Supplement to Agenda Paper 7A / 175A – Constraint on Estimates of Variable Consideration

The following supplement to Agenda Paper 7A/175A aggregates the rationale for including paragraph 56.6 (see Appendix A in that paper, formerly paragraph 85 in the 2011 ED) which is an exception to the constraint guidance for licenses of intellectual property with a sales or usage-based royalty.

> *Alternative 1 in paper 7A/175A*
>
> 56.6 Notwithstanding the requirements in paragraphs 56.1 – 56.5, if an entity licenses intellectual property in which the consideration is in the form of a sales or usage-based royalty, the entity shall include that consideration in the transaction price only when the subsequent sales or usage occur.

Basis for reintroducing exception for licenses of intellectual property with sales or usage-based royalties:

1. ***Why should the exception be limited to licenses of intellectual property? (Paragraph 48 in Paper 7A/175A)***
    a) *Length of license term* – A contract with a royalty arrangement may extend for a number of years causing the uncertainty in the transaction price to be unresolved or partially unresolved for a significant length of time. In contrast, contracts that require delivery of tangible products may result in the uncertainty being resolved in a shorter period of time. This is because contracts that require delivery of tangible products usually result in distinct goods being transferred at different points in time during the term of the contract.
    b) *Significant uncertainty* – The unique nature of these arrangements leads to significant uncertainty about the value of the item transferred (ie the license of intellectual property). For example, it might be the first time the entity has licensed the intellectual property in that specific location. As a result, royalty arrangements are far more prevalent in licenses of intellectual property than for sales of tangible items.
    c) *Cost profile* **–** In a license of intellectual property, there is generally no asset to derecognize and therefore there is no concern that there will be costs recognized but no revenue.
2. ***More useful information (Paragraphs 32-34 in Paper 7A/175A)*** – Users and preparers thought it would *not* be useful to recognize revenue at estimated amounts (typically a minimum) only to make significant adjustments throughout the life of the contract. Those users explained that for licenses subject to sales-based royalties, recognizing revenue when the uncertainty is resolved (ie when the customer's subsequent sales occur) would provide more useful information because: (a) the amount recognized 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 depicts the economics of these transactions.
3. ***Cost & complexity (Paragraphs 38 and 40 in Paper 7A/175A)*** – In the majority of these transactions the Boards thought it would be unlikely that entities could develop an estimate that would not be subject to significant true-ups. Given that, the boards thought the benefits of a simpler model and consistency of treatment for this class of transactions outweighed the disadvantages of requiring an entity to estimate royalties at contract inception and at each reporting date over an extended period of time.
4. ***Interaction with implementation guidance on licenses (Paragraph 46 in Paper 7A/175A)*** – For licenses of intellectual property with sales or usage-based royalties, the exception will relieve the

tension around requiring an entity to determine whether the nature of a license provides access (transfers over time) or a right (transferred at a point in time).

References:

- Memo 7A/175A (October 2013), paragraphs 31 – 50
- Memo 7C/173C (July 2013), paragraphs 22 – 27
- Memo 7D/165D (December 2012), paragraph 9
- 2011 ED, paragraph BC203
- Memo 10C/140C (March 2011), paragraphs 8 – 15
- Memo 10E/140E (March 2011), paragraphs 24 – 36
- Memo 2A/141A (April 2011), paragraphs 29 – 35