

# STAFF PAPER

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Project	Revenue Recognition		
Paper topic	Implementation Guidance: Licenses		
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## Purpose of the paper

1. This paper proposes to clarify the Implementation Guidance for licenses based on recent feedback. Specifically, this paper proposes clarifications to the criteria for differentiating between licenses that provide a customer with:
  - (a) Access to the entity's intellectual property as it exists at any given time;
  - or
  - (b) A right to use the entity's intellectual property as it exists at a point in time.

## Staff recommendation

2. If the Boards agree with the intent and direction explained in this paper for differentiating between the two types of licenses (those that provide access and those that provide a right to use), the staff will continue to improve and clarify the drafting of the Implementation Guidance for licenses shown in Appendix A.

## Structure of the paper

3. This paper is organized as follows:
  - (a) Background (paragraphs 4—8)
  - (b) Objective of the criteria (paragraphs 9—12)
  - (c) Feedback (paragraphs 13—14)
  - (d) Improving the Implementation Guidance and the criteria (paragraph 15)
  - (e) Including a criterion for sales-based royalties? (paragraphs 16—18)
  - (f) Additional analysis performed (paragraph 19)
  - (g) Staff recommendation (paragraph 20)
  - (h) Appendix A—Staff working draft
  - (i) Appendix B—marked up version of the criteria as shown in September 2013 Agenda Paper 7A/174A
  - (j) Appendix C—Illustrative Examples
  - (k) Appendix D—Rejected factors for differentiating between the two types of licenses

## Background

4. During the redeliberations of the 2011 Exposure Draft the Boards discussed the feedback received on the Implementation Guidance for licenses at the joint Board meetings in July and November of 2012. In many of their discussions, the Boards noted that, as with all contracts, it is important to appropriately identify all of the promises to transfer goods or services and apply the criteria for identifying the performance obligations (paragraphs 23-29.1 of the proposed standard).
5. In their discussions, the Boards also considered, but ultimately rejected, two alternatives that would have required all distinct licenses to be:

- (a) Performance obligations satisfied over time—that is because the license provides access to the entity’s intellectual property; or
  - (b) Performance obligations satisfied at a point in time—that is because the license provides a right (this was consistent with the approach in the 2011 ED).
6. Instead, at the November 2012 joint Board meeting, the Boards tentatively decided that for some licenses, the nature of the promise in transferring a license is to provide access to the entity’s intellectual property, while for other licenses, the nature of the promise is to provide a right to use the entity’s intellectual property. The Boards reconfirmed this view in September 2013. This is because the Boards observed that licenses can vary significantly and include a wide array of different features and economic characteristics, which lead to significant differences in the rights provided by a license.
7. To distinguish between the two types of licenses the Boards tentatively decided to specify criteria rather than only relying on the control guidance. This is because the nature of the promised goods or services in a license needs to be defined before an entity can assess when control of those promised goods or services has transferred.
8. Throughout their discussion on licenses, the Boards considered but ultimately rejected other factors to distinguish between the two types of licenses. These rejected factors were outlined in Alternative E of Agenda Paper 7A/175A at the September 2013 Board meeting and are discussed in more detail in Appendix D.

### **Objective of the criteria**

9. As mentioned above, an entity should assess the goods and services to be transferred and identify the performance obligations. Thus, the criteria will only be applied to distinct licenses; a license that is not distinct from other goods or services in the contract would follow the recognition pattern for the combined goods or services.

10. In developing the criteria, the staff observed that it is helpful to think about the nature of the asset that underlies the license—that is, whether the intellectual property is dynamic or static. This is because the entity has the ability to change the underlying intellectual property to which the customer has rights as a result of its control over that underlying intellectual property. Consequently, the customer cannot direct the use of and obtain substantially all of the remaining benefits from the license. Instead, in these cases, what the customer has obtained (and hence, what the license provides) is access to the entity’s intellectual property *as it exists at the time the customer accesses the intellectual property*. In fact, in these cases, the nature of the customer’s rights are such that the customer is obligated to use the most recent form of the entity’s intellectual property.
11. The criteria to help an entity determine when its intellectual property is dynamic as follows (see also Appendix A):

***Criterion a***

**The contract requires or the customer reasonably expects that the entity will undertake activities that significantly affect the intellectual property to which the customer has rights (that is, the intellectual property to which the customer has rights is dynamic). Factors that may indicate that a customer could reasonably expect an entity will undertake activities that [significantly] affect the intellectual property, include the entity’s customary business practices, published policies, specific statements or the existence of a shared economic interest (eg a sales-based royalty) between the entity and the customer (or potential customer) related to the intellectual property licensed to the customer.**

**Rationale**

**This criterion establishes why an entity’s intellectual property is dynamic. The staff observed that the main factor that results in the intellectual property being dynamic is that the entity undertakes activities that do not directly transfer goods or services to a customer (ie they do not meet the definition of a performance obligation). The activities may be part of an entity’s on-going and ordinary activities and customary business practices, however, the customer may benefit from the activities because the activities affect the intellectual property to which the customer has rights. These notions are discussed in the next**

two criteria.

*Criterion b*

Those activities do not transfer a good or a service to the customer as those activities occur (that is, the activities are not accounted for as performance obligations).

**Rationale**

This criterion emphasizes that the activities that may affect the intellectual property are not in and of themselves additional performance obligations in the contract. This criterion is necessary because the assessment of the criteria should not be affected by other promises in the contract to transfer distinct goods or services (that is, performance obligations) that are separate from the license. This is because the nature and pattern of transfer of each (separate) performance obligation in a contract would not affect the timing of other promised goods or services in the contract and thus would not affect the determination of the rights provided by the license. That is because by definition, a customer can control the use of and obtain the remaining benefits from distinct goods or services without the other (distinct) goods or services in a contract. Consider a contract to provide a car and ongoing maintenance services—that is, two distinct goods or services (and thus two separate performance obligations). In this case, it seems counterintuitive to determine the nature and timing of the entity's performance related to the transfer of the car because the entity has also promised a (separate) maintenance service. A similar example can be drawn from a contract that includes a software license and a promise to provide a service of updating the customer's software (sometimes included in a contract as post-contract customer support), which are each often identified as a distinct good or service (ie a separate performance obligation because the customer can use and benefit from the license on its own, without the updates). A promise to transfer separate updates to the license would be specifically excluded

by this criterion in the assessment of the nature of the promise.

***Criterion c***

The rights granted by the license directly expose the customer to any positive or negative effects of the entity's activities that affect the intellectual property as and when the entity undertakes those activities and the entity expects that the customer entered to the contract with the intention of being exposed to those effects.

**Rationale**

In their analysis of various examples, the staff observed that it is not sufficient for the entity to undertake activities as described in criterion (a)—that is the activities should affect the customer, because of the customer's rights to that intellectual property in the contract. Without criterion (c), criterion (a), (that is, that the entity undertakes activities to change its intellectual property), would be too broad, and would result in almost all licenses being classified as providing access. When the activities do not affect the customer, the entity is merely changing its own asset which, although it may affect the entity's ability to provide future licenses, would not affect the determination of what the license provides to the customer or what the customer controls. As a result, the staff determined that all three criteria must be met for a license to provide access. This is because, when all three criteria are met, it is evident that the customer will not be able to direct the use of and obtain substantially all of the remaining benefits from the license at the time of transfer.

12. When the criteria are not met, the license provides the customer with a right to use the entity's intellectual property as that intellectual property exists (in the form and with the functionality) at the point in time when the license transfers to the customer.

## Feedback

13. Feedback received subsequent to the Boards' November 2012 decision indicated that most reviewers and participants in outreach agreed with the Boards' tentative decision to differentiate between the two types of licenses. They appreciated that it would allow entities to more appropriately depict their license arrangements because, given the spectrum of license arrangements, the distinction would allow an entity to make an assessment of its own facts and circumstances. Many, however, suggested that the criteria would be difficult to apply in practice without additional supporting material.
14. During the drafting process, some reviewers also raised questions about the operability of the criteria that the staff had proposed for differentiating between the two types of licenses. At the September 2013 joint Board meeting, the Boards considered this feedback and possible paths forward. In their discussion the Boards confirmed their November 2012 tentative decision to differentiate between the two types of licenses—that is, that some licenses are promises to provide access to the entity's intellectual property as it exists at any given time, while other licenses are promises to transfer a right to use the entity's intellectual property as it exists at a point in time. To address the feedback received, the Boards also tentatively decided to improve the criteria.

## Improving the Implementation Guidance and the criteria

15. In response to comments received during the drafting process, the Boards decided in September 2013 to improve the Implementation Guidance broadly, including the drafting of the criteria to differentiate between the two types of licenses. The staff have included that drafting in Appendix A. A summary of the improvements the staff have completed since the draft included in the September 2013 Agenda Paper 7A/174A are as follows:
  - (a) Place greater emphasis on the importance of identifying performance obligations before applying the criteria to distinguish between the two types of licenses. Although a similar notion existed in previous drafts,

reviewers were uncertain about whether they needed to identify performance obligations before or after applying the criteria and furthermore some questioned the interaction between identifying performance obligations and assessing the criteria. The staff think some of these concerns were raised because of the position of the separation paragraph towards the end of the licenses Implementation Guidance. As a result, the staff have relocated the separation paragraph to earlier in the licenses Implementation Guidance (paragraph IG34; see Appendix A) to make it more prominent.

- (b) Provided greater prominence is given to the notions of ‘dynamic’ and ‘static’ intellectual property.
- (c) Although not directly in the criteria, included the notion of ‘continuing involvement’ in the lead-in to the criteria (see Appendix A) because the staff thought it would be helpful for entities, while still being consistent with the notion that a license is dynamic.
- (d) Included the notion of ‘shared economic interest’ as an indicator of when the customer might reasonably expect the entity to undertake activities.

### **Including a criterion for sales-based royalties?**

16. In recent discussions, some have suggested including an additional criterion that would result in a license being classified as providing access (ie would be a performance obligation over time) when the promised consideration includes a sales- or usage-based royalty. As a criterion for recognition, this would result in *all* of the promised consideration being recognized over time for such licenses, including the fixed amount. Consider, for example, an entity that licenses a musical recording to a customer in exchange for fixed consideration of CU 1 million as well as a 1p usage-based royalty. Including a criterion in the Implementation Guidance that classifies a license as providing access when there is a sales- or usage-based royalty would result in the CU 1 million being



recognized over time, in addition to the usage-based royalty. However, in this example, the customer has obtained control of intellectual property that will not change and requires no further performance from the entity.

17. The staff do not think that a recognition criterion would be appropriate because the existence of a sales or usage-based royalty is not solely definitive of performance over time. In some cases, the existence of a ‘shared economic interest’ between the entity and the customer in the intellectual property being licensed can indicate that a customer could reasonably expect that an entity will undertake activities that affect the intellectual property to which the license relates. The staff incorporated this notion to help identify when the customer might reasonably expect the entity to undertake activities.
18. The staff note that even with this improvement to the criteria, there are still many concerns related to the revenue recognition pattern of licenses that include a sales- or usage-based royalty. This is because of the Boards decision to require an entity to recognize a minimum amount of revenue and the removal of a specific requirement in the 2011 ED that required an entity to recognize revenue for licenses of intellectual property a sales-based royalty as those subsequent sales occur (paragraph 85 of the 2011 ED). In the staff’s view, the concerns related to the revenue recognition pattern for sales- or usage-based royalties would be more appropriately addressed as a measurement issue. Specifically, the staff think this should be addressed in the constraint on estimates of variable consideration (see Agenda Paper 7A/175A).

### **Additional analysis performed**

19. The staff tested the criteria with examples (see Appendix C) and circulated the proposed drafting with a few external parties. Most of this feedback has been incorporated into the revised drafting shown in Appendix A. However, some still had concerns that it may be challenging to apply the criteria. Some respondents suggested that additional examples may help in the application of the criteria.

## Staff recommendation

20. The staff think that if the Boards agree with the intent and direction explained in this paper for differentiating between the two types of licenses (those that provide access and those that provide a right to use), then the staff can continue to improve and clarify the drafting of the Implementation Guidance for licenses shown in Appendix A.

### Question for the Boards

Do the Boards agree with the direction explained in this paper for differentiating between the two types of licenses (those that provide access and those that provide a right to use)?

## Appendix A – Staff working draft

### Implementation Guidance - Licenses

- IG33. A license establishes a customer's rights related to the intellectual property of an entity. Licenses of intellectual property may include the following:
- Software and technology
  - Motion pictures, music and other forms of media and entertainment
  - Franchises
  - Patents, trademarks and copyrights
- IG34. A contract to transfer a license to a customer may include performance obligations in addition to the promised license. Those promises may be specified in the contract or implied by the entity's customary business practices, published policies or specific statements. Consequently, as with other types of contracts, when a contract with a customer includes a promise to transfer a license, an entity applies paragraphs 23–29.1 to identify each of the performance obligations in the contract.
- IG35. When the criteria in paragraph 28 are not met, the license is not distinct from other goods or services in the contract. If the promised license is not distinct from other goods or services promised in the contract, an entity shall account for the license and those other promised goods or services together as a single performance obligation. Examples of licenses that are not distinct from other goods or services promised in the contract include the following:
- A license that forms a component of a tangible good and that is integral to the good's functionality.
  - A license that the customer can benefit from only in conjunction with a related service (for example, software that is hosted on the internet).
- In those cases when the license is not distinct, the entity shall apply paragraphs 31-48 to determine whether the single performance obligation is a performance obligation that is satisfied over time or at a point in time.
- IG36. If the promised license is distinct from other promised goods or services in the contract, and hence the promised license is a separate performance obligation, an entity must determine whether control is transferred at a point in time or over time. In making this determination, an entity shall consider whether the nature of the entity's promise in transferring the license to the customer is to provide a customer with either:
- Access to the entity's intellectual property as it exists at any given time;
  - A right to use the entity's intellectual property as it exists at a point in time.

- IG37. The nature of the entity's promise may be to provide access to the entity's intellectual property if the entity continues to be involved with its intellectual property and that involvement affects the customer because of the rights granted by the license. An entity continues to be involved with its intellectual property by undertaking activities that do not transfer goods or services to the customer, but instead change its intellectual property to which the customer has rights. Therefore, the nature of the entity's promise in transferring a license is to provide a customer with access to the entity's intellectual property if all of the following criteria are met:
- a. The contract requires or the customer reasonably expects that the entity will undertake activities that significantly affect the intellectual property to which the customer has rights (that is, the intellectual property to which the customer has rights is dynamic). Factors that may indicate that a customer could reasonably expect an entity will undertake activities that [significantly] affect the intellectual property, include the entity's customary business practices, published policies, specific statements or the existence of a shared economic interest (eg a sales-based royalty) between the entity and the customer (or potential customer) related to the intellectual property licensed to the customer.
  - b. Those activities do not transfer a good or a service to the customer as those activities occur (that is, the activities are not accounted for as performance obligations).
  - c. The rights granted by the license directly expose the customer to any positive or negative effects of the entity's activities that affect the intellectual property as and when the entity undertakes those activities and the entity expects that the customer entered to the contract with the intention of being exposed to those effects.
- IG38. If the criteria in paragraph IG37 are met, an entity shall account for the promised license as a performance obligation satisfied over time because the customer will simultaneously receive and benefit from the entity's performance as the performance occurs (paragraph 35(aa)). An entity shall apply paragraphs 38–48 to select an appropriate method to measure its progress toward complete satisfaction of that performance obligation to provide access.
- IG39. A license that does not meet all of the criteria in paragraph IG33.2 transfers a right to the customer, which would enable the customer to direct the use of and obtain substantially all of the remaining benefits from the license at the point in time that the license transfers to the customer. This is because the intellectual property to which the customer has rights is static. If the license is distinct (in accordance with paragraphs 28-29.1), an entity shall account for the promise of a license that transfers a right as a performance obligation satisfied at a point in time. An entity shall apply paragraph 37 to determine the point in time when the license transfers to the customer. However, control of a right cannot be transferred before the beginning of the period during which the customer is able to use and benefit from the licensed intellectual property. For example, if a software license period begins before the entity provides (or otherwise makes available) to the customer an access code that enables the customer to

immediately access or use the software, an entity would not recognize revenue before that code has been provided (or otherwise made available).

- IG40. An entity shall disregard the following factors when determining whether a license provides access or transfers a right:
- a. Restrictions of time, geography, or use. Those restrictions define the attributes of the promised license, rather than define whether the entity satisfies its performance obligation at a point in time or over time.
  - b. Guarantees provided by the entity that it has a valid patent to intellectual property and that it will defend that patent from unauthorized use. A promise to defend a patent right is not a performance obligation because the act of defending a patent protects the value of the entity's intellectual property assets and provides assurance to the customer that the license transferred meets the specifications of the license promised in the contract.

**Appendix B—marked up version of the criteria as shown in September 2013  
Agenda Paper 7A/174A**

IG373-2. The nature of the entity's promise may be to provide access to the entity's intellectual property if the entity continues to be involved with its intellectual property and that involvement affects the customer because of the rights granted by the license. An entity continues to be involved with its intellectual property by undertaking activities that do not transfer goods or services to the customer, but instead change its intellectual property to which the customer has rights. Therefore, the nature of the entity's promise in transferring a license is to provide  
~~A license provides the~~ customer with access to the entity's intellectual property if all of the following criteria are met:

- a. The contract requires or the customer ~~has a valid expectation arising from the entity's customary business practices, published policies, or specific statements~~ reasonably expects that the entity will undertake activities that ~~modify the nature or value of~~ significantly affect the intellectual property to which the ~~license relates~~ the customer has rights (that is, the intellectual property to which the customer has rights is dynamic). Factors that may indicate that a customer could reasonably expect an entity will undertake activities that [significantly] affect the intellectual property, include the entity's customary business practices, published policies, specific statements or the existence of a shared economic interest (eg a sales-based royalty) between the entity and the customer (or potential customer) related to the intellectual property licensed to the customer.
- b. Those activities ~~undertaken by the entity to modify the nature or value of the intellectual property to which the license relates~~ do not transfer a good or a service to the customer as those activities occur (that is, the activities are not accounted for as performance obligations).
- c. The rights granted by the license directly expose the customer to any positive or negative effects ~~on the nature or value of the activities that affect the intellectual property arising from those activities~~ as and when the entity undertakes those activities and the entity expects that the customer entered to the contract with the intention of being exposed to those effects.

## Appendix C—Illustrative examples

### Example 1—License of Intellectual Property

An entity enters into a contract with a customer to license (for a period of 3 years) intellectual property related to the design and production processes for a good. The contract also specifies that the customer will obtain any updates and new designs or production processes that may be developed by the entity. The updates are essential to the customer's ability to use the license because it operates in an industry in which new and improved technologies change rapidly. The customer expects that the entity will continue to perform research and development activities to meet the needs of its customers for updates, new designs and production processes. The entity does not sell the enhancements separately and the customer does not have the option to purchase the license without the enhancements.

The entity assesses the goods and services promised to the customer to determine which goods and services are distinct in accordance with paragraph 28. The entity determines that the promise to transfer the license is not separable from the promise to provide the updates, in accordance with paragraph 28(b) and the indicators in paragraph 29. This is because the license is highly dependent on the updates and customer cannot benefit from the license without the updates. In other words, the customer could not have purchased the license without the updates without significantly affecting the license.

Since the criterion in paragraph 28(b) is not met, the license is not distinct.

Consequently, the entity assesses the performance obligation, which includes the combined services, to determine whether the performance obligation is satisfied over time or at a point in time. The entity concludes that the performance obligation is satisfied over time in accordance with paragraph 35(aa).

### Example 2—Identification of Performance Obligations

#### Scenario A—Distinct Goods and Services

An entity, a software developer, enters into a contract with a customer to transfer a perpetual software license, perform installation services, and provide unspecified software updates and technical support (online and telephone) for a two-year period. The entity sells the license, installation services, and technical support separately. The installation service includes changing the web screen for each type of user (for example, marketing, inventory management, and information technology). The installation service is not complex and is routinely performed by other entities. The software updates and

technical support are optional services, and the software remains functional without the updates and the technical support.

The entity assesses the goods and services promised to the customer to determine which goods and services are distinct in accordance with paragraph 28. The entity observes that the customer can benefit from each of the goods and services either on their own or together with the other goods and services that are readily available in accordance with paragraph 28(a).

The entity also determines that the promise to transfer each good and service to the customer is separable from each of the other promises in accordance with paragraph 28(b) and the indicators in paragraph 29. In particular, although the entity has promised to install the software on the customer's information technology system, the installation does not significantly modify or customize the software.

Based on this assessment, the entity identifies four performance obligations in the contract:

- a. The software license
- b. Installation services
- c. Software updates
- d. Technical support

The entity applies paragraphs 31-37 to determine whether the performance obligations for installation services, software updates, and technical support are satisfied at a point in time or over time.

The entity also evaluates the nature of the entity's promise to transfer the software license in accordance with paragraph IG37. The entity concludes that none of the criteria are met because the entity is not required and the customer does not reasonably expect the entity to undertake activities that significantly affect the intellectual property to which the license relates. The entity does not consider in its assessment of the criteria in paragraph IG37 the separate performance obligation of promising to provide software updates. Therefore, the nature of the entity's promise in transferring the license is to provide a right to use the entity's intellectual property as it exists at a point in time—that is, the intellectual property to which the customer has rights is static. Consequently, the entity accounts for the license as a performance obligation satisfied at a point in time.

#### Scenario B—Significant Customization

The goods and services are the same as in Scenario A except that the contract specifies that the software is to be substantially customized. This customization will add significant new functionality to the software that is specific to the customer's needs and will ensure



that the software is able to interface with other complex customer-specific software applications used by the customer.

The entity assesses the goods and services promised to the customer to determine which goods and services are distinct in accordance with paragraph 28. The entity determines that the promise to transfer the license is not separable from the customization service, in accordance with paragraph 28(b) and the indicators in paragraph 29. This is because the entity provides a significant service of integrating the license and the customization service into a single new software system as specified in the contract. In other words, the entity is using the license and the customization service as inputs to produce the combined output specified in the contract. In addition, the software is significantly modified and customized by the service. Therefore, the entity determines that the software license and customization and installation services are not distinct.

As in Scenario A, the entity concludes that the software updates and technical support are distinct from the other promises in the contract. This is because the customer can benefit from the updates and technical support either on their own or together with the other goods and services that are readily available, and the promise to transfer the software updates and the technical support to the customer are separable from each of the other promises.

Based on this assessment, the entity identifies three performance obligations in the contract:

- a. The customized licensed software including the installation services
- b. Software updates
- c. Technical support

The entity applies paragraph 31-37 to determine whether each performance obligation is satisfied at a point in time or over time.

### **Example 3—Identifying a Distinct License**

An entity, a pharmaceutical company, licenses to a customer its patent rights to an approved drug for 10 years and also promises to manufacture the drug for the customer. The drug is a mature product and therefore, consistent with its customary business practices, the entity will not undertake any activities to support the drug.

Scenario A—License Is Not Distinct

No other entity can manufacture this drug because of the highly specialized nature of the manufacturing process. As a result, the license cannot be purchased separately.

The entity assesses the goods and services promised to the customer to determine which goods and services are distinct in accordance with paragraph 28. The entity determines that the customer cannot benefit from the license without the manufacturing service. The entity accounts for the license and the manufacturing services as a single performance obligation. Consequently, the entity applies paragraphs 31–37 to determine whether the performance obligation is a performance obligation satisfied over time or at a point in time.

#### Scenario B—License is Distinct

The manufacturing process used to produce the drug is not unique or specialized, and several other entities can also manufacture the drug for the customer.

The entity assesses the goods and services promised to the customer to determine which goods and services are distinct in accordance with paragraph 28. Because the manufacturing process can be provided by other entities, the entity concludes that the customer can benefit from the license on its own (that is, without the manufacturing service) and the license is separable from the manufacturing process. Therefore, the entity concludes that the license is distinct from the manufacturing services and the entity has two performance obligations:

- a. License to the drug
- b. Manufacturing service

The entity applies paragraphs 31–37 to determine whether the manufacturing service is a performance obligation satisfied over time or at a point in time.

The entity also evaluates the nature of the entity's promise to transfer the license in accordance with paragraph IG37. The drug compound has been approved, is being manufactured and is commercially ready for sale. Therefore, the entity concludes that the criteria in IG37 cannot be met, because the entity is not required and the customer does not reasonably expect the entity to undertake activities that significantly affect the intellectual property to which the customer has rights. The entity does not consider in its assessment of the criteria in paragraph IG37 the separate performance obligation of promising to provide a manufacturing service. Therefore, the nature of the entity's promise in transferring the license is to provide a right to use the entity's intellectual property as it exists at a point in time—that is, the intellectual property to which the customer has rights is static. Consequently, the entity accounts for the license as a performance obligation satisfied at a point in time.

**Example 4—Franchise Rights**

An entity enters into a contract with a customer and promises to transfer a franchise license that provides the customer with the right to use the entity's trade name and sell the entity's products for 10 years. In addition to the license, the entity has also promised to provide the equipment necessary to operate a franchise store. In exchange for providing the license, the entity receives a sales-based royalty of 5 percent of the customer's monthly sales. The fixed consideration for the equipment is \$150,000 payable when the equipment is delivered.

The entity assesses the goods and services promised to the customer to determine which goods and services are distinct in accordance with paragraph 28. The entity determines that the customer can benefit from the equipment on its own or together with other resources that are readily available because the equipment can be used in the franchise or sold for an amount other than scrap value. The entity also determines that the equipment is separable from the license because the none of the indicators in paragraph 29 are present. Therefore, the entity concludes that the license is distinct from the equipment and the entity has two performance obligations:

- a. Franchise license
- b. Equipment

The transaction price includes fixed consideration of \$150,000 (for the equipment) and variable consideration (5 percent of customer sales) that the entity must estimate in accordance with paragraph 55. The entity uses the expected value approach and estimates the amount of variable consideration to be \$1 million.

The entity evaluates paragraph 76.1 to determine if the variable consideration can be allocated entirely to the performance obligation to transfer the franchise license. The entity concludes that the variable consideration (ie the sales-based royalty) can be allocated entirely to the franchise license because the variable consideration relates entirely to the customer's sales as defined by the license. In addition, the entity observes that allocating \$150,000 to the equipment and \$1 million to the franchise license would be consistent with an allocation based on the entity's relative standalone selling prices in similar contracts.

The entity concludes that the promise to transfer equipment is a performance obligation satisfied at a point in time and recognizes revenue of \$150,000 for the equipment when control of the equipment transfers to the customer in accordance with paragraph 37.

The entity also evaluates the nature of the entity's promise to transfer the franchise license in accordance with paragraph IG37. The entity concludes that the criteria in IG37

are met and the nature of the entity's promise is to provide access to the entity's intellectual property as it exists at any given time. This is because:

- a. The entity's customary business practice is to undertake activities that significantly affect the franchise (ie the intellectual property to which the customer has rights). For example, the entity analyzes changing customer preferences and implements product improvements, pricing strategies, marketing campaigns, and operational efficiencies. In addition, the entity observes that its shared economic interest with the customer (as evidenced through the sales-based royalty) indicates that the customer will expect the entity to undertake these activities to maximize earnings.
- b. The entity also observes that even though the customer may benefit from the activities, it is not clear that they transfer a good or service to the customer as those activities occur.
- c. The entity also observes that the customer is affected by the activities because the franchise license requires the customer to implement any changes that result from those activities.

Since the criteria in IG37 are met, the entity concludes the promise to transfer a license is a performance obligation satisfied over time in accordance with paragraph 35(aa). The entity then applies paragraphs 38-48 to determine a measure of progress that will depict the entity's performance and concludes that the best depiction of its performance would be to recognize revenue for the sales-based royalty allocated to the franchise license as the customer's sales occur.

*[NOTE: the staff observe that in some cases a franchise license may specify that the entity will provide additional goods or services to the customer. These goods or services may not be separable from the license and therefore the entity may conclude that the combined performance obligation (that includes the license) is satisfied over time. This will likely result in the same pattern of revenue recognition as described in the example above.]*

#### **Example 5—Access to Intellectual Property**

An entity, a creator of comic strips, licenses the use of the images and names of its comic strip characters in three of its comic strips to a customer for a four-year term. While there are main characters involved in each of the comic strips, newly created characters appear regularly and the images of the characters evolve over time. The customer, an operator of cruise ships, can use the entity's characters in various ways, such as in

shows or parades, within reasonable guidelines. The contract requires that the customer use the latest images of the characters.

In exchange for providing the license, the entity receives a fixed payment of \$1 million each year.

The entity assesses the goods and services promised to the customer to determine which goods and services are distinct in accordance with paragraph 28. The entity concludes that it has no other performance obligations other than the promise to transfer a license. That is, the additional activities associated with the license do not transfer a good or service to the customer as those activities occur.

The entity evaluates the nature of the entity's promise to transfer the license in accordance with paragraph IG37. In evaluating the criteria the entity considers the following:

- a. The customer reasonably expects (arising from the entity's customary business practices) that a weekly comic strip will be published and distributed and other activities will continue to be undertaken by the entity such as internal creative development of the characters and other marketing and promotional activities that it regularly undertakes in enhancing the awareness of its characters. Therefore the intellectual property to which the customer has rights (that is, the comic strip characters) is dynamic.
- b. Those activities undertaken by the entity are part of the entity's ordinary activities and although the customer may benefit from them, the activities do not transfer a good or a service to the customer as those activities occur. (That is, the activities are not identified as separate performance obligations.)
- c. The contract requires that the customer must use the latest characters that result from the activities of the entity. Thus, the rights granted by the license directly expose the customer to any positive or negative effects of those activities.

Therefore, the entity concludes that the criteria in IG37 are met and the nature of the entity's promise in transferring a license is to provide the customer with access to the entity's intellectual property as it exists at any given time. Consequently, the entity accounts for the promised license as a performance obligation satisfied over time (that is, the criterion in paragraph 35(aa) of the standard is met).

The entity evaluates paragraphs 38–48 to identify the method that best depicts its performance in the license. Since the contract provides the customer with unlimited use of the licensed characters, the entity determines that a time-based method would be the most appropriate measure of progress toward complete satisfaction of the performance obligation.

**Example 6—Right to Use Intellectual Property**

An entity, a music record label, licenses a 1975 recording of a classical symphony by a noted royal orchestra to a customer. The customer, a consumer products company, has the right to use the recorded symphony in all commercials, including television, radio, and online advertisements for two years in Australia. In exchange for providing the license, the entity receives fixed consideration of \$10,000 per month. The contract does not include any other goods or services to be provided by the entity.

The entity assesses the goods and services promised to the customer to determine which goods and services are distinct in accordance with paragraph 28. The entity concludes that it has no other performance obligations other than the promise to transfer a license.

The entity evaluates the nature of the entity's promise to transfer the license in accordance with paragraph IG37. The entity observes that it does not have any contractual or implied obligations to change the licensed music—the recorded symphony is complete. Thus, the intellectual property to which the customer has rights is static. Therefore, the entity concludes that the nature of the entity's promise in transferring the license is to provide the customer with a right to use the entity's intellectual property as it exists at a point in time and therefore represents a performance obligation satisfied at a point in time. The entity recognizes revenue at the beginning of the period during which the customer can use and benefit from the licensed intellectual property.

The contract is noncancellable, the entity calculates the stated contract price to be \$240,000 ( $\$10,000 \times 24$  months), before evaluating paragraphs 58–62 to determine whether there is a significant financing component in the contract.

**Example 7— Access to Intellectual Property**

An entity, a movie distribution company, licenses Movie XYZ to a customer. The customer, a movie theatre, has the right to show the movie in cinemas for 6 weeks. In exchange for providing the license, the entity will receive a portion of the ticket sales of the movie theatre (that is, variable consideration in the form of a sales-based royalty). The contract states that the entity will promote the movie by advertising it on billboards or enlisting the movie's actors to promote the movie on talk shows.

The entity assesses the goods and services promised to the customer to determine which goods and services are distinct in accordance with paragraph 28. The entity determines that the promise to transfer the license is not separable from the promise to provide the promotional services, in accordance with paragraph 28(b) and the indicators in paragraph 29.

Since the criterion in paragraph 28(b) is not met, the license is not distinct.

Consequently, the entity assesses the performance obligation, which includes the promotional services, to determine whether the performance obligation is satisfied over time or at a point in time. The entity concludes that the performance obligation is satisfied over time in accordance with paragraph 35(aa).

The entity then applies paragraphs 38-48 to determine a measure of progress that will depict the entity's performance and concludes that the best depiction of its performance would be to recognize revenue for the sales-based royalty allocated to the license as the customer's sales occur.

#### **Example 8 — Access to Intellectual Property**

An entity, a well-known sports team, licenses the use of its name and logo to a customer. The customer, an apparel designer, has the right to use the sports team's name and logo on items including t-shirts, caps, mugs and towels for one year. In exchange for providing the license, the entity will receive fixed consideration of CU 2 million and a sales-based royalty of 5%. The contract does not include any other goods or services to be provided by the entity.

The entity assesses the goods and services promised to the customer to determine which goods and services are distinct in accordance with paragraph 28. The entity concludes that it has no other performance obligations other than the promise to transfer a license. That is, the additional activities associated with the license do not transfer a good or service to the customer as those activities occur.

The entity evaluates the nature of the entity's promise to transfer the license in accordance with paragraph IG37. In evaluating the criteria the entity considers the following:

- a. The existence of the sales-based royalty suggests that the entity and the customer have a shared economic interest. As a result, the entity concludes that the customer reasonably expects that the entity will undertake activities that significantly affect the intellectual property to which the license relates to maximise its return on the sales-based

royalty. These activities could include promotions and other advertising, but also other ordinary activities such as continuing to play games and providing a competitive team.

b. Those activities undertaken by the entity are part of the entity's ordinary activities and although the customer may benefit from them, the activities do not transfer a good or a service to the customer as those activities occur. (That is, the activities are not identified as a separate performance obligation.)

c. As a result of the rights granted by the license, that is, the customer can use the name and logo on various merchandise, the customer is directly affected by any activities that also affect the name or logo—either positively or negatively. In essence, the customer must use the latest form of the intellectual property (that is, the name and the logo) as it exists at any given time.

The entity concludes that the criteria in IG37 are met and the nature of the entity's promise in transferring the license is to provide the customer with access to the entity's intellectual property as it exists at any given time. Consequently, the entity accounts for the promised license as performance obligation over time (that is, the criterion in paragraph 35(aa) of the standard is met.

The entity then applies paragraphs 38-48 to determine a measure of progress that will depict the entity's performance.



## Appendix D—Rejected factors for differentiating between the two types of licenses

D1. Throughout their discussion on licenses, the Boards considered, but ultimately rejected, using the following factors to distinguish between the two types of licenses:

Indicator	Reason for rejection
<p><i>Term of the license</i></p> <ul style="list-style-type: none"> <li>• A term license generally provides access to the entity’s intellectual property (eg a performance obligation satisfied over time)</li> <li>• A perpetual license generally provides a right to use the entity’s intellectual property (eg a performance obligation satisfied at a point in time)</li> </ul>	<p>The length of a license term is a restriction that represents an attribute of the asset transferred and does not provide information on the nature of the underlying intellectual property nor the rights provided by the license. As such, the license term is not necessarily indicative of when a customer obtains control of the promised license nor is indicative of the entity’s performance. In their discussions, the Boards noted that there are many examples of term licenses where the entity is not required to do anything further after the license is transferred, even though it is a term based license (eg some software licenses).</p> <p>Typically, differences in the term of a license are reflected in the price which the customer pays for the use of that license.</p>
<p><i>Exclusivity</i></p> <ul style="list-style-type: none"> <li>• Exclusive license generally provides access to the entity’s intellectual property (eg a performance obligation satisfied over time)</li> <li>• Non-exclusive license generally provides a right to use the entity’s intellectual property (eg a performance obligation satisfied at a point in time)</li> </ul>	<p>The 2010 ED proposed to distinguish between licenses (ie whether they were a performance obligation satisfied over time or at a point in time) based on whether the license was exclusive or not. Many respondents to the 2010 ED explained that a distinction based on exclusivity was inconsistent with the control principle because exclusivity does not affect the determination of the entity’s performance. In addition, respondents did not think a distinction based on exclusivity would be operational because it would require the Boards to provide more clarity around how the term ‘exclusive’ would be interpreted. The Boards observed that exclusivity is another restriction that represents an attribute of the asset transferred rather than the nature of the</p>

	underlying intellectual property.
<p><i>Payment terms</i></p> <ul style="list-style-type: none"> <li>• Payment terms over time (including sales-based royalties) generally indicate that the license provides access to the entity's intellectual property (eg a performance obligation satisfied over time)</li> <li>• Payments up front generally indicate the license provides a right to use the entity's intellectual property (eg a performance obligation satisfied at a point in time)</li> </ul>	<p>Payment terms are part of the terms and conditions of a contract and are not determinative of either the entity's performance nor are they indicative of when control transfers. However, the notion of 'shared economic interest'—which may be demonstrated by the existence of a sales-based royalty—has been included as an indicator of when the customer may reasonably expect an entity to perform additional activities that may also benefit the customer.</p>
<p><i>Consumption of the underlying intellectual property</i></p> <ul style="list-style-type: none"> <li>• A license typically provides access to the entity's intellectual property (eg a performance obligation satisfied over time) when it will result in only an insignificant amount of consumption of the economic benefit of the underlying intellectual property during the license term (that is, the entity intends to exploit the intellectual property through another license at the end of the original license term)</li> <li>• A license typically represents a right to use the entity's intellectual property (eg a performance obligation satisfied at a point in time) when the value in the intellectual property is expected to be substantially consumed by the end of the license term.</li> </ul>	<p>Some suggested that the Boards differentiate licenses based on the notion of 'consumption' that the Boards used in the 2013 ED for leases. This is because license shares some characteristics with a lease. However, an important difference between the two is the nature of the underlying asset to which the customer or lessee obtains rights. In a license, the underlying asset is an intangible asset, while in a lease it is a tangible asset. This difference is important and is the reason the Boards decided not to use the principle of 'consumption' of the underlying asset to differentiate between licenses. This is because the rights to an intangible asset can be defined and divided through licenses in many more ways than a tangible asset subject to a lease—for example, an intangible asset can be divided by time, geography or other restrictions on use, and the rights can be provided to more than one customer at the same time through different licenses. This difference could make it very difficult to assess whether the intellectual property has been 'consumed' by a particular license.</p>