STAFF PAPER

Week of 16 September 2013

FASB | IASB Meeting

Project	**Revenue Recognition**		
Paper topic	Collectibility, Constraint and Licenses		
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Purpose

1. This paper summarizes feedback received on the external review draft (sent to reviewers in June 2013) and in subsequent discussions about the Boards' tentative decisions in July 2013 on three key areas:
   (a) Collectibility;
   (b) Constraint; and
   (c) Licenses.
2. This paper also provides the Boards with high-level descriptions of possible paths forward on those three key areas. The alternatives described as paths forward represent the staff's preliminary thinking on these areas.
3. The objective of this paper is not to ask the Boards for decisions on the alternatives, rather to narrow the possible paths forward by seeking direction on the topics and alternatives that should be brought back to the Boards for a full discussion in October. A detailed analysis of the viable alternatives will be provided at the October Board meeting for any topics the Boards decide to redeliberate.

Structure of the paper

4. This paper is organized as follows:

   (a) Collectibility (paragraphs 5 – 14)

      (i) Background & feedback (paragraph 5)

      (ii) The possible paths forward (paragraphs 6 – 14)

   (b) Constraint (paragraphs 15 – 34)

      (i) Background & feedback (paragraphs 15 – 22)

      (ii) The possible paths forward (paragraphs 23 – 34)

   (c) Licenses (paragraphs 35 – 43)

      (i) Background & feedback (paragraphs 35 – 37)

      (ii) The possible paths forward (paragraphs 38 – 43)

   (d) Appendix A – Staff working draft of excerpts from the standard

Collectibility (paragraphs 12-14, 50-53.3 in Appendix A)

Background & feedback

5. The Boards tentatively decided that a customer may be committed to a contract in accordance with paragraph 12(e) (see Appendix A) and therefore the contract may pass Step 1 despite significant doubts about the customer's capacity to pay all of the promised consideration (that is, customer credit risk). The Boards also tentatively decided that customer credit risk would not be reflected in the measurement of the transaction price in a contract with a customer, except when there is a significant financing component. Instead, paragraph 53.2(b) (see Appendix A) states that entering into a contract with a customer who is a significant credit risk may be an indicator that the entity intends to provide a price concession. Feedback on the draft language in Appendix A was as follows:

   (a) A number of respondents broadly understood the concern the Boards were trying to address, however they thought the drafting created confusion and was unnecessary for typical contracts. Many suggested placing less emphasis on the idea of what is a price concession by removing much of the guidance in paragraphs 50-53.3 and eliminating the references to 'credit risk' in determining the transaction price.

(b) A few suggested that challenges with collectibility in specific industries (for example, U.S. healthcare) be addressed in implementation.

(c) Additionally, a few suggested that the notion of 'commercial substance' in paragraph12(d) could be used by auditors to ensure that only the substantive terms are accounted for in the revenue standard. In these cases, the contractually stated price may not be used as the transaction price (that is, the 'entitled' amount).

(d) Many explained that it would be extremely difficult to estimate (and audit) the transaction price as explained in Appendix A paragraphs 53.2 and 53.3 for price concessions that the entity may 'intend' to provide because of credit risk. This is because when a contract has significant credit risk, estimates of the amount of consideration to which the entity expects to be entitled are inherently imprecise. Those respondents suggested that the Boards establish a clearer 'gate' in paragraph 12 (that is, a threshold) for contracts where there is significant doubt about collectibilty at contract inception. When that threshold is not met, an entity would recognize no revenue until such time the threshold is met. Some also suggested that before that threshold is met an entity could apply another model such as the cost-recovery or installment method used in U.S. GAAP today[1].

(e) Many expressed difficulty in subsequent accounting for price concessions versus impairment losses.

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[1] The cost-recovery and installment methods are outlined in paragraph 605-10-25-4 (*Revenue Recognition*) "As defined in 360-20-55-7 through 55-9 (*Property, Plant and Equipment – Real Estate Sales*), the installment method apportions collections received between cost recovered and profit. The apportionment is in the same ratio as total cost and total profit bear to the sales value. Under the cost-recovery method, equal amounts of revenue and expense are recognized as collections are made until all costs have been recovered, postponing any recognition of profit until that time."

(f) Some also questioned how the entity would assess whether a contract meets the criteria in paragraph 12, and furthermore how it would determine the transaction price, when the entity enters into a portfolio of contracts with low credit quality customers. Consider the example of an entity selling products to a portfolio of customers with a contract price of CU100. However the class of customer has significant credit risk and therefore the entity is likely to receive CU100 from some customers and NIL from other customers.

(g) Some raised other drafting suggestions that the staff will take into consideration. One such suggestion was to remove paragraph 12(e) which seemed duplicative of paragraph 12(a).

The possible paths forward

Alternatives		
A	**B**	**C**
Drafting improvements	Collectibility threshold in 'Step 1' (that is, no revenue is recognized until threshold is met)	Targeted approach for a subset of contracts – for these contracts either: 1) measure the transaction price net of customer credit risk or 2) present impairment losses adjacent to revenue (2011 ED)

Alternative A – Drafting improvements

6. Based on that feedback, the Staff think that (at a minimum) drafting improvements are required. Those improvements could include some or all of the following:

(a) *Refine or eliminate paragraph 12(e).* Refine paragraph 12(e) by removing the notion of 'intending to enforce'. If paragraph 12(e) is deleted, incorporate "commitment" into another indicator (potentially either paragraph 12(a) (acceptance) or paragraph 12(d) (commercial substance)).

(b) *Remove additional guidance in paragraphs 50-53.3 or move to implementation guidance.* Drafting should acknowledge price concessions but not identify conditions whereby they may be more likely to occur.

(c) *Clarify subsequent accounting.* Clarify that when facts and circumstances indicate that the entity intends to issue a price concession at contract inception, subsequent changes in that estimate are likely changes in the transaction price (not impairment losses).

7. The consequence of retaining the Boards' tentative decisions and refining the drafting as above is that for contracts that meet the criteria in paragraph 12 —even when the customer is a significant credit risk or is within a customer class that is more likely to default—an entity would be required to apply judgement to determine whether it intends to offer a price concession (that is, a reduction in the transaction price) or it will recognize an impairment expense. In some cases, this may result in the entity recognizing revenue at the stated contract price and recording an impairment expense (that may be significant).

Additional alternatives

8. In light of the fact that some of the concerns related to contracts with significant credit risk may not solely be addressed by drafting improvements, the Boards may want to consider the following alternatives to supplement the drafting improvements:

(a) Alternative B - Collectibility threshold in Step 1

(b) Alternative C - Targeted approach for a subset of contracts

Alternative B – Collectibility threshold in 'Step 1'

9. Include a collectibility threshold in Step 1 (that is, the identification of a contract):

   (a) Include in paragraph 12 a threshold that would mean an entity applies the remaining guidance in the revenue model only when a specified collectibility threshold is met. That is, collectibility of the contract price is reasonably assured or probable (the Boards would need to establish the appropriate term). The Boards would need to clearly define collectibility (that is, whether amounts are uncollectible because of credit risk or broader measurement uncertainty) and consider application guidance about how much of the contract price would need to be 'collectible' in order for this criterion to be met and how this determination is made when the entity considers measurement by reference to a portfolio.

   (b) The Boards could define this threshold in a way that is similar to the notion in the 2011 ED and the staff draft (April 2013) that suggests that the parties may not be committed to a contract if collectibility is not reasonably assured/probable or if there is significant doubt about collectibility at contract inception. To help entities assess this threshold, paragraph 12(e) could include indicators of when parties may not be committed and therefore a contract fails Step 1.

   (c) When the threshold is not met, as with other contracts that do not meet the criteria in paragraph 12, the entity should continue to reassess the criteria. Until the criteria are met, consistent with the Boards' July 2013 tentative decision, no revenue is recognized until:

      (i) The contract with the customer indicates that the entity has no remaining obligations to transfer goods or services and all of the consideration promised by the customer has been received by the entity and is nonrefundable.

      (ii) The contract has been terminated or abandoned and the consideration received from the customer is nonrefundable (see paragraph 15.3 of Appendix A).

(d) For contracts that pass Step 1, impairment losses will be presented consistently.

10. A consequence of this alternative is that an entity will not recognize revenue for the goods or services transferred to a customer until the collectibility threshold is passed or the criteria in paragraph 15.3 are met (if the threshold has not been passed). Importantly, when the threshold is not met, an entity would not be required to estimate any amount that it may expect to collect as the transaction price, nor reduce the contractually stated amount by an estimate of expected price concessions or impairment. Consider the following example:

> An entity enters into a contract to transfer goods or services in exchange for CU1,000. The entity determines that it is not 'reasonably assured' / 'probable' that the customer will pay the CU1,000 (but does think it will recover some nominal amount under the contract). The entity does not recognize <u>any</u> revenue (not even the nominal amount) until such time as either:
>
> (1) the contract is reassessed and the entity is 'reasonably assured'/'probable' it will collect the CU1,000.
>
> (2) performance is complete and all consideration has been received and is nonrefundable
>
> (3) the contract is terminated or abandoned and consideration received is nonrefundable.

Alternative C – Targeted approach

11. This alternative would require contracts with significant credit risk at contract inception to be accounted for differently. Specifically, when a contract meets the specified criteria, an entity would be required to either:

(a) Measure the transaction price net of customer credit risk (that is, at the amount that the entity expects to collect). This is similar to the 2010 ED approach, however, the 2010 ED required this measurement for all transactions; or

(b) Present any impairment losses on these contracts adjacent to revenue. This is similar to the 2011 ED approach, however, the 2011 ED required this measurement for all transactions that did not include a significant financing component.

12. The Boards would need to clearly define the subset of contracts that exhibit 'significant credit risk' at contract inception and consider application questions such as (i) how much risk is 'significant' and (ii) how to estimate the amount that the entity expects to collect. To address these concerns, the Boards could consider providing additional guidance on how to determine when a contract has significant credit risk by using the factors in paragraph 53.3 and utilize the principles in the 2010 ED for estimating the transaction price for this subset.

13. Additionally, under this approach the Boards would need to determine the accounting for reassessment (that is, subsequent adjustments to the initial estimate) and any additional disclosures.

Other alternatives

14. The staff also noted two other alternatives that were proposed in the 2010 and 2011 Exposure Drafts. However, those proposals have not been previously supported by the Boards nor have these proposals been supported by a majority of respondents in recent discussions. Those alternatives are as follows:

    (a) Present all impairment expense in a line adjacent to revenue. This was proposed in the 2011 ED and discussed in September 2012 (see agenda papers 162B/7B and 162C/7C), November 2012 (see agenda paper 164E/7E) and July 2013 (see agenda paper 173A/7A).

    (b) Adjust the transaction price for the effects of customer credit risk. This was proposed in the 2010 ED.

Constraint

Background & feedback

15. The Boards tentatively decided that an entity would reduce the amount of variable consideration included in the transaction price if the entity expects that, based on

the factors in paragraph 56.2, including that variable consideration in the transaction price would result in a significant revenue reversal.

16. Feedback on the draft language in Appendix A focused on (a) the overall clarity of the objective and (b) the Boards' decision that an entity should include a portion (or minimum amount) of the variable consideration in the transaction price if the entity expects that including that minimum amount in the transaction price would not result in a significant revenue reversal.

Feedback on the overall clarity of the objective

17. Several of the auditors suggested including wording that conveys clearly that the Boards' objective for the constraint is that revenue should be constrained when the entity cannot estimate the amount of variable consideration with a certain level of confidence. Furthermore, both preparers and auditors stated that there is a lack of clarity as to the level of confidence that the Boards were intending in paragraph 56.1 (see Appendix A). In other words, preparers and auditors are asking what is the level or range of confidence that entities should be considering before including an amount of variable consideration in the transaction price?

18. Auditors and preparers suggested that the objective of the constraint, as currently described, places too much emphasis on the possibility of a downward adjustment, rather than the entity's ability to make an estimate that is predictive of the consideration to which it is entitled. They commented that any reversal – regardless of how infrequent – would come under intense scrutiny from auditors and regulators.

19. Many of the preparers are confused with what appears to be a two-step process. That is, first estimate the transaction price in accordance with paragraph 55 (see Appendix A) and secondly test that transaction price against the constraint requirement in paragraph 56.1. Those preparers stated that this is confusing because when they apply paragraph 55, their objective is to make a realistic estimate of the transaction price.

Feedback on the requirement to include a minimum amount

20. Preparers in the Media & Entertainment and Pharmaceutical industries strongly disagree with the requirement to always include a minimum amount of variable consideration in the transaction price if the entity can estimate some amount where the entity would not expect a significant revenue reversal. Preparers stated that it would be operationally challenging to make this minimum estimate due to the large number of contracts and the controls and processes they would need to put in place to generate the estimates. Furthermore, they did not see the informational value to users, of preparing these estimates. In addition, some auditors stated that the requirements would change the way in which distribution channel sales are currently accounted for in the retail and software industries (that is, sell-in / sell-through accounting) and they did not think the resulting revenue amounts would provide relevant information. Currently, these entities either recognize revenue when they sell products to their direct customer (that is, the distributor) if they can make reliable estimates of returns and price discounts, or they recognize revenue only when the products are sold to the distributors' customers if they cannot make reliable estimates of returns and price discounts. Under the proposed model, these entities would be required to recognize a minimum amount of revenue based on their estimates of returns or price discounts.

21. Preparers in the Media & Entertainment and Pharmaceutical industries think it would not faithfully represent the economics if they recognize revenue for a usage-based royalty prior to their licensee recognizing revenue because they consider those arrangements to include economic risk-sharing similar to a partnership arrangement.

22. The auditors stated that this estimate would be difficult to audit, particularly if the level of confidence that an entity is required to have around the minimum is not clarified. Some of the auditors also pointed out that the requirements would affect more than just the Media & Entertainment and Pharmaceutical industries, for example, the requirements would result in different accounting to that applied

today to distribution channel sales in the retail and software industries (that is, sell-in / sell-through accounting).

The possible paths forward

Issue 1 – overall clarity of the objective	
Alternative 1A	**Alternative 1B**
Retain external review draft with some drafting improvements	Include an explanation of the level of confidence for the constraint as well as drafting improvements

Issue 2 – requirement to include a minimum amount		
Alternative 2A	**Alternative 2B**	**Alternative 2C**
Retain external review draft, that is, a minimum amount would always be included if the entity did not expect that minimum to reverse	Reinstate specific guidance for a usage-based royalty, that is, royalties on licenses of intellectual property would only be recognized when the subsequent sale occurs.	Predictive value approach, that is, if the entity expects that its estimate is a good predictor of the amount of revenue it will be entitled to, it includes that estimate, otherwise it includes none of the variable consideration.

Issue 1 – overall objective

23. **Alternative 1A** – Retain the Boards' tentative decision that the objective would remain as follows: "*an entity expects, based on an assessment of factors in 56.2, a subsequent change in the estimate of the amount of variable consideration would not result in a significant revenue reversal.*" As a result, this alternative clearly focuses the objective on downside risk of future changes as compared to an unbiased estimate. The staff would address concerns raised in the feedback by including some or all of the following:

    (a) *Clarify the "two-step" process may practically be "one-step"*. Clarify in the basis for conclusions and through amendments to relevant examples that the entity may not practically need to go through a "two-step" process provided that the entity's estimation methodology incorporates the objective of paragraphs 56.1 – 56.3. The requirements and structure of the standard would however remain consistent with the external review draft (that is, the requirements would retain the two steps for estimating variable consideration).

(b) *Include a decision tree in the application guidance.* Include a decision tree in the application guidance that explains the steps that an entity should apply to any circumstance in which variable consideration is part of the promised consideration.

24. **Alternative 1B** – Include an explanation of the level of confidence required to include an estimate of variable consideration in the transaction price:

(a) This alternative would result in the final drafting including a qualitative word that more clearly depicts a level of confidence that is needed before an entity includes variable consideration in the estimate of the transaction price. For example, paragraph 56.1 of the external review draft could be amended as follows, "an entity <u>is highly confident</u> ~~expects~~, based on an assessment of factors in 56.2, a subsequent change in the estimate of the amount of variable consideration would not result in a significant revenue reversal."

(b) The guidance would clarify the confidence level represented by the qualitative word that is used. For example, the basis for conclusions could state that the Boards define 'highly confident' as a minimum confidence level that is less than virtually certain (95%) and greater than more likely than not (50%) and should, at a minimum, be at or above the range of 75-85%. However, the basis for conclusions would also clarify that although the Boards have indicated the quantitative range intended to apply to the constraint, the Boards are not requiring or intending for an entity to prepare probability analyses for all circumstances where the consideration is variable.

25. In addition, the Boards could include some of the drafting improvements proposed in Alternative 1A to address the confusion raised on the perceived "two-step" process.

Issue 2 – requirement to include a minimum amount

26. **Alternative 2A** – Retain the Boards' tentative decision and wording from the external review draft with possible minor clarifications.

27. **Alternative 2B** – Reinstate specific guidance for a usage-based royalty when the consideration due to the entity is directly impacted by the customer's subsequent sales or usage as discussed in Option 2 in the July 2013 memo 173C/7C:

    (a) This alternative would result in a general requirement for the recognition of a minimum if the full amount of the estimate of variable consideration does not pass the objective of the constraint but some portion of the variable consideration does pass the objective of the constraint.

    (b) However, when the performance obligation arises from a license of intellectual property and the consideration is based on the usage of that license, no revenue would be recognized until the customer's subsequent sales or usage occurs.

28. In other words, this approach to the minimums requirements is generally consistent with the 2011 ED and would address some of the concerns raised by respondents with respect to the licenses guidance (discussed in more detail in the 'Licenses' section).

29. The approach would not result in similar accounting to that provided today for distribution channel sales in the retail and software industries (that is, sell-in / sell-through accounting). While this alternative is generally understood as described above, the Boards may need to further consider the appropriate scoping for this alternative.

30. **Alternative 2C** – Only include the estimate of variable consideration in the transaction price if that estimate faithfully represents the amount to which the entity expects to ultimately be entitled (that is, the estimate is predictive):

    (a) If the promised consideration is variable (or includes a variable component) the entity would estimate the transaction price in accordance with paragraph 55.

    (b) In making that estimate, the entity would assess whether the entity has 'sufficient confidence' that the estimate of the variable consideration is predictive of the amount of revenue to which the entity is entitled ('sufficient confidence' could be quantified based on the decision in Issue 1). If the entity has sufficient confidence that its estimate of the variable consideration is predictive, that estimate is included in the transaction price. However, if the entity does not have sufficient confidence that the estimate is predictive, none of the estimate of the variable consideration is included in the transaction price.

    (c) The estimate of the variable consideration included in the transaction price is predictive when the entity has assessed the other realistic outcomes and is 'sufficiently confident' that its estimate will be the amount to which the entity is entitled in exchange for the transferred goods or services. The entity would consider the indicators in paragraph 56.2 when determining whether the entity does not have sufficient confidence that the estimate of variable consideration is predictive. For example, where the consideration is highly susceptible to actions of third parties, this would diminish an entity's confidence in its estimate and indicate that the entity should not include the estimate of variable consideration in the transaction price.

31. The approach would produce an outcome for most usage-based royalties that is consistent with the 2011 ED and would address some of the concerns raised with the licenses guidance (as discussed below). However, if an entity can make an estimate of the future royalties that is predictive of the amount to which the entity

expects to be entitled, the entity would recognize revenue when the performance obligation is satisfied (different from the 2011 ED and Alternative 2B).

32. This approach would result in similar accounting to that provided today for distribution channel sales in the retail and software industries (that is, sell-in / sell-through accounting). That is, if an entity can make a reliable estimate of its future returns and discounts then it may use that estimate in its transaction price; however, if the entity's estimate is subject to high volatility then it should not use an estimate of variable consideration and wait until the uncertainty is resolved.

33. This approach will include some interaction with Issue 1 because the objective of the constraint may need to be amended to be consistent with this approach Specifically, the objective will focus on the entity's ability to make an estimate that is predictive of the amount to which the entity is entitled when the entity applies paragraph 55, rather than a focus on significant revenue reversals. Consequently, the confusion of a perceived two-step process could be mitigated.

34. The Boards would need to decide if the assessment of the estimate being predictive is made once only at contract inception or whether the entity should reassess, at each reporting period, if new information would allow for a predictive estimate of the variable consideration to be included in the transaction price.

Licenses (paragraphs IG33-IG33.6 in Appendix A)

Background & feedback

35. The Boards tentatively decided that an entity should assess the performance obligations in a license and determine whether the promised license is distinct from other goods or services promised in the contract (paragraph IG33.6 in Appendix A). The Boards also tentatively decided that an entity should evaluate whether a license provides a customer with either:

    (a) Access to the entity's intellectual property as it exists at any given time (that is a license that provides access); or

(b) A right to use the entity's intellectual property as it exists at a point in time (that is, a license that transfers a right).

36. The criteria for determining if the license provides the customer with access are set out in paragraph IG33.2:

(a) The contract requires or the customer has a valid expectation arising from the entity's customary business practices, published policies, or specific statements that the entity will undertake activities that modify the nature or value of the intellectual property to which the license relates.

(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.

(c) The rights granted by the license expose the customer to any positive or negative effects on the nature or value of the intellectual property arising from those activities as and when the entity undertakes those activities.

37. Feedback on the draft language in paragraphs IG33-IG33.6 in Appendix A is as follows:

(a) Concerns that the additional criteria in paragraph IG33.2 were not operational for differentiating between a license that represents access versus a right and would not lead to consistent application. Many thought it was difficult to determine what an 'activity' was, and how it was different from a performance obligation. Some also though that too many things would be captured by the word 'activity' which may result in some entities inappropriately concluding their license provides 'access' (for example, some software licenses).

(b) Some questioned the apparent creation of a 'separate' model for licenses and therefore the need to distinguish between two types of licenses.

(c) Many disagreed with the pattern of revenue recognition that would result from applying the minimums requirements in the constraint to licenses that provide a right (that is, performance obligations satisfied at a point in time) and also include a sales-based royalty or other consideration that depends on customer sales (see discussion in Constraint above). This is because the entity would be required to recognize an estimate of the amount of consideration to which it will be entitled at the time of transfer of the license. Some suggested that the substance of these arrangements is more like a partnership and thus revenue should be recognized as the customer's subsequent sales occur. These respondents suggested that their concern would be resolved by re-instating a paragraph similar to the one included in the 2011 ED (paragraph 85 of the 2011 ED) that requires revenue to be recognized in a sales-based royalty of intellectual property when a customer's subsequent sales occur.

(d) In addition to the suggestion in (c) above, there were a number of suggestions about how the Boards could improve the operationality of the implementation guidance for licenses as follows:

  (i) Delete the criteria in paragraph IG33.2 for differentiating licenses, however, the implementation guidance would still acknowledge that there are two types of licenses.

  (ii) Emphasize the importance of applying the revenue model to contracts that include a license. For example, emphasize the importance of assessing what the performance obligations in the contract are and thus when goods or services transfer to the customer.

  (iii) Include only explicit promises (that is, those stated in the contract) in the assessment of the criteria or identification of performance obligations in contracts that include a promised license.

  (iv) Require revenue to be recognized over time for all licenses.

(v) Introduce additional criteria, possibly as indicators, to help determine whether a license provides a right or access. Those indicators include the term of the license, payment terms and restrictions imposed by the license such as geography or exclusivity.

The possible paths forward

	Alternatives			
A	**B**	**C**	**D**	**E**
Drafting improvements	Delete the criteria in paragraph IG33.2 for differentiating licenses.	Licenses represent a right of use that transfers at a point in time (that is, 2011 ED approach)	Licenses represent access to an entity's intellectual property (that is, a performance obligation that is satisfied over time)	Introduce additional criteria or indicators for determining whether a license provides a right or access.

38. The alternatives outlined for licenses do not include a discussion of re-instating a paragraph similar to paragraph 85 of the 2011 ED. (This was discussed above as a path forward for the minimums requirements.) The staff note that some respondents suggested a significant number of their concerns related to licenses may be resolved by requiring the recognition of revenue from sales-based royalties as those royalties are due as a result of customer's subsequent sales or usage (that is, over time).

39. The staff also note that each alternative would require an entity to assess and identify the performance obligations (that is, 'Step 2' of the revenue model) in a contract that includes a license. The staff suggest that in any of the approaches, the drafting should emphasize that requirement. The main difference in each alternative is the assessment and ultimately the accounting for a promised license.

Alternative A – drafting improvements

40. Retain the Boards' tentative decisions to date—that is, a promised license provides either access (performance obligation satisfied over time) or a right

(performance obligation satisfied at a point in time). Improve drafting, including some or all of the following:

(a) Clarify what is meant by 'activities' that indicate that access rather than a right is being transferred to the customer. That is, the types of activities are intended to be those that do not transfer a good or service to the customer, but will affect the intellectual property to which the customer has rights. This will require some further clarification of what 'affect the intellectual property' means to ensure that it does not capture too many things. For example, 'activities' should not capture things like advertising activities by a software licensor that would not directly impact the nature of the software license that the licensee is using.

(b) Clarify that the criteria in paragraph IG33.2 are intended to help an entity assess the nature of the performance obligation in a promised license.

Alternative B – Delete the criteria for differentiating licenses

41. Retain the Boards' tentative decisions to date—that is, a promised license provides either access (performance obligation satisfied over time) or a right (performance obligation satisfied at a point in time) as described in paragraph IG33.1 of Appendix A, however, because the feedback indicated that the criteria are confusing, no guidance will be provided to help an entity assess how that differentiation would be made. Specifically, in this alternative the drafting in paragraph IG33.2 of Appendix A would be deleted and an entity would assess the promises in a contract that includes a license similarly to any other contract using the guidance in paragraphs 23-29 (Step 2 – identifying performance obligations) and paragraphs 31-37 (Step 5 – recognizing revenue when (or as) the entity satisfies a performance obligation).

Alternative C – Distinct licenses represents a right of use (2011 ED) ***OR*** *Alternative D – Distinct licenses represent access*

42. In both Alternative C and D, an entity would identify and assess performance obligations in the contract using guidance on separation (that is, 'Step 2' – this

assessment would be required in all of the alternatives). However, the accounting for distinct licenses would differ as follows:

(a) *Alternative C* – distinct licenses represent a right to use the entity's intellectual property, which would be a performance obligation satisfied at a point in time. (This was proposed in the 2011 ED and as 'View A' in the November 2012 Agenda Paper 7E/164E.) However, in this alternative revenue is not always recognized at a point in time (for example, when a license is combined with a non-distinct service or when the variable consideration is constrained).

(b) *Alternative D* – distinct licenses represent access to the entity's intellectual property, which would be a performance obligation satisfied over time. (This was proposed in the November 2012 Agenda Paper 7E/164E.)

Alternative E – Include indicators for differentiating licenses

43. Retain the Boards' tentative decisions to date—that is, a promised license provides either access (performance obligation satisfied over time) or a right (performance obligation satisfied at a point in time) (as described in paragraph IG33.1 of Appendix A), however the criteria outlined in IG33.2 would be supplemented or replaced with indicators (rather than criteria) as follows:

(a) A term license generally provides access, whereas a perpetual license generally provides a right;

(b) An exclusive license generally provides access, whereas a perpetual license generally provides a right;

(c) Payment terms of over time generally indicate that the license provides access, whereas payments up front generally indicate the license provides a right. In addition, payment terms that depend on the customer's subsequent actions, such as a sales-based royalty, generally means that the license provides access (that is, because it is like a partnership).

(d) A license typically provides access 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), whereas a license typically represents a right when the value in the intellectual property is expected to be substantially consumed by the end of the license term. This indicator is intended to be consistent with the Boards tentative decisions in their joint leasing project.

(e) When facts and circumstances indicate that the arrangement is a partnership, rather than a sale, then the license typically provides access to the intellectual property of the entity rather than the sale of a right.

Appendix A: Staff working draft of excerpts from the standard

Recognition

Identifying the Contract

12. An entity shall apply the guidance in this Topic to a contract with a customer only when all of the following criteria are met:

- **a. The parties to the contract have approved the contract (in writing, orally, or in accordance with other customary business practices), which creates enforceable rights and obligations.**
- **b. The entity can identify each party's rights regarding the goods or services to be transferred.**
- **c. The entity can identify the payment terms for the goods or services to be transferred.**
- **d. The contract has commercial substance (that is, the risk, timing, or amount of the entity's future cash flows is expected to change as a result of the contract).**
- **e. The parties are committed to perform their respective obligations and they intend to enforce their respective contractual rights (see paragraph 14).**

13. An entity shall consider all relevant facts and circumstances when assessing whether a contract between an entity and a customer meets all of the criteria in paragraph 12. Enforceability of the rights and obligations in a contract is a matter of law. Contracts can be written, oral, or implied by an entity's customary business practices. The practices and processes for establishing contracts with customers vary across legal jurisdictions, industries, and entities. Additionally, they may vary within an entity (for example, they may depend on the class of customer or the nature of the promised goods or services). An entity shall consider those practices and processes in determining when an agreement with a customer creates enforceable rights and obligations.

14. A contract may meet the criteria in paragraph 12 if facts and circumstances indicate that the entity and the customer are committed to the contract (see paragraph 12(e)) even though there are doubts about the customer's capacity to pay all of the promised consideration or doubts about the entity's intention to enforce all of the rights under the contract. However, the existence of those doubts could affect the determination of the amount of consideration to which the entity expects to be entitled under the contract (see paragraph 50).

15. For the purpose of applying the guidance in this Topic, a contract does not exist if each party to the contract has the unilateral enforceable right to terminate a wholly unperformed contract without compensating the other party (parties). A contract is wholly unperformed if both of the following criteria are met:

    a. The entity has not yet transferred any promised goods or services to the customer.
    b. The entity has not yet received, and is not yet entitled to receive, any consideration in exchange for promised goods or services.

15.1. Some contracts with customers may have no fixed term and can be terminated or modified by either party at any time. Other contracts may have terms that automatically renew on a periodic basis. An entity shall apply the guidance in this Topic to the term of the contract in which the parties to the contract have present enforceable rights and obligations.

15.2. If a contract with a customer does not meet the criteria in paragraph 12, an entity shall reassess the contract at each reporting date to determine whether the criteria in paragraph 12 are subsequently met.

15.3 When a contract with a customer does not meet the criteria in paragraph 12 and an entity receives consideration from the customer, the entity shall recognize the consideration received as revenue only when one of the following events has occurred:

    a. The contract with the customer indicates that the entity has no remaining obligations to transfer goods or services to the customer and all of the consideration promised by the customer has been received by the entity and is nonrefundable.
    b. The contract has been terminated and the consideration received from the customer is nonrefundable.

15.4 If none of the events in the preceding paragraph [15.3] have occurred, an entity shall recognize the consideration received from a customer as a liability. For example, depending on the facts and circumstances relating to the agreement, an entity might recognize a liability for the entity's obligation to either transfer goods or services in the future or refund the consideration received. The liability shall be measured at the amount of consideration received from the customer.

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Measurement

49. When (or as) a performance obligation is satisfied, an entity shall recognize as revenue the amount of the transaction price (which may be constrained in accordance with paragraphs 56.1–56.4) that is allocated to that performance obligation.

Determining the Transaction Price

50. An entity shall consider the terms of the contract and its customary business practices to determine the transaction price. The transaction price is the amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer, excluding amounts collected on behalf of third parties (for example, sales taxes). The consideration promised in a contract with a customer may include fixed amounts or variable amounts, or both. The transaction price is not adjusted for the effects of the customer's credit risk, except as follows:

    a. when facts and circumstances indicate that the entity's intention is to offer a price concession (see paragraph 53.2 and 53.3), for example when entering into a contract with a customer that is a significant credit risk.

    b. the contract has a significant financing component (in accordance with paragraphs 58-62) and thus the transaction price is determined by adjusting the promised consideration using a rate that reflects the customer's credit risk.

51. [Not used]

52. The nature, timing, and amount of consideration promised by the customer affect the estimate of the transaction price. When determining the transaction price, an entity shall consider the effects of all of the following:

    a. Variable consideration (see paragraphs 53–56)
    b. Constraining estimates of variable consideration (see paragraphs 56.1–57)
    c. The existence of a significant financing component in the contract (see paragraphs 58–62)
    d. Noncash consideration (see paragraphs 63–64.1)
    e. Consideration payable to a customer (see paragraphs 65–67).

52.1 [Not used]

52.2. For the purpose of determining the transaction price, an entity shall assume that the goods or services will be transferred to the customer as promised in accordance with the existing contract and that the contract will not be cancelled, renewed, or modified.

Variable Consideration

53. If the consideration promised in a contract includes a variable amount, an entity shall estimate the amount of consideration to which the entity will be entitled in exchange for transferring the promised goods or services to a customer.

53.1. The amount of consideration to which an entity will be entitled can vary because of discounts, rebates, refunds, credits, price concessions, incentives, performance bonuses, penalties, or other similar items. The promised consideration also can vary if the entity's entitlement to the consideration is contingent on the occurrence or non-occurrence of a future event. For example, the amount of consideration promised in a fixed-price contract would be variable if the contract included a right of return.

53.2. The variability relating to the consideration promised by the customer may be specified in the contract. In addition to the terms and conditions specified in the contract, the promised consideration is variable if either of the following circumstances exist:

a. The customer has a valid expectation arising from the entity's customary business practices, published policies or specific statements that the entity will accept a lower amount of consideration than the stated contractual price in exchange for the promised goods or services. That is, the entity will offer a price concession and depending on jurisdiction, industry or customer this offer may be referred to as a discount, rebate, refund or credit.

b. Other facts and circumstances indicate that the entity's intention, when entering into the contract with the customer, is to offer a price concession to the customer. For example, those facts and circumstances indicate that there is [significant doubt][significant uncertainty] about the ability of the customer to pay all of the promised consideration (that is, the customer is a significant credit risk).

53.3. Factors that indicate that, at the time of entering into a contract, an entity intends to offer a price concession to a customer who is a significant credit risk include, but are not limited to, the following:

a. The goods or services promised to the customer are not expected to expose the entity to a significant economic loss if the customer does not pay the promised consideration. For example, an entity would not be expected to incur a significant economic loss in any of the following circumstances:

   (i) The incremental costs that an entity incurs to produce the good or service or transfer it to the customer would be negligible.

   (ii) The entity can deny the customer further access to the promised good or service if the customer fails to meet its obligations under the contract.

   (iii) The good that transfers to the customer is not expected to depreciate substantially (or diminish in value) and, therefore, the good provides the entity with sufficient collateral in the event of the customer failing to meet its obligations under the contract. For example, the good is a tangible asset that is not expected to have depreciated substantially if and when the entity obtains control of the good from the customer.

b. The entity has previously chosen not to enforce its rights to the promised consideration in similar contracts with the customer (or class of customer) under similar circumstances.

c. The entity has experience (or other evidence) about the customer not fulfilling its obligations to pay the promised consideration in other contracts.

d. The entity has experience (or other evidence) about the class of customer to which the customer belongs not fulfilling their obligations to pay the promised consideration in similar contracts under similar circumstances.

53.4. If it is determined that an entity would accept a lower amount of consideration than the stated contractual price in exchange for the promised goods or services from a customer who is a significant credit risk, an entity shall apply paragraph 55 to estimate the amount of consideration to which the entity expects to be entitled in exchange the promised goods or services.

53.5. If an assessment of the facts and circumstances in paragraph 53.3 does not indicate that the entity intends to offer a price concession to a customer who is a significant credit risk, an entity shall subsequently consider the customer's credit risk when assessing the carrying amount of a contract asset (or a receivable) for impairment in accordance with Topic 310 on receivables [IFRS 9 *Financial Instruments*].

54. [Not used]

55. An entity shall estimate an amount of variable consideration by using either of the following methods, depending on which method the entity expects to better predict the amount of consideration to which it will be entitled:

   a. The expected value. The expected value is the sum of probability-weighted amounts in a range of possible consideration amounts. An expected value may be an appropriate estimate of the amount of variable consideration if an entity has a large number of contracts with similar characteristics.

   b. The most likely amount. The most likely amount is the single most likely amount in a range of possible consideration amounts (that is, the single most likely outcome of the contract). The most likely amount may be an appropriate estimate of the amount of variable consideration if the contract has only two possible outcomes (for example, an entity either achieves a performance bonus or does not).

56. An entity shall apply one method consistently throughout the contract when estimating the effect of an uncertainty on the amount of variable consideration. In addition, an entity shall consider all the information (historical, current, and forecasted) that is reasonably available to the entity and shall identify a reasonable number of possible consideration amounts. The information that an entity uses to estimate the amount of variable consideration typically would be similar to the information that the entity's management uses during the bid-and-proposal process and in establishing prices for promised goods or services.

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Constraining Estimates of Variable Consideration

56.1. An entity shall include the amount of variable consideration estimated in accordance with paragraph 55 in the transaction price only if the entity expects that, based on the assessment of factors in paragraph 56.2, a subsequent change in the estimate of the amount of variable consideration would not result in a significant revenue reversal. A significant revenue reversal would occur if a subsequent change in the estimate of the variable consideration would result in a significant downward adjustment to the amount of cumulative revenue recognized from that contract with that customer.

56.2. An entity shall use judgment and consider all facts and circumstances when assessing the risk that a subsequent change in an estimate of variable consideration would result in a significant revenue reversal. This assessment considers both the likelihood of a downward adjustment in the estimate of variable consideration and the magnitude of the possible revenue reversal when the uncertainty related to the variable consideration has been resolved. Factors that indicate that including an estimate of variable consideration in the transaction price could result in a significant revenue reversal include, but are not limited to, any of the following:

a. The amount of consideration is highly susceptible to factors outside the entity's influence. Those factors include volatility in a market, the judgment or actions of third parties (for example, the consideration promised by a customer in exchange for a license varies based on the customer's subsequent sales of a good or service), weather conditions, and a high risk of obsolescence of the promised good or service.

b. The uncertainty about the amount of consideration is not expected to be resolved for a long period of time.

c. The entity's experience (or other evidence) with similar types of contracts is limited or that experience (or other evidence) has limited predictive value.

cc. The entity has a practice of either offering a broad range of price concessions or changing the payment terms and conditions of similar contracts in similar circumstances.

d. The contract has a large number and broad range of possible consideration amounts.

56.3. If an entity expects that including some, but not all, of the estimated amount of variable consideration (that is, a minimum amount) in the transaction price would not result in a significant revenue reversal, the entity shall include that amount (and subsequent changes to that amount) in the estimate of the transaction price.

Reassessment of variable consideration

56.4. An entity shall update the estimated transaction price at each reporting date to represent faithfully the circumstances present at the reporting date and the changes in circumstances during the reporting period, including the entity's assessment of a minimum amount of consideration that may be included in the transaction price (see the preceding paragraph [56.3]). An entity shall account for changes in the transaction price in accordance with paragraphs 77–80.

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Licensing

IG33. A license establishes a customer's rights related to intellectual property of an entity. Licenses of intellectual property can include any of the following:

a. Software and technology
b. Motion pictures, music, and other forms of media and entertainment
c. Franchises
d. Patents, trademarks, and copyrights.

IG33.1. By licensing its intellectual property to other parties, an entity maintains control of the underlying intellectual property. An entity may continue to undertake activities to further develop or enhance its intellectual property to which the customer has rights. Those activities could change the scope, form, function or value of the intellectual property. Consequently, when identifying the goods or services promised in a contract with a customer, an entity shall evaluate whether a promised license provides a customer with either:

a. Access to the entity's intellectual property as it exists at any given time (that is, a licence that provides access); or
b. A right to use the entity's intellectual property as it exists at a point in time (that is, a licence that transfers a right).

IG33.2. 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 that the entity will undertake activities that modify the nature or value of the intellectual property to which the license relates.
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.
c. The rights granted by the license expose the customer to any positive or negative effects on the nature or value of the intellectual property arising from those activities as and when the entity undertakes those activities.

IG33.3.If the criteria in paragraph IG33.2 are met and the license is distinct (in accordance with paragraphs 28-29.1), 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.

IG33.4. 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. 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 can 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).

IG33.5.An entity shall disregard the following factors when determining whether a license represents the provision of access or the transfer of 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.

IG33.6. An entity may promise to transfer other goods or services to the customer in addition to the promised license. Those promises may be specified in the contract or otherwise implied by the entity's customary business practices, published policies or specific statements. If, in accordance with paragraphs 28–29.1, an entity assesses that a promised license is not distinct from other goods or services promised in the contract, the entity shall account for the license and other promised goods or services 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. The license forms a component of a tangible good and is integral to the good's functionality.
b. The service is integral to the license.

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