STAFF PAPER

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Project	**FASB/IASB Joint Transition Resource Group for Revenue Recognition**		
Paper topic	Sales-Based and Usage-Based Royalties in Contracts with Licenses and Goods or Services Other than Licenses		
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Purpose

1. Some stakeholders informed the staff that there may be differing interpretations of the application of the guidance in Accounting Standards Update No. 2014-09, *Revenue from Contracts with Customers*, and IFRS 15 *Revenue from Contracts with Customers* (collectively, the "new revenue standard") about sales-based and usage-based royalties promised in exchange for licenses of intellectual property to a contract that includes a promise to deliver (a) one or more licenses of intellectual property *and* (b) one or more goods or services that are not licenses of intellectual property. This paper includes a summary of two potential implementation issues that stakeholders reported to the staff about that scenario. The staff plans to ask the members of the FASB-IASB Joint Transition Resource Group for Revenue Recognition for their input about those potential implementation issues.

Accounting Guidance

2. The guidance in the new revenue standard that is applicable to sales- and usage-based royalties promised in exchange for a license of intellectual property (referred to as the "royalties constraint") follows:

> > > Sales-Based or Usage-Based Royalties

606-10-55-65 [IFRS 15, paragraph B63] Notwithstanding the guidance in paragraphs 606-10-32-11 through 32-14 [56–59], an entity should recognize revenue for a sales-based or usage-based royalty promised in exchange for a license of intellectual property only when (or as) the later of the following events occurs:

a. The subsequent sale or usage occurs.

b. The performance obligation to which some or all of the sales-based or usage-based royalty has been allocated has been satisfied (or partially satisfied).

3. The guidance in the new revenue standard that is applicable to variable consideration other than sales- or usage-based royalties promised in exchange for a license of intellectual property follows:

606-10-32-8 [53] 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).

> > > Constraining Estimates of Variable Consideration

606-10-32-11 [56] An entity shall include in the transaction price some or all of an amount of variable consideration estimated in accordance with paragraph 606-10-32-8 [53] only to the extent that it is probable that a significant reversal in the amount of cumulative revenue recognized will not occur when the uncertainty associated with the variable consideration is subsequently resolved.

606-10-32-12 [57] In assessing whether it is probable that a significant reversal in the amount of cumulative revenue recognized will not occur once the uncertainty related to the variable consideration is subsequently resolved, an entity shall consider both the likelihood and the magnitude of the revenue reversal. Factors that could increase the likelihood or the magnitude of a 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 may include volatility in a market, the judgment or actions of third parties, 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.

d. 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.

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

606-10-32-13 [58] An entity shall apply paragraph 606-10-55-65 [B63] to account for consideration in the form of a sales-based

or usage-based royalty that is promised in exchange for a license of intellectual property.

> > > Reassessment of Variable Consideration

606-10-32-14 [59] At the end of each reporting period, an entity shall update the estimated transaction price (including updating its assessment of whether an estimate of variable consideration is constrained) to represent faithfully the circumstances present at the end of the reporting period and the changes in circumstances during the reporting period. The entity shall account for changes in the transaction price in accordance with paragraphs 606-10-32-42 [87] through 32-45 [90].

4. The new revenue standard includes an example of the application of the royalties constraint:

> > > Example 60—Access to Intellectual Property

606-10-55-393 [IE307] An entity, a movie distribution company, licenses Movie XYZ to a customer. The customer, an operator of cinemas, has the right to show the movie in its cinemas for six weeks. In exchange for providing the license, the entity will receive a portion of the operator's ticket sales for Movie XYZ (that is, variable consideration in the form of a sales-based royalty). The entity concludes that its only performance obligation is the promise to grant the license.

606-10-55-394 [IE308] The entity observes that regardless of whether the promise to grant the license represents a right to access the entity's intellectual property or a right to use the entity's intellectual property, the entity applies paragraph 606-10-55-65 [B63] and recognizes revenue as and when the ticket sales occur. This is because the consideration for its license of intellectual property is a sales-based royalty and the entity has already transferred the license to the movie to which the sales-based royalty relates.

5. The Boards addressed the royalties constraint in paragraphs BC415–BC421 in the Basis for Conclusions of the new revenue standard. In addition, paragraph BC407, which follows, is relevant to this paper:

> **BC407.** If the customer cannot benefit from the license on its own, and/or the license cannot be separated from other promises in the contract, the license would not be distinct and, thus, would be combined with those other promises (see paragraph 606-10-25-22 [30]). The entity would then determine when the single performance obligation is satisfied on the basis of when the good or service (that is, the output) is transferred to the customer. The Boards noted that in some cases, the combined good or service transferred to the customer may have a license as its primary or dominant component. When the output that is transferred is a license, or when the license is distinct, the entity would apply the criteria in paragraph 606-10-55-60 [B58] to determine whether the promised license provides the customer with access to the entity's intellectual property or a right to use the entity's intellectual property.

Potential Implementation Issues Reported by Stakeholders

Issue 1: When is a sales-based or usage-based royalty "promised in exchange for a license of intellectual property" such that the royalties constraint should apply?

6. Licenses of intellectual property are often sold with other goods and/or services. For example:

   (a) Software licenses are commonly sold with post-contract customer support (PCS), other services (for example, hosting or implementation services), and/or hardware.

   (b) Franchise licenses are frequently sold with consulting or training services and/or equipment.

(c) Bio-technology and pharmaceutical licenses are often sold with research and development services and/or a promise to manufacture the drug for the customer.

7. Each of those examples frequently involves at least a portion of the licensor's compensation to be in the form of a sales- or usage-based royalty. Stakeholders have raised questions about, in examples such as those outlined above, when a sales- or usage-based royalty has been "promised in exchange for a license of intellectual property."

8. The staff are aware of the following three interpretations of stakeholders as to when a sales- or usage-based royalty is "promised in exchange for a license of intellectual property" (and therefore, when the royalties constraint would apply to that sales- or usage-based royalty), each of which is discussed in further detail below:

(a) *Interpretation A* – A sales- or usage-based royalty is promised in exchange for a license of intellectual property whenever that royalty relates to a license, regardless of (i) whether the royalty *also* relates to another non-license good or service or (ii) whether the license is a separate performance obligation (that is, not combined for accounting purposes with a non-license good or service)

(b) *Interpretation B* – A sales- or usage-based royalty is promised in exchange for a license of intellectual property *only* when that royalty relates *solely* to a license and that license is a separate performance obligation (that is, it is not combined for accounting purposes with a non-license good or service).

(c) *Interpretation C* – A sales- or usage-based royalty is promised in exchange for a license of intellectual property when the royalty relates (i) solely to a license of intellectual property, *or* (ii) the royalty relates to a license and one or more other non-license goods or services, but the license is the primary or dominant component to which the royalty relates.

9. The staff are not aware of diversity in stakeholders' interpretations to date that the royalties constraint applies to any sales- or usage-based royalty:

(a) That relates specifically to a license of intellectual property (that is, to the entity's efforts to transfer the license or to a specific outcome from transferring the license, for example, the customer's sale of a product that utilizes the license); *and*

(b) If the license is a separate performance obligation (that is, *not* combined with any other goods or services).

10. In addition, the staff are not aware of diversity in stakeholders' interpretations to date that the royalties constraint would *not* apply to any royalty that relates specifically to a good or service that is *not* a license of intellectual property.

11. Stakeholders appear to have differing interpretations, expressed in Interpretations A-C, about whether the royalties constraint should apply to a royalty:

(a) That does not specifically relate to a license of intellectual property (that is, the royalty relates to *both* a distinct license *and* one or more non-license goods or services that are distinct from the license); *or*

(b) If the license to which the royalty specifically relates is *not* distinct and, therefore, is combined with other non-license goods or services.

12. The differing interpretations in those scenarios could have an effect on an entity's financial reporting. For example, assume that a contract includes a 10-year license of intellectual property and a related service component that is not distinct from the license, and that a significant portion of the total consideration in the contract is in the form of a sales-based royalty. If one entity (the licensor in this contract) were to conclude that the royalties constraint applies and a second entity were to conclude that it does *not* apply, their revenue recognition could differ throughout the 10-year period. The first entity would recognize the royalties as revenue only when the customer's subsequent sales occur. The second entity *may* (depending on the nature of the license and application of the general constraint on variable consideration) recognize a significant portion of the total expected royalties at or near the beginning of the 10-year license term, with true-up adjustments recorded throughout the remainder of the term.

Interpretation A

13. Some stakeholders think that a sales- or usage-based royalty is promised in exchange for a license of intellectual property whenever that royalty relates to a license; and therefore, the royalties constraint applies to *any* sales- or usage-based royalty that relates to a license of intellectual property, regardless of whether the royalty relates to:

    (a) A license *and* another good or service that is not a license, *or*

    (b) A license that is combined with other goods or services (that is, in a single performance obligation).

14. Those stakeholders appear to read paragraph 606-10-55-65 [B63] and note that it does not require that the royalty be promised *only* in exchange for a license of intellectual property.

15. Those stakeholders further consider the Boards' rationale for the guidance on sales- and usage-based royalties for licenses of intellectual property, as described in the Basis for Conclusions in paragraph BC415. Users and preparers of financial statements indicated that it would not be useful, and would not provide relevant information, for an entity to recognize a minimum amount of revenue in contracts that include sales- or usage-based royalties paid over a long period of time. This is because that approach would require the entity to report throughout the life of the contract significant adjustments to the amount of revenue recognized at inception of the contract as a result of changes in circumstances even though those changes in circumstances are not related to the entity's performance.

16. Given that the reason for the royalties constraint was to reduce complexity and provide more relevant financial statement information about licensing scenarios, this interpretation suggests that the royalties constraint should apply to any sales- or usage-based royalty that relates to a license of intellectual property.

17. Conversely, the discussion in paragraph BC416 might suggest that this constraint was not intended to apply to *all* cases in which the royalty relates to a license of intellectual property. Paragraph BC416 explains that, in establishing the sales-based royalty constraint in the 2011 ED, the Boards did not intend it to apply to

"tangible goods that include a significant amount of intellectual property" (for example, a machine that utilizes a significant amount of software to operate, and may include an explicit end-user license to the operating software). This suggests that there were circumstances envisioned in which a license is conveyed, but the royalties constraint would not apply.

Interpretation B

18. Some stakeholders think that a sales- or usage-based royalty is promised in exchange for a license of intellectual property only when that royalty relates solely to a license and that license is a separate performance obligation (that is, it is not combined for accounting purposes with a non-license good or service). In those cases in which the license is combined with other non-license goods or services (that is, in a single performance obligation) *or* in which the royalty relates to a distinct license *and* another non-license good or service that is also distinct, a sales- or usage-based royalty would be subject only to the general constraint on estimates of variable consideration. This would mean that an entity would be required to estimate the amount of variable consideration to which it expects to be entitled stemming from the royalty over the term of the contract and continually reassess both (a) those estimates and (b) what portion of that expected amount should or should not be constrained.

19. Stakeholders who have communicated this interpretation observe that the royalties constraint is an exception to the general variable consideration model (paragraphs BC413 and BC421 specifically refer to it as an exception) and that BC421 specifically outlines the Boards' intention that this exception would be applied only to limited circumstances. Those stakeholders think that an exception to the general model should be applied only in those circumstances that the new revenue standard explicitly requires its application. These stakeholders read the guidance in paragraph 606-10-55-65 [B63] as requiring application of this exception only when a sales- or usage-based royalty is promised *solely* in exchange for a license of intellectual property, *not* when it is promised in exchange for a license and something else or for a combined obligation in which the license is just a component (viewing the combined item as something other than a license of intellectual property).

Interpretation C

20. Other stakeholders think that a sales- or usage-based royalty is promised in exchange for a license (that is, the royalties constraint should apply) whenever a license of intellectual property is the primary or dominant component to which the royalty relates. For example, under this interpretation the royalties constraint would apply to each of the following:

    (a) A sales- or usage-based royalty relates to two, separate performance obligations (one license and another good or service, each of which is distinct), and the license is the primary or dominant performance obligation to which the royalty relates.

    (b) A sales- or usage-based royalty specifically relates to a single performance obligation that includes a license and one or more other goods or services, and the license is the primary or dominant component within that single performance obligation.

    (c) A sales- or usage-based royalty relates to a single performance obligation (that includes a license and one or more other goods or services), as well as a second performance obligation that does not include a license, and the license is the primary or dominant good to which the royalty relates.

21. Stakeholders who have suggested this interpretation note that paragraph BC407 introduces the notion that a non-distinct license may be the "primary or dominant component" within a single performance obligation. While this discussion in the Basis for Conclusions is in the context of determining whether a single performance obligation that includes a license is transferred to the customer over time or at a point in time, stakeholders suggesting Interpretation C think that a license can also be the primary or dominant component *to which a sales- or usage-based royalty relates* (that is, the primary or dominant component for which the royalty is promised) even if the royalty is not promised *solely* in exchange for the license. Those stakeholders think that applying the royalties constraint when the license is the primary or dominant component to which the royalty relates is consistent with the Boards' objectives (as expressed in paragraphs BC415 and BC421) of:

(a) Providing useful information by not requiring entities to report significant adjustments to revenue likely to result from changes in circumstances during the contract term; and

(b) Not applying this exception to a broad population of contracts (which might be the result if applied to contracts that include licenses of intellectual property only as incidental or complementary components). Application of the royalties constraint when the license is the primary or dominant component should restrict the circumstances when the constraint is applied while (i) not requiring entities to undertake the estimation and reassessment processes inherent in the general guidance on variable consideration when the license is the dominant component to which the royalty relates, and (ii) ensuring similar licensing transactions are not accounted for very differently just because the royalty also relates to a relatively insignificant non-license element.

22. This interpretation would ensure that neither (i) a minor license, nor (ii) an insignificant non-license component would trigger the application (or non-application) of the royalties constraint, potentially enhancing comparability between similar transactions. A royalty promised in exchange for a license bundled with an insignificant service component would be accounted for in the same manner as a royalty promised in exchange for the same (or substantially similar) license sold separately. Conversely, a usage-based royalty promised in exchange for a piece of equipment would not be subject to the royalties constraint solely because of the inclusion of a license that is not the primary or dominant feature of the equipment (for example, some operational software).

23. Some might conclude that in the following contracts, the license is the primary or dominant component to which the royalty relates (that conclusion would depend on the specific facts and circumstances):

(a) A contract that includes a 10-year franchise license and includes consulting or training services that will be provided over the first 12 to 18 months of the franchise agreement.

(b) A contract that includes a software licence that allows the customer to embed the licensor's software in the customer's products for a period of three years and includes customization services that will occur upfront.

(c) A contract that includes a license to show a movie for three months and includes a promise by the movie studio to produce and air television and radio advertisements for that movie in the customer's specific geographic area.

24. An entity may conclude that in any of those examples the royalties do not relate solely to (that is, are not promised solely in exchange for) the license because the effectiveness of the franchisor's consulting/training services, the software vendor's customizations, or the movie studio's advertising have a meaningful effect on the royalties that will be earned (for example, the movie studio's specific promise of advertising in the customer's geographic area affects the number of tickets sold to the licensed movie).

Issue 2: Can a royalty be <u>partially</u> within the scope of the royalties constraint?

25. Depending on the interpretation of Issue 1, it is possible that a sales- or usage-based royalty would be considered to relate partially to a license (that is, not solely to a license), but the royalties constraint would not apply to the royalty as a whole. For example, this would occur under Interpretation B if the royalty is promised in exchange for the license *and* at least one other good or service that is not a license, and would occur under Interpretation C if the entity also concludes that the license is not the primary or dominant component for which the royalty is promised. Some stakeholders have questioned whether, in those examples, any *portion* of the royalty should be subject to the royalties constraint (that is, whether the royalty should be partially within the scope of the royalties constraint and partially within the scope of the general guidance on variable consideration).

26. The view of some stakeholders is that, with respect to a single sales- or usage-based royalty, the royalties constraint either applies or it does not apply. This view appears to be premised on the language in the guidance stating that the royalties constraint applies only to a royalty "promised in exchange for a license of intellectual property" (paragraph 606-10-55-65 [B63]). If the royalty is promised

wholly or partially in exchange for goods or services that are not licenses (and in the case of Interpretation C in Issue 1, the license is not the primary component to which the royalty relates), then one interpretation of that guidance is to conclude that the royalties constraint does not apply. This would mean that, in either case described in the paragraph above, the entity would be required to estimate the amount of variable consideration to which it expects to be entitled from the royalty over the term of the contract and continually reassess both (a) those estimates and (b) what portion of that expected amount should or should not be constrained.

27. The view of other stakeholders is that the royalties constraint should be applied partially to a single sales- or usage-based royalty (that is, the *part* that will be paid in exchange for the license of intellectual property). These stakeholders think that a portion of a sales- or usage-based royalty can be considered a promise "in exchange for a license of intellectual property," (or primarily in exchange for a license of intellectual property) and therefore, that the royalties constraint should apply to that portion. An entity would estimate the total amount to which it expects to be entitled from the royalty and allocate that estimated amount to the license and the other goods or services to which the royalty relates. As the customer's subsequent sales or usage occur, the portion allocable to the license would be recognized in accordance with the royalties constraint. The remainder would be considered in the context of the general variable consideration guidance. This application would likely be more complex than if the entity were to apply the general constraint to the entire royalty. However, application in this manner may contribute to comparability in the recognition of royalties from licenses of intellectual property among entities. This is because it would mitigate differences that might arise between entities from different judgments with respect to separation, to which goods or services a royalty relates, and/or determining whether a license is the primary or dominant component to which a royalty relates (under Interpretation C).

Questions for TRG Members

1. What are your views about the two potential implementation issues included in this paper?

2. Are you aware of other interpretations for any of the two issues that are not included in this paper?

3. Are there any related potential interpretation issues not included in this paper?