STAFF PAPER

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Project	Revenue from Contracts with Customers		
Paper topic	Licences of intellectual property—issues emerging from TRG discussions		
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Purpose of the paper

1. The purpose of this paper is to explain the specific issues relating to the application of the licensing guidance highlighted during the TRG discussions so that the IASB can decide what, if any, action it would like to take at this stage to address the issues.

2. This paper refers to analysis and alternatives included in FASB Memo No. 1: *Determining the Nature of the Entity's Promise in Granting a License; The Sales- and Usage-Based Royalties Exception*. This memo has been distributed to IASB members and should be read in conjunction with this agenda paper.

Background

3. IFRS 15 *Revenue from Contracts with Customers* and Accounting Standards Update No. 2014-09 *Revenue from Contracts with Customers* (collectively referred to as the 'new revenue Standard') provides application guidance on the recognition of revenue from an entity's licensing of intellectual property (refer to the Appendix for relevant extracts of the application guidance on licensing in IFRS 15).

4. Discussions at the TRG meetings have highlighted two main implementation questions about the following aspects of the licensing guidance:

   (a) Determining the nature of an entity's promise in granting a licence (ie determining whether an entity's promise in granting a licence is a promise to provide a *right to access* the entity's intellectual property or a *right to use* the entity's intellectual property); and

   (b) Determining when the exception to the general requirements for variable consideration for sales-based or usage-based royalties promised in exchange for a licence of intellectual property (royalties constraint) applies.

5. The following less significant issues have also been highlighted at the TRG meetings:

   (a) Should an entity assess the nature of a licence if the licence of intellectual property is not distinct from other goods or services promised in the contract?

   (b) If there are restrictions on the customer's rights to use or access the entity's intellectual property (of the nature described in paragraph B62 of IFRS 15), do these restrictions affect the number of promises in the contract?

6. TRG agenda paper 8 (click the link to access the paper) of the October 2014 meeting discusses the issues in paragraphs 4(a) and 5 above. TRG agenda paper 3 (click the link to access the paper) of the July 2014 meeting discusses the issue in paragraph 4(b) above.

Staff recommendations

7. The staff recommend the following:

   (a) Regarding determining the nature of an entity's promise in granting a licence, that the IASB explore proposing a limited amendment to IFRS

15 along the lines of Articulation A set out in paragraph 30 of this paper (subject to the additional consultation discussed in Agenda Paper 7A).

(b) Regarding determining when the royalties constraint applies, that the IASB explore proposing a limited amendment to IFRS 15 along the lines of what is set out in paragraph 54 of this paper (subject to the additional consultation discussed in Agenda Paper 7A).

(c) Regarding the two less significant issues described above in paragraph 5 of this paper, that the IASB does not undertake standard-setting.

Staff analysis

Determining the nature of the entity's promise in granting a licence

8. The Application Guidance in IFRS 15 requires an entity to assess whether the nature of the entity's promise in granting a licence to a customer is to provide the customer with either:

   (a) a *right to access* the entity's intellectual property as it exists throughout the licence period (ie the intellectual property to which the customer has obtained rights is dynamic). In this case, the performance obligation is satisfied over time and thus the entity recognises revenue over time; or

   (b) a *right to use* the entity's intellectual property as it exists at the point in time at which the licence is granted (ie the intellectual property to which the customer has obtained rights is static). In this case, the performance obligation is satisfied at a point in time and thus the entity recognises revenue at a point in time.

9. Paragraph B58 specifies three criteria that an entity should consider in assessing whether the nature of its promise in granting a licence is a promise to provide a right to access its intellectual property (ie revenue over time). The criteria that should be met are:

   (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;

   (b) the rights granted by the licence directly expose the customer to any positive or negative effects of the entity's activities identified in paragraph B58(a); and

   (c) those activities do not result in the transfer of a good or a service to the customer as those activities occur.

10. If all of the criteria are not met, the nature of the entity's promise is to provide a right to use the entity's intellectual property (ie revenue at a point in time).

11. The main implementation question raised regarding the nature of an entity's promise relates to the determination of when the entity's activities (contractual or reasonably expected by the customer) *significantly affect the intellectual property to which the customer has rights*. In particular, what attribute of the intellectual property, ie form, functionality, value or all, should be significantly affected by the entity's activities to conclude that the entity's promise is to provide a right to access intellectual property.

12. Paragraphs 4-9 of the FASB memo explain some of the different views expressed by stakeholders that were considered at the October 2014 TRG meeting. In essence, the different views have arisen mainly because paragraph B61 states that "…the nature of an entity's promise is to provide a right to use the entity's intellectual property as that intellectual property exists (*in terms of form and functionality*) at the point in time at which the licence is granted to the customer…" (emphasis added). Consequently, the new revenue Standard could be read to conclude that the nature of the entity's promise is to provide a right to access the entity's intellectual property only if the entity's activities significantly

affect the *form or functionality* of the intellectual property to which the customer has rights. Some stakeholders also refer to particular paragraphs of the Application Guidance, Basis for Conclusions and Illustrative Examples in support of this view. For example, Examples 54, 56 and 58-59 consider whether an entity's activities change the intellectual property to which a customer has rights with reference (either directly or indirectly) to whether the activities change the form or functionality of the intellectual property.

13. In saying that, Example 61 illustrates the application of the licensing guidance to a contract for which an entity (sports team) licenses the use of its name and logo to a customer. Paragraph IE310 states that "…the additional activities associated with the licence do not directly transfer a good or service to the customer because they are part of the entity's promise to grant the licence and, in effect, *change the intellectual property* to which the customer has rights…" (emphasis added). Therefore, the example concludes that the entity has provided a right to access its intellectual property. Although the example does not explain how the additional activities *change* the intellectual property, some stakeholders think that changes in form or functionality are not relevant in this example because there is no indication that the form or functionality of the sports team's name and logo will change during the period of the licence. Rather, it is the value of the name and logo that is significantly affected by the sports team continuing to play and remain competitive. Consequently, the new revenue Standard could also be read to conclude that the nature of the entity's promise is to provide a right to access the entity's intellectual property if the entity's activities significantly affect the *value* of the intellectual property to which the customer has access even if the form or functionality does not change.

14. The following example illustrates where stakeholders might reach different conclusions:

> **Example 1—Assessing the nature of the entity's promise in granting the licence to a customer**
>
> An entity, a television production company, licences season 1 of show XYZ to a customer. The customer has rights to broadcast the episodes of the show in sequential order. The entity is currently producing season 2 of the show and hence is promoting that show.
>
> When assessing the nature of the entity's promise in granting the licence, the TRG discussed the following possible interpretations:
>
> (a) Interpretation A: the entity has granted a right to use intellectual property because the entity's promotional activities do not affect the form or functionality of season 1 of show XYZ (on the basis that only activities that affect the form or functionality of intellectual property are activities that significantly affect the intellectual property).
>
> (b) Interpretation B: the entity has granted a right to access intellectual property because the customer indirectly benefits from the entity's promotional activities and, thus, the entity's activities affect the value of the intellectual property (on the basis that any activities that affect the value of the intellectual property are activities that significantly affect the intellectual property).
>
> (c) Interpretation C: the entity has granted a right to use intellectual property on the basis that the entity's promotional activities do not *significantly* affect season 1 of show XYZ because those activities do not, in effect, *give* the intellectual property value and, therefore, the entity's performance or non-performance of those activities does not significantly affect the utility of the licensed intellectual property.

15. Many TRG members thought that the Boards intended 'significantly affects the intellectual property' to capture more than just changes in the form or functionality of the intellectual property, but not necessarily all changes in the value of the intellectual property (ie Interpretation C set out in Example 1 above). Rather, an entity's activities would be expected to significantly affect the intellectual property when those activities define the intellectual property and, therefore, can significantly change or alter the *utility* of that intellectual property.

Accordingly, a licensor's activities that affect the value of a brand might be judged to significantly affect the intellectual property. However, a licensor's promotional or other activities relating to intellectual property with substantial standalone functionality, such as software or a music recording, might not be judged to significantly affect the intellectual property. Nonetheless, these TRG members also did not think this intention was apparent from the words in the Standard.

Possible approaches to clarifying the issue relating to determining the nature of the entity's promise in granting a licence

No standard-setting action

16. The IASB could conclude that no standard-setting is required to address this issue.

17. The staff think that the Boards envisaged that distinguishing between a licence for the right to access intellectual property and a licence for the right to use intellectual property would sometimes require significant judgement. Although the Application Guidance does not specify what attribute of the intellectual property should be significantly affected by the entity's activities, the Illustrative Examples illustrate the application of the Standard. There is an illustrative example in which the entity's activities might be viewed as significantly affecting the form and functionality of the intellectual property (Example 58) and another in which the entity's activities might be viewed as significantly affecting the value of the intellectual property (Example 61). Consequently, the examples highlight that the attribute of the intellectual property that is significantly affected by the entity's activities is assessed based on the particular facts and circumstances.

18. The judgement required in applying the criteria in paragraph B58 is made in the context of the explanation in paragraph B57 that describes the nature of the two types of licences as well as the explanation in the Basis for Conclusions. In particular, paragraph B57 explains that in the case of a right to access intellectual property, the intellectual property to which the customer has rights 'changes throughout the licence period'. Paragraph BC403 refers to the intellectual property in such cases as 'dynamic' because it will 'change as a result of the entity's continuing involvement in its intellectual property'.

19. In addition, the staff do not think the Boards intended the reference to form and functionality in paragraph B61 (and some of the Illustrative Examples and Basis for Conclusions) to be read so as to suggest that the nature of a licence is a right to access intellectual property only if the entity's activities significantly affect the form or functionality of the intellectual property to which the customer has rights. The reference to form and functionality in paragraph B61 and in Example 56 is in connection with a right to use licence. Whether a licence is a right to access intellectual property is defined by the criteria in paragraph B58, which do not refer to form or functionality.

20. In applying the criteria in paragraph B58 and determining whether a licence is a right to access intellectual property, the staff think that there are limitations on the extent of the entity's activities that should be considered. Paragraph B58 specifies that the entity's activities should '*significantly* affect the intellectual property to which the customer has rights'. The staff does not think that the Boards intended this to capture activities that affect the value of the intellectual property only in a 'more-than-insignificant' manner (eg the promotional activities of the television production company in Example 1 above related to season 2 of show XYZ, assuming that those promotional activities affect the value of season 1 of the show to which the customer has rights only in a limited way).

21. The staff also observe that the new licensing guidance should reduce the amount of diversity in accounting for licences compared with IAS 18 *Revenue*. Despite some of the concerns raised, the new Standard provides a more cogent framework for accounting for licences compared to the limited guidance in IAS 18, which specifies only that an entity should recognise licence fees 'in accordance with the substance of the agreement'. Furthermore, if the judgement an entity makes would significantly affect the determination of revenue, that judgement would be disclosed.

22. For these reasons, as well as the wider considerations noted in Agenda Paper 7A, the IASB could decide at this stage not to amend the Standard or Illustrative Examples. The discussion in this paper could help to educate practice on how to interpret and apply the licensing guidance.

Limited standard-setting needed

23. Alternatively, the IASB could conclude that it should undertake some limited standard-setting activity to provide greater clarity about the distinction between a licence for the right to access intellectual property and a licence for the right to use intellectual property. It could do so by clarifying when an entity's activities significantly affect the entity's intellectual property to which a customer has rights.

24. The staff have considered whether such clarification could be achieved by amending or adding new examples, but note that IFRS 15 contains more examples about licences than any other topic in IFRS 15. The diversity in views expressed at the TRG meetings might suggest that, if the IASB wishes to clarify when an entity's activities significantly affect intellectual property, some amendment might be required to the Application Guidance. Some TRG members also highlighted the risks in this instance of trying to undertake standard-setting through examples.

25. Paragraphs 28-45 of the FASB memo explain a proposal to clarify when activities significantly affect an entity's intellectual property. This is a targeted solution to clarify the existing requirements—ie it has been developed within the context of the existing dual model for licences.

26. In summary, the FASB staff propose that entities should be required to consider the *utility* of the intellectual property to the customer and how the entity's activities (that do not transfer a good or service to the customer) affect that utility. The utility of the intellectual property refers to its ability to fulfil a desired role or function.

    (a) When the utility of the intellectual property to the customer is substantially derived from or dependent upon the entity's activities, a customer would benefit from the intellectual property only by having the entity carry out those activities. For example, the utility of a brand name is typically derived from, and dependent upon, the entity's ongoing activities. In such cases, the entity's activities significantly affect the intellectual property and hence the criterion in paragraph

B58(a) would be met (so the licence would be a right to access intellectual property).

(b) When intellectual property has significant standalone functionality, a substantial portion of its utility is derived from that functionality, and is generally unaffected by the entity’s activities that do not change that functionality. Accordingly, in such cases, the entity’s activities would not significantly affect the intellectual property and, thus, the criterion in paragraph B58(a) would not be met (so the licence would be a right to use intellectual property). For example, this would be the case for most software and completed media content, such as films or music recordings.

27. The staff think that the principles in paragraph 26 above provide greater clarity about when an entity should consider activities that affect the *value* of the intellectual property, which is at the heart of the concern expressed by TRG members.

28. Applying the above principles to Example 1 in paragraph 14 of this paper, the entity would conclude that it has granted a right to use licence on the basis that the customer would not expect the entity to undertake activities that change the utility of the season 1 episodes of show XYZ. The season 1 episodes of the show have substantial standalone functionality, ie they can be broadcast by the customer without any ongoing involvement by the entity. Any ongoing promotional activities of the entity for season 2 of the show would not affect the *utility* of season 1 of the show to which the customer has rights, even though those activities might in some way affect the value of the season 1 episodes. Consequently, the entity would recognise revenue at a point in time.

29. The FASB staff have developed two ways of articulating the principles above (Articulations A and B) as explained in paragraphs 35-43 of the FASB memo.

30. The IASB staff think that Articulation A could result in the principles being incorporated into IFRS 15 largely by including an additional explanatory paragraph. The additional explanatory paragraph (paragraph 59A) could be drafted along the following lines:

B59A Activities of an entity significantly affect the intellectual property when those activities affect the utility of the intellectual property. Utility of the intellectual property is affected when either of the following criteria are met:

(a) the activities of the entity change the form (ie the design) or functionality (ie the ability to perform a function or task) of the intellectual property; or

(b) the utility of the intellectual property is substantially derived from or dependent upon those activities. For example, the utility of a brand name is typically derived from, and dependent upon, the entity's ongoing activities.

When intellectual property has significant standalone functionality, a substantial portion of its utility is derived from that functionality, and is unaffected by the entity's activities that do not change that functionality.

31. This paragraph would be incremental to the existing guidance and the staff do not think it would change the conclusions already reached by the Boards on this topic.

32. Articulation B in the FASB memo would capture the principles in paragraph 26 above by classifying intellectual property into one of two categories. That categorisation would define whether the entity's promise in granting a licence to the intellectual property includes undertaking activities to continue to support and maintain the intellectual property. Consequently, it would define whether the entity's promise is to provide a right to access or right to use the entity's intellectual property. This approach would replace the criteria in paragraph B58. The two categories of intellectual property would be as follows:

(a) *Functional intellectual property*. Intellectual property that derives a substantial portion of its utility from its standalone functionality. Functional intellectual property would generally include intellectual property such as software, biological compounds or drug formulas, and completed media content (for example, films, television shows, or music recordings). Because functional intellectual property has significant utility independent of the licensor's past or ongoing activities (and where that functionality is not changing because of the licensor's ongoing activities), the licensor's ongoing activities are not a part of an integrated promise to the customer in granting a licence. As a result, the licence is satisfied at the point in time that the intellectual property is made available for the customer's use and benefit.

(b) *Symbolic intellectual property*. Intellectual property that does not have significant standalone functionality (ie intellectual property that is not 'functional' intellectual property). Substantially all of the utility of symbolic intellectual property is derived from its association with the licensor's past or ongoing activities (including its ordinary business activities) that do not transfer a promised good or service to the customer. Symbolic intellectual property would generally include intellectual property such as brands, team names, trade names, logos, franchise rights, etc. The absence of significant independent functionality means that the utility of symbolic intellectual property is dependent on the licensor continuing to support and maintain that intellectual property (for example, a licence to a sports team's name and logo would typically have limited residual value if the team stops playing games). Therefore, the entity's promise to the customer is to both (i) grant the customer rights to use and benefit from the entity's intellectual property and (ii) continue to support and maintain the intellectual property. As a result, a licence to symbolic intellectual property is satisfied over time as the entity fulfils the totality of its promise to the customer.

33. The FASB staff think that the two articulations should result in little difference in outcomes. A difference would seem to arise when the entity licenses ‘symbolic intellectual property’ (for instance, a brand) for which the entity is not expected to undertake any significant activities (ie the utility of the brand is not dependent on the entity undertaking ongoing activities). Articulation A would classify such licences as rights to use intellectual property, whereas they would be rights to access intellectual property according to Articulation B.

34. The staff think that both Articulation A and Articulation B could provide greater clarity about the activities of an entity that significantly affect its intellectual property, although judgement would still be required under both articulations. That said, the FASB staff note that, during recent outreach, most of the outreach participants expressed a preference for Articulation B, principally for operational reasons. They viewed Articulation B as narrowing the potential population of activities that an entity would assess when determining the nature of a licence compared with Articulation A. Accordingly, in their view, Articulation B would require less judgement and should result in greater consistency in application.

35. If the IASB wishes to consider amending IFRS 15, the staff would recommend Articulation A. This is because we think:

    (a) Alternative A is more consistent with the existing basis of the licensing guidance. Articulation B would result in some licences, albeit likely in limited instances, being accounted for as rights to access licences when the intellectual property would not be expected to change over the licence period (ie the licence might not be considered to be ‘dynamic’).

    (b) Articulation A limits the amount of change to IFRS 15 and yet clarifies the guidance as described above. Articulation B would require greater change to the licensing guidance in the new revenue Standard. As noted in Agenda Paper 7A, the more significant the change to the guidance, the greater the risk of unintended consequences.

Staff recommendation

36. The staff has considered the wider implications about the risks of amending the Standard at this relatively early stage as discussed in Agenda Paper 7A. However, the extent of the discussion at the TRG meeting on this issue has highlighted the difficulties stakeholders are having at present in understanding the Boards' intentions as to where the line is between a right to use licence and a right to access licence. Because stakeholders have difficulty understanding where that line is, they find it challenging to make judgements when they apply these requirements to their contracts. In addition, the TRG discussion on this issue did not highlight any significant difference in perspectives between US and IFRS stakeholders—many IFRS stakeholders thought some clarification would be helpful. Consequently, the staff recommend that the IASB explore proposing a limited amendment to IFRS 15 along the lines of Articulation A set out in paragraph 30 of this paper, subject to the additional consultation discussed in Agenda Paper 7A.

Question 1: Determining the nature of the entity's promise in granting a licence
(a) Does the IASB agree with the staff recommendation to explore proposing a limited amendment to IFRS 15, subject to the additional consultation discussed in Agenda Paper 7A? (b) Does the IASB disagree with any of the analysis in this paper regarding determining the nature of the entity's promise in granting a licence?

Sales-based and usage-based royalties

37. Paragraph B63 specifies an exception to the general requirements for variable consideration as follows:

> Notwithstanding the requirements in paragraphs 56–59, an entity shall recognise revenue for a sales-based or usage-based royalty promised in exchange for a licence of intellectual property only when (or as) the later of the following events occurs:
>
> (a) the subsequent sale or usage occurs; and
>
> (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).

38. This exception—the royalties constraint—results in an entity potentially accounting for royalties promised in exchange for licences differently from royalties or other variable consideration related to other promised goods or services.

39. The implementation question relates to how the royalties constraint should be applied when a contract includes other promised goods or services in addition to a licence of intellectual property. For example, assume an entity licenses some intellectual property and, under the contract, is also required to provide some services to the customer. The consideration in the contract is a royalty based on the customer's sales.

40. The following interpretations about when the royalties constraint applies were discussed by the TRG:

    (a) *Interpretation A* – The royalties constraint applies whenever the royalty is in a contract that includes a licence of intellectual property, regardless of whether (i) the royalty also relates to another non-licence good or service or (ii) the licence is a separate performance obligation.

(b) *Interpretation B* – The royalties constraint applies only when the royalty relates solely to a licence of intellectual property and that licence is a separate performance obligation.

(c) *Interpretation C* – The royalties constraint applies when the royalty relates (i) solely to a licence of intellectual property or (ii) to a licence and one or more other non-licence goods or services, but the licence is the primary or dominant component to which the royalty relates.

41. In addition, the TRG members had different views about whether a single royalty should be split between a portion to which the royalties constraint would apply and a portion to which it would not (and, therefore, to which the general variable consideration guidance would apply).

Possible approaches to clarifying the issue relating to sales-based and usage-based royalties

No standard-setting action

42. The staff think that it is clear that the royalties constraint applies when:

(a) the licence of intellectual property is distinct from other promised goods or services in the contract; and

(b) the sales-based or usage-based royalty can be entirely attributed to the licence of intellectual property.

43. Based on the TRG discussions, the staff think that diversity about the application of the royalties constraint could arise in the following scenarios:

(a) the royalty relates to both a distinct licence and one or more non-licence goods or services that are distinct from the licence; or

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

44. In relation to (b), it was clear that some of the IFRS stakeholders at the TRG meeting might apply the royalties constraint when the royalty relates to a licence that is combined with other non-licence goods or services when the licence is the primary or dominant component of a performance obligation containing other

goods or services (ie similar to Interpretation C discussed by the TRG and set out above in paragraph 40 of this paper). They thought such an interpretation would be consistent with the basis set out in paragraph BC407. Paragraph BC407 explains that the criteria in paragraph B63 for distinguishing between a right to access intellectual property and a right to use intellectual property would be applicable when a licence is the primary or dominant component of a performance obligation containing other goods or services. That is because such a performance obligation would essentially still be characterised as a licence.

45. It is not clear from the TRG discussions how pervasive this issue might be for IFRS stakeholders. Based on discussions to date, the staff suspect that any diversity in practice is more likely to exist across industries, rather than within a particular industry—ie consistent industry practice is likely to develop. There is also a risk that any standard-setting action might have an effect on how some entities are already interpreting the application of the royalties constraint, which could be disruptive to the implementation process.

46. In addition, although helpful in reducing possible diversity in practice, the staff think that the narrow focus of any clarification in this respect is unlikely to resolve all questions that could arise regarding the royalties constraint. In particular, the application of the royalties constraint also requires an entity to distinguish between (a) a licence of intellectual property and a sale, and (b) royalties and other forms of consideration. The staff are aware that, in some cases, judgement is required to identify both the nature of a promise as a licence, and also that the consideration is in the form of a royalty.

47. For these reasons, the IASB could decide to take no standard-setting action at this time and continue to monitor implementation to better assess how pervasive an issue this might become.

Limited standard-setting needed

48. Alternatively, the IASB could conclude that it should undertake some limited standard-setting activity to clarify the scope of the royalties constraint and, thus, reduce the possibility of diversity developing in practice.

49. The staff have considered whether this clarity could be achieved by adding an example. Whilst an example could be helpful in some respects, the staff think that any such example would not be able to address the questions raised without *interpreting* the guidance in IFRS 15, instead of simply *illustrating* that guidance. In other words, if an example is added to address this issue, the staff think there is a risk that it would be standard setting through an example.

50. Consequently, if the IASB wishes to address the questions raised and clarify the scope of the royalties constraint, the staff think it would need to add guidance to paragraph B63 to explain when a sales-based or usage-based royalty is promised in exchange for a licence of intellectual property.

51. Paragraphs 46-55 of the FASB memo explain a proposal to do this. Again, this proposal is developed in the context of existing decisions and does not seek to re-debate the royalties constraint more fundamentally.

52. In summary the FASB memo explains that clarifying the scope would require the Boards to decide:

    (a) Whether an entity should split a royalty into a portion that is subject to the royalties constraint and a portion that is not (and, therefore, is subject to the general guidance on variable consideration); and

    (b) Whether the royalty constraint should apply:

        (i) when the royalty (or portion thereof, if the royalty is split) relates *only* to a licence that is a separate performance obligation; or

        (ii) when the predominant item to which the royalty relates is a licence.

53. If the IASB wishes to clarify the scope of the royalties constraint, the staff recommend that:

    (a) an entity should not split a royalty into a portion that is subject to the royalties constraint and a portion that is not (ie the royalty in its entirety is either in the scope or it is not); and

(b) the royalties constraint should apply when the predominant item to which the royalty relates is a licence.

This recommendation is in line with the staff recommendation in the FASB memo regarding the royalties constraint.

54. The IASB staff think that this clarification could be incorporated into IFRS 15 largely by including an additional explanatory paragraph. The additional explanatory paragraph (paragraph 63A) could be drafted along the following lines:

B63A A sales-based or usage-based royalty is promised in exchange for a licence of intellectual property when it relates only to a licence or when the licence is the predominant item to which the royalty relates.

55. The following example from the FASB memo illustrates the application of the proposed explanatory paragraph.

Example 2—Sales-based royalty in a contract that includes a licence of intellectual property and other goods or services

An entity, a movie distribution company, licences 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 addition, the entity has agreed to provide memorabilia from the filming to the customer for display at its cinemas and to sponsor radio advertisements for Movie XYZ on popular radio stations in the customer's geographic area. In exchange for providing the licence and these additional promotional goods and services, the entity will receive a portion of the operator's ticket sales for Movie XYZ (ie variable consideration in the form of a sales-based royalty).

The entity does not evaluate whether the licence and the other promotional goods and services are distinct, or whether the promise to grant the licence represents a right to access the entity's intellectual property. This is because, regardless of whether the promised goods or services are separate performance obligations or a single performance obligation, and regardless of the nature of the licence, the entity concludes that the license to show Movie XYZ is the predominant component to which the sales-based royalties relates.

> The entity concludes that there is significantly more value to the customer from the licence than from the promotional activities. Therefore, the entity recognises revenue from the sales-based royalty, the only fees to which the entity is entitled under the contract, when the customer's ticket sales occur.

56. The staff think that the benefits of such a clarification could be as follows:

    (a) It could avoid complexity for preparers and users because a royalty would not be accounted for under different models in the scenarios explained in paragraph 43 above;

    (b) It would remain consistent with the rationale in paragraph BC415 for the royalties constraint in IFRS 15; and

    (c) It could be achieved with a relatively minor change to IFRS 15.

Staff recommendation

57. The TRG discussions have highlighted that diversity could arise when applying the royalties constraint in some situations because the guidance in IFRS 15 does not address all possible scenarios (ie the royalties constraint guidance is clear in particular scenarios and not clear in somewhat more complicated scenarios). The potential diversity could be reduced by adding an explanatory paragraph to IFRS 15. On the other hand, the staff are not fully aware of the pervasiveness for IFRS stakeholders of the issue identified. On balance, however, given that the TRG discussions have identified that the guidance does not provide sufficient clarity in some scenarios, the staff recommend that the IASB explore proposing a limited amendment to IFRS 15 along the lines of what is set out in paragraph 54 of this paper, subject to the additional consultation discussed in Agenda Paper 7A.

Question 2: Sales-based and usage-based royalties
(a) Does the IASB agree with the staff recommendation to explore proposing a limited amendment to IFRS 15 subject to the additional consultation discussed in Agenda Paper 7A?
(b) Does the IASB disagree with any of the analysis in this paper regarding sales-based and usage-based royalties?

Other less significant issues

58. The following less significant issues have also been highlighted at TRG meetings:

    (a) Should an entity assess the nature of a licence if the licence of intellectual property is not distinct from other goods or services promised in the contract?

    (b) If there are restrictions on the customer's rights to use or access the entity's intellectual property (of the nature described in paragraph B62 of IFRS 15), do these restrictions affect the number of promises in the contract?

Determining when an entity should assess the nature of a licence

59. Paragraphs B55 and B56 of IFRS 15 specify that:

    B55 If the licence is not distinct, an entity shall apply paragraphs 31-38 [general guidance on satisfaction of performance obligations] to determine whether the performance obligation (which includes the promised licence) is a performance obligation that is satisfied over time or satisfied at a point in time.

    B56 If the promise to grant the licence is distinct from the other promised goods or services in the contract and, therefore, the promise to grant the licence is a separate performance obligation, an entity shall determine whether the licence transfers to a customer either 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 granting the licence to a customer is to provide the customer with either:

    (a) a right to access the entity's intellectual property as it exists throughout the licence period; or

(b) a right to use the entity's intellectual property as it exists at the point in time at which the licence is granted.

60. The TRG considered questions raised by stakeholders about whether an entity would need to consider the nature of its promise in granting a licence to the customer (ie whether the licence is a right to use intellectual property or a right to access intellectual property) when the licence is not distinct and is combined with another good or service. Some think that paragraph B55 could be read to suggest that an entity would be required to consider the nature of its promise in granting a licence *only* when the licence is distinct. Others think that in many cases an entity would be required to consider the nature of its promise in granting a licence when the licence is not distinct to appropriately (i) determine whether the combined performance obligation that includes a licence of intellectual property is satisfied over time or at a point in time; and (ii) measure progress towards complete satisfaction of that combined performance obligation.

61. For example, assume an entity grants a ten-year licence that would be considered to be a right to access intellectual property and, thus, the entity would recognise revenue over ten years. Now assume the entity provides a one-year service obligation together with that same licence, and the two are combined into a single performance obligation (because they are not distinct). Would it be appropriate to conclude that the combined performance obligation is satisfied over the one-year service period?

Possible approaches to clarifying the issue relating to determining when an entity should assess the nature of a licence

No standard-setting action

62. The IASB could conclude that no standard-setting is required to clarify when an entity should assess the nature of a licence.

63. In accounting for a licence that is combined with another good or service in accordance with the general model, an entity would need to apply judgement to (a) determine the nature of the performance obligation and (b) to select a method of measuring progress that is consistent with the clearly stated objective of

depicting the entity's performance. In making that judgement, the staff think that it was not the Boards' intentions that an entity should disregard the application guidance related to determining whether a licence is a right to use or right to access intellectual property. Therefore in some cases it could be necessary for an entity to consider the nature of the entity's promise in granting a licence even when the licence is not distinct. Paragraph BC407 also highlights that an entity would consider the nature of the entity's promise in granting the licence if the licence is the primary or dominant component of a combined performance obligation.

64. Consequently, in the example in paragraph 61 of this paper, the staff think that the guidance in the new revenue Standard would lead the entity to conclude that it would not be appropriate to recognise revenue for the combined performance obligation over the one-year service period.

Limited standard-setting needed

65. Alternatively, the IASB could conclude that it should undertake some limited standard-setting activity to clarify when an entity should assess the nature of a licence.

66. In paragraph 59(a) of the FASB memo, the FASB staff recommend making a limited amendment to the licensing guidance to highlight that, in some cases, an entity would need to determine the nature of a licence that is not distinct. That determination would be necessary in order to apply the general guidance on whether a performance obligation is satisfied over time or at a point in time and/or to determine the appropriate measure of progress. In the example in paragraph 61 of this paper, it would clarify that it would not be appropriate to conclude that the combined performance obligation is satisfied over the one-year service period.

Staff recommendation

67. Although a clarification would entail only a limited amendment, feedback from IFRS stakeholders suggested that such a clarification is not required. There is adequate guidance in the Standard to help entities determine when to assess the

nature of a licence. Consequently, the staff recommend that the IASB does not undertake standard-setting in this respect.

Contractual restrictions in licence arrangements

68. The TRG considered questions raised by stakeholders as to how some types of contractual restrictions in licensing arrangements affect the identification of the promised goods or services in the contract.

69. For example, a customer may license a television program or movie for a three-year period, but be restricted to showing that licensed content only on a specified day (eg Christmas Eve or New Year's Eve) during each of those three years. Does that contract include a promise to deliver a single licence or to deliver three licences? Assuming the licence is a right to use intellectual property, if the contract contains a single licence, then the entity would recognise revenue from that single licence at the point in time that the customer is first able to use and benefit from the content. However, if the contract contains three licences, then the entity would allocate the transaction price to those three licences, with each allocation recognised at the point in time the customer is able to use and benefit from the content under the applicable licence.

Possible approaches to clarifying the issue relating to contractual restrictions in licence arrangements

No standard-setting action

70. The IASB could conclude that no standard-setting is required to clarify whether contractual restrictions in licensing arrangements affect the identification of the promised goods or services in the contract.

71. Paragraph B62 states that restrictions of time, geographical region or use define the attributes of the promised licence, rather than define whether the entity satisfies its performance obligation at a point in time or over time. Further, paragraph BC411 explains the Boards' considerations in this regard:

> … restrictions of time, geographical region or use … define attributes of the rights transferred rather than the nature of

> the underlying intellectual property and the rights provided by the licence. Consider, for example, a term licence that permits the customer to show a movie in its theatre six times over the next two years. The restrictions in that example determine the nature of the asset that the entity has obtained (ie six showings of the movie), rather than the nature of the underlying intellectual property (ie the underlying movie).

72. Therefore, paragraphs B62 and BC411 explain that, in the example in paragraph 68, the 'airing' restriction is an attribute of the rights transferred to the customer, ie the contractual restrictions define the attributes of the licence and do not change the number of promises in the contract. Accordingly, the accounting in this example is the same as it would be if the customer had unlimited rights to air the same movie over the three-year period.

73. Consequently, the staff do not think it was the Boards' intention that a licence to show a movie on the same date over a three-year period should be treated as three licences (whether distinct or not), but instead should be treated as a single licence.

Limited standard-setting needed

74. Alternatively, the IASB could undertake limited standard-setting to clarify whether contractual restrictions in licensing arrangements affect the identification of the promised goods or services in the contract.

75. This is because the TRG discussion highlighted that in considering the example in paragraph 68, some stakeholders look to the requirement in paragraph B61. This paragraph specifies that revenue cannot be recognised for a licence that provides a right to use the entity's intellectual property before the beginning of the period during which the customer is able to use and benefit from the licence. Therefore this leads some to conclude that, in the above example, there are three licence periods and revenue should be recognised for each licence period separately.

76. Therefore, the IASB could consider adding an example to illustrate the principle in B62 and supporting explanation in BC411.

77. Alternatively, the IASB could consider amending the Application Guidance. In paragraph 59(b) of the FASB memo, the FASB staff recommend that the FASB should make a limited amendment to the application guidance to state that contractual restrictions of time, geographical region or use are attributes of the licence and do not affect the identification of promised goods or services in the contract. As a consequence, for example, an entity would not identify a different number of promised licences in a contract that grants a customer unlimited rights to use specified intellectual property for a period of time, than it would in a similar contract that restricts how often the intellectual property may be used during that period of time. This would clarify that those restrictions define the scope of the licence rather than change the number of promises in the contract.

Staff recommendation

78. Although the staff envisage that a clarification to the Application Guidance would entail adding only a sentence to paragraph B62, the staff think that the combination of the guidance in paragraph B62 and the corresponding explanation in paragraph BC411 provides sufficient guidance. Consequently, the staff recommend that the IASB does not undertake standard-setting in this respect.

Question 3: Other less significant issues
(a) Does the IASB agree with the staff recommendation not to undertake standard-setting regarding the two less significant issues discussed in paragraphs 58-77 of this paper? (b) Does the IASB disagree with any of the analysis in this paper regarding the less significant issues?

Appendix

Relevant extracts of the application guidance on licensing in IFRS 15

Licensing

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Determining the nature of the entity's promise

B57 To determine whether an entity's promise to grant a licence provides a customer with either a right to access an entity's intellectual property or a right to use an entity's intellectual property, an entity shall consider whether a customer can direct the use of, and obtain substantially all of the remaining benefits from, a licence at the point in time at which the licence is granted. A customer cannot direct the use of, and obtain substantially all of the remaining benefits from, a licence at the point in time at which the licence is granted if the intellectual property to which the customer has rights changes throughout the licence period. The intellectual property will change (and thus affect the entity's assessment of when the customer controls the licence) when the entity continues to be involved with its intellectual property and the entity undertakes activities that significantly affect the intellectual property to which the customer has rights. In these cases, the licence provides the customer with a right to access the entity's intellectual property (see paragraph B58). In contrast, a customer can direct the use of, and obtain substantially all of the remaining benefits from, the licence at the point in time at which the licence is granted if the intellectual property to which the customer has rights will not change (see paragraph B61). In those cases, any activities undertaken by the entity merely change its own asset (ie the underlying intellectual property), which may affect the entity's ability to provide future licences; however, those activities would not affect the determination of what the licence provides or what the customer controls.

B58 The nature of an entity's promise in granting a licence is a promise to provide a right to access 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 (see paragraph B59);

(b) the rights granted by the licence directly expose the customer to any positive or negative effects of the entity's activities identified in paragraph B58(a); and

(c) those activities do not result in the transfer of a good or a service to the customer as those activities occur (see paragraph 25).

B59 Factors that may indicate that a customer could reasonably expect that an entity will undertake activities that significantly affect the intellectual property include the entity's customary business practices, published policies or specific statements. Although not determinative, the existence of a shared economic interest (for example, a sales-based royalty) between the entity and the customer related to the intellectual property to which the customer has rights may also indicate that the customer could reasonably expect that the entity will undertake such activities.

B60 If the criteria in paragraph B58 are met, an entity shall account for the promise to grant a licence as a performance obligation satisfied over time because the customer will simultaneously receive and consume the benefit from the entity's performance of providing access to its intellectual property as the performance occurs (see paragraph 35(a)). An entity shall apply paragraphs 39–45 to select an appropriate method to measure its progress towards complete satisfaction of that performance obligation to provide access.

B61 If the criteria in paragraph B58 are not met, the nature of an entity's promise is to provide a right to use the entity's intellectual property as that intellectual property exists (in terms of form and functionality) at the point in time at which the licence is granted to the customer. This means that the customer can direct the use of, and obtain substantially all of the remaining benefits from, the licence at the point in time at which the licence transfers. An entity shall account for the promise to provide a right to use the entity's intellectual property as a performance obligation satisfied at a point in time. An entity shall apply paragraph 38 to determine the point in time at which the licence transfers to the customer. However, revenue cannot be recognised for a licence that provides a right to use the entity's intellectual property before the beginning of the period during which the customer is able to use and benefit from the licence. For example, if a software licence period begins before an entity provides (or otherwise makes available) to the customer a code that enables the customer to immediately use the software, the entity would not recognise revenue before that code has been provided (or otherwise made available).

B62 An entity shall disregard the following factors when determining whether a licence provides a right to access the entity's intellectual property or a right to use the entity's intellectual property:

(a) Restrictions of time, geographical region or use—those restrictions define the attributes of the promised licence, 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 unauthorised 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 licence transferred meets the specifications of the licence promised in the contract.