arrangements, the conclusion for the license on a standalone basis (as determined under View A, B or C) changes based upon application of the rest of the model in light of other promises and elements of the license arrangement.

Example 1A: Pharmaceutical

	Description	View A	View B	View C
License	Pharma licenses its patent rights for drug X in Germany to Drug Co. for a 5 year, non-exclusive term beginning in year 3 of the patent's 20 year useful life.	**<u>Provide a right</u>:** *Right is transferred by Pharma and controlled by the customer.* **Conclusion:** performance obligation is satisfied at a point in time.	**<u>Provide a right</u>:** *Drug Co.'s right to the patented drug represents an output that results from Pharma's IP (ie the drug's formulaic composition), similar to a tangible good. Drug Co. can determine how and when to use the asset and can consume the right without further performance by Pharma.* **Conclusion:** performance obligation is satisfied at a point in time.	**<u>Provide access to Pharma's IP</u>:** *The underlying intellectual property will not substantially diminish in value over the term of the license, and the license term is for a specified period that is substantially less than the useful life of the underlying intellectual property.* **Conclusion:** performance obligation satisfied over time.
Other promises in the contract	Pharma also agrees to manufacture the drug for Drug Co. because the manufacturing process is unique.	**License is not distinct** *The license for the drug is <u>not</u> distinct from the manufacturing service because Drug Co. cannot benefit from the license without the supply of the drug from Pharma.* **Conclusion: One separate performance obligation** Bundle - recognize revenue over time.		
Constraining revenue recognized (Applying paragraph 85)	Drug Co. will compensate Pharma with a CU2 million upfront payment plus a 5 percent royalty on net sales.	**Consideration varies based on Drug Co.'s subsequent sales.** *Revenue for the variable amount will be recognized when Drug Co.'s subsequent sales occur (ie over time).*		
Overall conclusion: License and other promises		***Bundle –*** revenue is recognized over time (royalty revenue would be recognized as subsequent sales occur)		

Example 1B: Pharmaceutical

	Description	View A	View B	View C
License	Pharma licenses its patent rights for drug X in Germany to Drug Co. for a 5 year, non-exclusive term beginning in year 15 of the patent's 20 year useful life.	**<u>Provide a right</u>:** *Right is transferred by Pharma and controlled by the customer.* **Conclusion:** performance obligation is satisfied at a point in time.	**<u>Provide a right</u>:** *Drug Co.'s right to the patented drug represents an output that results from Pharma's IP (ie the drug's formulaic composition), similar to a tangible good. Drug Co. can determine how and when to use the asset and can consume the right without further performance by Pharma.* **Conclusion:** performance obligation is satisfied at a point in time.	**<u>Sale (in effect) of intellectual property</u>:** *The license period represents a period of time that is substantially all of the remaining useful life of the underlying intellectual property.* **Conclusion:** performance obligation is satisfied at a point in time.
Other promises in the contract	Pharma has contracted to co-promote the product in certain regions where Drug Co. does not have a presence.	**License is distinct** *The license for the drug is distinct from the co-promotion services because co-promotion services generally do not require any skills or knowledge that would be unique to Pharma and Drug Co. would be able to find other co-promotion resources that are readily available to them.* **Conclusion: Two separate performance obligations** (1) License – recognize revenue at a point in time. (2) Co-promotion services – recognize revenue over time.		
Constraining revenue recognized (Applying paragraph 85)	Drug Co. will compensate Pharma with a CU2 million upfront payment plus a 5 percent royalty on net sales.	**Consideration varies based on customer's subsequent sales** *Revenue for the variable amount will be recognized when the Drug Co.'s subsequent sales occur (ie over time).*		
Overall conclusion: License and other promises		***License –***revenue is recognized at a point in time (allocated based on estimate of transaction price) ***Co-promotion services –***revenue is recognized over time (allocated based on estimate of transaction price) (Note that royalties will be recognized as subsequent sales occur)		

Example 2A: Software

	Description	View A	View B	View C
License	Tech Z licenses software on January 1, 20x1 to Customer A for 3 years. (License is non-exclusive.) The software is not expected to decline significantly in value over the short to medium term as the software is complex and upgrades entail an extended effort of cost and time by Tech Z.	**Provide a right:** *Right is transferred by Tech Z and controlled by the customer.* **Conclusion:** performance obligation is satisfied at a point in time.	**Provide a right:** *Customer A.'s right to the software represents an output that results from Tech Z's IP (ie the underlying software program), similar to a tangible good. Customer A can determine how and when to use the right without further performance by Tech Z.* **Conclusion:** performance obligation is satisfied at a point in time.	**Provide access to Tech Z's IP:** *The software is not expected to substantially diminish in value over the 3 year term.* **Conclusion:** performance obligation is satisfied over time.
Other promises in the contract	The contract also requires Tech Z to provide post contract support (PCS) in the form of rights to unspecified future upgrades when and if available and phone support.	**License is distinct** *The license for the software is distinct from the PCS because Customer A can benefit from the license on its own (par. 28(b) of the 2011 ED, also reflected in the tentative decisions of the Boards in July 2012), that is, the PCS is not required for Customer A to be able to use the software.* **Conclusion: Two separate performance obligations** (1) License – recognize revenue at a point in time. (2) PCS – recognize revenue over time.		**License is distinct** *While the 'distinct' analysis is the same as that for Views A and B, the nature of the promise in the license is different under View C and therefore the revenue for the performance obligation related to the transfer of the license is recognized differently.* **Conclusion: Two separate POs** (1) License – recognize revenue over time. (2) PCS – recognize revenue over time.
Constraining revenue recognized (paragraph 85)	Customer A will pay CU1.2 million a year, payable in monthly installments of CU100,000.	**Consideration does not vary based on Customer A's subsequent sales.** *Paragraph 85 of the 2011 ED is not be relevant for this fact pattern.*		**Consideration does not vary based on Customer A's subsequent sales** *Paragraph 85 of the 2011 ED is not be relevant for this fact pattern.*
Overall conclusion: License and other promises		***License –*** revenue is recognized at a point in time ***PCS –*** revenue is recognized over time		***License –*** revenue recognized over time ***PCS –*** revenue is recognized over time

Example 2B: Software

	Description	View A	View B	View C
License	Tech Z licenses software on January 1, 20x1 to Customer A for 3 years. (License is non-exclusive.) The software is not expected to decline significantly in value over the short to medium term as the software is complex and upgrades entail an extended effort of cost and time by Tech Z.	**Provide a right:** *Right is transferred by Tech Z and controlled by the customer.* **Conclusion:** performance obligation is satisfied at a point in time.	**Provide a right:** *Customer A's right to the software represents an output that results from Tech Z's IP (ie the underlying software code), similar to a tangible good. Customer A can determine how and when to use the right without further performance by Tech Z.* **Conclusion:** performance obligation is satisfied at a point in time.	**Provide access to Tech Z's IP:** *The software is not expected to substantially diminish in value over the 3 year term.* **Conclusion:** performance obligation is satisfied over time.
Other promises in the contract	The contract also requires Tech Z to provide periodic upgrades that are critical to the software as it must reflect the latest government regulations.	**License is not distinct** *The license for the software is not distinct from the upgrades because Customer A cannot benefit from the software over the license term without the upgrades (par. 28(b) of 2011 ED). Customer A relies on Tech Z's knowledge of current government regulations and would not be able to address the periodically-occurring regulation updates itself without extensive cost and effort.* **Conclusion: One separate performance obligation (ie a bundle)** Bundle - recognize revenue over time.		
Constraining revenue recognized (Applying paragraph 85)	Customer A will pay CU1.2 million a year, payable in monthly installments of CU100,000.	**Consideration does not vary based on Customer A's subsequent sales.** *Paragraph 85 of the 2011 ED is not be relevant for this fact pattern.*		
Overall conclusion: License and other promises		***Bundle –*** revenue is recognized over time (royalty revenue would be recognized as subsequent sales occur)		

Example 2C: Software

	Description	View A	View B	View C
License	Tech Z licenses software on January 1, 20x1 to Customer A for 3 years. (License is non-exclusive.) The software is not expected to decline significantly in value over the short to medium term as the software is complex and upgrades entail an extended effort of cost and time by Tech Z.	**Provide a right:** *Right is transferred by Tech Z and controlled by the customer.* **Conclusion:** performance obligation is satisfied at a point in time.	**Provide a right:** *Customer A.'s right to the software represents an output that results from Tech Z's IP (ie the underlying software code), similar to a tangible good. Customer A can determine how and when to use the right without further performance by Tech Z.* **Conclusion:** performance obligation is satisfied at a point in time.	**Provide access to Tech Z's IP:** *The software is not expected to substantially diminish in value over the 3 year term.* **Conclusion:** performance obligation is satisfied over time.
Other promises in the contract	Customer A can only obtain use and benefit of the software by accessing it from Tech Z's hosted server.	**License is not distinct** *The license for the software is not distinct from the provision of access because Customer A cannot benefit from the software without Tech Z providing Customer A the ability to use the software that is hosted on its servers (par. 28(b) of 2011 ED). Customer A relies on Tech Z hosting the software because Customer A is not otherwise able to download the software onto its servers or obtain the software via a compact disk or other deliverable device.* **Conclusion: One separate performance obligation (ie a bundle)** Bundle - recognize revenue over time.		
Constraining revenue recognized (Applying paragraph 85)	Customer A will pay CU1.2 million a year, payable in monthly installments of CU100,000.	**Consideration does not vary based on Customer A's subsequent sales.** *Paragraph 85 of the 2011 ED is not be relevant for this fact pattern.*		
Overall conclusion: License and other promises		***Bundle –*** revenue is recognized over time (royalty revenue would be recognized as subsequent sales occur)		

Example 3A: Media & entertainment

<table>
<tr><th></th><th>Description</th><th>View A</th><th>View B</th><th>View C</th></tr>
<tr><td>License</td><td>Character Co. licenses the use of the images, names and likenesses of its animated characters to Cruise Ship for a 4 year term. Cruise Ship can use Character Co.'s characters in various ways (eg in shows or parades), within reasonable guidelines. Character Co. expects that it can re-license the characters at the end of the 4 year term.</td><td><u>Provide a right</u>:
Right is transferred by Character Co. and controlled by the customer.

Conclusion: performance obligation is satisfied at a point in time.</td><td><u>Provide a right</u>:
Cruise Ship's right to the licensed characters represents an output that results from Character Co.'s IP (ie the images, names, likenesses), similar to a tangible good. Cruise Ship can determine how and when to use the right without further performance by Character Co.

Conclusion: performance obligation is satisfied at a point in time.</td><td><u>Provide access to an entity's IP</u>:
The characters are not expected to substantially diminish in value over the 4 year term as evidenced by the expectation that Character Co. will be able to grant licenses of the underlying intellectual property at the end of the license term.

Conclusion: performance obligation is satisfied over time.</td></tr>
<tr><td>Other promises in the contract</td><td>The contract also provides for Character Co. to develop two new characters specific to Cruise Ship in the first two years of the license term.</td><td colspan="2">License is distinct
The license for the existing characters is distinct from the development of new characters because Cruise Ship can benefit from them on its own (par. 28(b)) - the new characters are not required to use and benefit from the existing characters.

Conclusion: Two separate performance obligations
(1) License – recognize revenue at a point in time.
(2) New characters – recognize revenue when (or as) performed.</td><td>License is distinct
While the 'distinct' analysis is the same as that for Views A and B, the nature of the promise in the license is different under View C and therefore the related revenue for the performance obligation related to the transfer of the license is recognized differently.

Conclusion: Two separate performance obligations
(1) License – recognize revenue over time
(2) New characters – recognize revenue when (or as) performed.</td></tr>
</table>

	Description	View A	View B	View C
Constraining revenue recognized (Applying paragraph 85)	Customer A will pay CU1 million a year plus a 1 percent royalty on net cruise sales.	**Consideration varies based on Drug Co.'s subsequent sales** *Revenue for the variable amount will be recognized when Cruise Ship's subsequent sales occur (ie over time).*		
Overall conclusion: License and other promises		***License* –** revenue is recognized at a point in time (allocated based on estimate of transaction price) ***New characters* –**revenue is recognized when (or as) performed (allocated based on estimate of transaction price) (Note that royalties will be recognized as subsequent sales occur)		***License* –** revenue is recognized over time (allocated based on estimate of transaction price) ***New characters* –** revenue is recognized when (or as) performed (allocated based on estimate of transaction price) (Note that royalties will be recognized as subsequent sales occur)

Example 3B: Media & entertainment

<table>
<tr><th></th><th>Description</th><th>View A</th><th>View B</th><th>View C</th></tr>
<tr><td>License</td><td>Character Co. licenses the use of the images, names and likenesses of its animated characters to Media Company. The license is perpetual.</td><td><u>Provide a right</u>:
Right is transferred by Character Co. and controlled by the customer.

Conclusion: performance obligation is satisfied at a point in time.</td><td><u>Provide a right</u>:
Media Company's right to the licensed characters represents an output that results from Character Co.'s IP (ie the images, names, likenesses), similar to a tangible good. Media Company can determine how and when to use the right without further performance by Character Co.

Conclusion: performance obligation is satisfied at a point in time.</td><td><u>Sale (in effect) of intellectual property</u>:
The license term (ie perpetual) is for substantially all of the remaining useful life of the remaining underlying intellectual property.

Conclusion: performance obligation is satisfied at a point in time.</td></tr>
<tr><td>Other promises in the contract</td><td>The contract also requires Character Co. to perform consulting services for a period of ten years to develop and promote characters. Those consulting services cannot be provided by any other entity.</td><td colspan="3">License is not distinct
The license for the existing characters is <u>not</u> distinct from the consulting services because the consulting services are unique and not easily replaceable. Media Company needs Character Co.'s expertise to benefit from the licensed characters (par. 28(b)). The consulting services are also not distinct in the context of the contract because they are not regularly sold separately (par. 28(a)).

Conclusion: One separate performance obligation (ie a bundle)
Bundle - recognize revenue over time.</td></tr>
<tr><td>Constraining revenue recognized (Applying paragraph 85)</td><td>Media Company will pay CU1 million a year plus a 1 percent royalty on revenues related to the animated characters.</td><td colspan="3">Consideration varies based on Media Company's subsequent sales

Revenue for the variable amount will be recognized when Media Company's subsequent sales occur (ie over time).</td></tr>
<tr><td>Overall conclusion: License and other promises</td><td></td><td colspan="3">Bundle –fixed fee revenue is recognized over time (over the 10 year period of service)
(Note that royalties will be recognized as subsequent sales occur)</td></tr>
</table>

Example 4A: Franchise

<table>
<tr><th></th><th>Description</th><th>View A</th><th>View B</th><th>View C</th></tr>
<tr><td>License</td><td>An established company, Franchisor A, licenses the right to open a franchise store in a specified location to Franchisee. The store will bear Franchisor’s trade name and the customer will have the right to sell Franchisor’s products for 10 years.</td><td><u>Provide a right</u>:
Right is transferred by Franchisor A and controlled by the customer. Franchisor A has no remaining performance obligations related to the franchised rights under license (ie trade name, market area, proprietary know-how for ten years).

Conclusion: performance obligation is satisfied at a point in time.</td><td><u>Provide access to Franchisor’s IP</u>:
The licensed right to open a franchise store is not similar to a tangible good or an output. Instead, the licensed right has a close connection with the underlying remaining intellectual property because reproduction will affect the value of the franchise right and changes in the underlying intellectual property could directly affect the value of the portion to which Franchisee has a right.

Conclusion: performance obligation is satisfied over time.</td><td><u>Provide access to Franchisor’s IP</u>:
The underlying intellectual property (ie brand name, trademarks, proprietary know-how) is not expected to substantially diminish in value over the term of the license given that Franchisor is an established company.

Conclusion: performance obligation is satisfied over time.</td></tr>
<tr><td>Other promises in the contract</td><td>Under the contract, Franchisor will also provide employee training and equipment, however Franchisee can purchase them from others.</td><td>License is distinct
The license to open a franchise store is distinct from the training services and equipment because Franchisee can obtain those services and equipment from other resources that are readily available to them (par. 28(b)). Similar services and equipment are regularly sold separately by other companies in the industry.

Conclusion: Three separate performance obligations
(1) License – recognize revenue at a point in time.
(2) Training – recognize revenue when (or as) performed.</td><td colspan="2">License is distinct
While the ‘distinct’ analysis is the same as that for Views B and C, the nature of the promise in the license is different under View A and therefore the related revenue for the performance obligation related to the transfer of the license is recognized differently.

Conclusion: Three separate performance obligations
(1) License – recognize revenue over time.
(2) Training – recognize revenue when (or as) performed.
(3) Equipment – recognize revenue when transferred.</td></tr>
</table>

	Description	View A	View B	View C
		(3) Equipment – recognize revenue when transferred.		
Constraining revenue recognized (Applying paragraph 85)	Franchisee promises to pay an upfront, fixed fee plus ongoing royalty payments of 1 percent of the customer's quarterly sales.	**Consideration varies based on Franchisee's subsequent sales** *Revenue for the variable amount will be recognized when Franchisee's subsequent sales occur (ie over time).*		
Overall conclusion: License and other promises		***License –*** revenue is recognized at a point in time (allocated based on estimate of transaction price) ***Training –*** revenue is recognized over time (allocated based on estimate of transaction price) ***Equipment –*** revenue is recognized over time (allocated based on estimate of transaction price) (Note that royalties will be recognized as subsequent sales occur)	***License –*** revenue is recognized over time (allocated based on estimate of transaction price) ***Training –*** revenue is recognized over time (allocated based on estimate of transaction price) ***Equipment –*** revenue is recognized over time (allocated based on estimate of transaction price) (Note that royalties will be recognized as subsequent sales occur)	

Example 4B: Franchise

<table>
<tr><th></th><th>Description</th><th>View A</th><th>View B</th><th>View C</th></tr>
<tr><td>License</td><td>A relative newcomer to an established and highly competitive industry, Franchisor B, licenses the right to open a franchise store in a specified location to Franchisee. The store will bear Franchisor’s trade name and the customer will have the right to sell Franchisor’s products for 5 years.</td><td><u>Provide a right</u>:
Right is transferred by Franchisor B and controlled by the customer. Franchisor B has no remaining performance obligations related to the franchised rights under license (ie trade name, market area, proprietary know-how for ten years).

Conclusion: performance obligation is satisfied at a point in time.</td><td><u>Provide access to Franchisor’s IP</u>:
The licensed right to open a franchise store is not similar to a tangible good or an output. Instead, the licensed right has a close connection with the underlying remaining intellectual property because reproduction will affect the value of the franchise right and changes in the underlying intellectual property could directly affect the value of the portion to which Franchisee has a right..

Conclusion: performance obligation is satisfied over time.</td><td><u>Sale (in effect) of intellectual property</u>:
The license term (ie 5 years) is for substantially all of the remaining useful life of the remaining underlying intellectual property, which is estimated to be fairly brief in light of heavy competition in the industry, challenges faced by start-ups in the industry and historic track record of newcomers to the industry.

Conclusion: performance obligation is satisfied at a point in time.</td></tr>
<tr><td>Other promises in the contract</td><td>Under the contract, Franchisor will also provide a number of services for Franchisee to support and enhance the franchise brand. For example: (a) advising and consulting on the operations of the store; (b) communicating know-how, and new developments, techniques and improvements in store management, inventory preparation and service; (c) providing business and training manuals; and (d) supporting advertising programs and training.</td><td colspan="3">License is not distinct
The license to open a franchise store is <u>not</u> distinct from the various services because the services are unique and not easily replaceable. Franchisee needs Franchisor’s expertise to benefit from the franchised store (par. 28(b)). The services are also not distinct because they are not regularly sold separately (par. 28(a)).
Conclusion: One separate performance obligation (ie a bundle)
Bundle - recognize revenue over time.</td></tr>
</table>

	Description	View A	View B	View C
Constraining revenue recognized (Applying paragraph 85)	Franchisee promises to pay an upfront, fixed fee plus ongoing royalty payments of 1 percent of the customer's quarterly sales.	**Consideration varies based on Franchisee's subsequent sales** *Revenue for the variable amount will be recognized when Franchisee's subsequent sales occur (ie over time).*		
Overall conclusion: License and other promises		***Bundle* –**revenue is recognized over time (royalty revenue would be recognized as subsequent sales occur)		