

Memo No. 1

**Memo**

Issue Date **February 6, 2015**

Meeting Date(s) **BM: February 18, 2015**

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Project	<b>Revenue Recognition—Licenses of Intellectual Property</b>
Project Stage	<b>Agenda Decision, Deliberations, and Permission to Ballot</b>
Issue(s)	<b>Determining the Nature of the Entity’s Promise in Granting a License; The Sales- and Usage-Based Royalties Exception</b>

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**Purpose**

1. The February 18, 2015 Board meeting is a decision-making meeting. The purpose of the Board meeting is for the Board to:
  - (a) Decide whether to add a project to its technical agenda to enact changes to the guidance on licenses of intellectual property included in ASU 2014-09, *Revenue from Contracts with Customers* (the new revenue standard)
  - (b) Select an approach to effecting changes in the guidance on licenses of intellectual property if the FASB decides to add a project on licenses of intellectual property to its technical agenda
  - (c) Grant the staff permission to begin drafting a proposed ASU for vote by written ballot.
2. This paper is structured as follows:
  - (a) Background
  - (b) Staff Analysis and Recommendations

- (i) Whether to add to Agenda
  - (ii) Determining the Nature of the Entity's Promise in Granting a License
  - (iii) Sales-Based and Usage-Based Royalties
  - (iv) Other Clarifications on Licenses
  - (v) Permission to Ballot
- (c) Appendix A – Flowchart Depicting Application of the Staff Proposal for Determining the Nature of the Entity's Promise in Granting a License
- (d) Appendix B – Licenses Guidance Currently in the New Revenue Standard

#### Questions for the FASB

1. Does the FASB want to add a project to its technical agenda to enact revisions to the licenses implementation guidance in the new revenue standard?

**The following questions only apply if the FASB answers Question #1 in the affirmative**

*Determining the Nature of the Entity's Promise in Granting a License*

2. Does the FASB agree with the staff proposal for clarifying the implementation guidance about determining the nature of the entity's promise in granting a license?
3. If the FASB agrees with the staff proposal in Question #2, which articulation (A or B) does the FASB want the staff to pursue in revising the guidance about determining the nature of the entity's promise in granting a license?

*Sales-Based and Usage-Based Royalties*

4. Does the FASB think an entity should, or should not, split a sales- or usage-based royalty into a portion subject to the royalties constraint and a portion that is not subject to the royalties constraint?
5. Which alternative (1 or 2) does the FASB want to adopt with respect to clarifying when a royalty is promised in exchange for a license of intellectual property?

*Other Minor Clarifications on Licenses*

6. Does the FASB agree with the other minor clarifications proposed by the staff about (a) when an entity should apply the guidance on determining the nature of the entity's promise in granting a license and (b) how contractual restrictions affect the identification of the promised goods or services in a contract?

*Permission to Ballot*

7. Does the FASB grant permission for the staff to draft a proposed ASU for vote by written ballot? If so, what is the comment period?

## **Background**

3. Appendix B includes the licenses implementation guidance in the new revenue standard, as well as the related discussion in the Basis for Conclusions.

### ***Determining the Nature of the Entity's Promise in Granting a License***

4. At the October 31, 2014 FASB-IASB Joint Transition Resource Group for Revenue Recognition (TRG) meeting, the TRG discussed issues stakeholders have raised about determining the nature of an entity's promise in granting a license of intellectual property (see TRG Agenda Paper No. 8 for additional detail). The principal implementation questions stakeholders have raised are about the application of the implementation guidance in the new revenue standard on determining the nature of an entity's promise in granting a license as either:
  - (a) A right to access the entity's intellectual property, which is satisfied over time and for which revenue is recognized over time, or
  - (b) A right to use the entity's intellectual property, which is satisfied at a point in time and for which revenue is recognized at a point in time.
5. The criteria for determining whether a license is a right to access the entity's intellectual property includes that the contract requires, or the customer reasonably expects, that the entity will undertake activities (*that do not transfer a*

*good or service to the customer*) that significantly affect the intellectual property to which the customer has rights.

6. Many stakeholders have suggested to the staff that the implementation guidance in the new revenue standard, as written, requires that the contractual or expected activities of the licensor must be expected to significantly change the form (for example, the design of a logo) or functionality (for example, the functions a software application can perform) of the underlying intellectual property in order for a license to represent a right to access the entity's intellectual property. In contrast, many other stakeholders have suggested that a license represents a right to access the entity's intellectual property under the new revenue standard whenever the contractual or expected activities of the licensor are expected to significantly change the form, functionality, *and/or value* of the intellectual property to which the customer has rights.
7. The following interpretations of the implementation guidance as it relates to *how* to apply the guidance on determining the nature of the entity's promise in granting a license of intellectual property have been communicated by stakeholders and were discussed at the October 31, 2014 TRG meeting:
  - (a) *Interpretation A* - For activities to significantly affect the intellectual property to which the customer has rights, those activities must be expected to change the form and/or functionality of that intellectual property. Changes that solely affect the value of the intellectual property do not significantly affect the intellectual property to which the customer has rights.
  - (b) *Interpretation B* - For activities to significantly affect the intellectual property to which the customer has rights, those activities only need to significantly affect (that is, change) the value of the intellectual property to the customer. Those activities also could significantly affect the form and/or functionality of the intellectual property, but changes to form and/or functionality are not required for an entity's activities to

significantly affect the intellectual property to which the customer has rights.

- (c) *Interpretation C* - This interpretation is the same as Interpretation B, except that the notion of "significantly affects the intellectual property" is a high threshold intended to capture those activities that effectively define the intellectual property and, therefore, can significantly change or alter the utility of that intellectual property to the customer. Interpretation C would generally not view promotional or other activities related to intellectual property that has substantial functionality, and therefore value, separate from those activities as ones that significantly affect the related intellectual property.
8. The staff notes that Entity X applying Interpretation A to its license arrangements would often reach the opposite conclusion about the nature of its promise in granting a license as Entity Y that applies Interpretation B. Entity Z, that applies Interpretation C, will reach some conclusions consistent with Entity X and some consistent with Entity Y. In other words, entities entering into substantially equivalent license arrangements are reaching significantly different accounting conclusions about how they would account those arrangements under the new revenue standard.
9. TRG members generally agreed that the guidance was unclear, and that they perceived certain pieces of the guidance to be *conflicting* within the implementation guidance and the Basis for Conclusions to the new revenue standard. Some of those excerpts would suggest changes to the intellectual property refer only to changes in the form and/or functionality of the intellectual property, while other excerpts suggest it was the Boards' intent for "changes in the IP" to include changes solely in the value of the underlying intellectual property. Most TRG members expressed the view that they think the intention of the Boards was to include, amongst those contractual or expected activities that would "significantly affect the intellectual property to which the customer has rights," activities that *significantly* change the value of the intellectual property (but do not

otherwise transfer a promised good or service to the customer) and would, therefore, be considered as to how they relate to the entity's promise to transfer the license. Many TRG members expressed the view that Interpretation C most accurately reflected what they viewed as the Boards' joint decision on licenses. However, those TRG members generally stated that Interpretation C was not apparent from the words in the new revenue standard. Some of those TRG members recalled, in expressing the view that Interpretation B is an overly expansive view of what activities "significantly affect the intellectual property to which the customer has rights," that the November 2012 staff paper that formed the initial basis for the issued licenses guidance pre-supposed that the joint decision would result in similar outcomes for "most license arrangements" as the guidance proposed in the 2011 Exposure Draft (ED). The 2011 ED licenses guidance would have recognized all licenses that were separate performance obligations as performance obligations satisfied at a point in time.

#### ***Sales-Based and Usage-Based Royalties***

10. Stakeholders have communicated different interpretations about the scope of the royalties constraint (included in paragraph 606-10-55-65 [IFRS 15, paragraph B63]). At the TRG meeting on July 18, 2014, different TRG members had different interpretations about this guidance. Three interpretations were discussed at the TRG meeting, and some TRG members expressed support for each of those three interpretations (that is, they think the guidance was written to be applied in that manner). The three interpretations as to when the royalties constraint applies that were discussed by the TRG were:
  - (a) *Interpretation A* - Whenever the royalty is in a contract that includes a license of intellectual property, regardless of whether (i) the royalty also relates to another nonlicense good or service or (ii) the license is a separate performance obligation
  - (b) *Interpretation B* - Only when the royalty relates solely to a license of intellectual property and that license is a separate performance obligation

- (c) *Interpretation C* - 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.
11. In addition, TRG members expressed that it was unclear 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).
  12. Two entities, one applying one interpretation and the other applying a different interpretation, either with respect to when the royalties constraint applies *or* whether a single royalty should be split, would likely come to very different revenue recognition conclusions for the same contract.

### ***Other Clarifications on Licenses***

13. In addition to the issues on applying the guidance about determining the nature of the entity's promise in granting a license and applying the royalties constraint, stakeholders raised the following two issues that were discussed at the October 31, 2014 TRG meeting:
  - (a) Stakeholders have raised questions about when the guidance on determining the nature of a license of intellectual property applies. For example, paragraph 606-10-55-57 [B55] could be read to suggest that an entity would consider the nature of its promise in granting a license only when the license is distinct. Some stakeholders think an entity would have to consider the nature of its promise in granting a license even when the license is *not* distinct in many cases in order to appropriately (i) determine whether a combined performance obligation that includes a license 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 if it is satisfied over time.

- (b) Stakeholders have also raised questions as to how certain contractual restrictions in license arrangements affect the identification of the promised goods or services in the contract. For example, a customer may license a well-known television program or movie for a period of time (for example, three years), but be restricted to showing that licensed content only on a specified day (for example, Christmas Eve or New Year's Eve) during each of those three years. Paragraph 606-10-55-64 [B62] explicitly states that restrictions of time, geography, or use do not affect the licensor's determination as to whether the license is satisfied over time or at a point in time. However, some stakeholders have suggested that the new revenue standard is unclear about whether, in the example above, the contract includes a promise to deliver a single license or to deliver multiple licenses.

## **Staff Analysis and Recommendations**

### ***Whether to add to Agenda***

14. The staff is of the view that *most* of the questions that have arisen about the new revenue standard should not result in standard setting. However, the staff thinks that the issues outlined above with respect to determining the nature of an entity's promise in granting a license and the royalties constraint necessitate remediation to the issued revenue guidance.
15. Because the staff has clearly heard that the guidance can be interpreted very differently by reasonable people, resulting in different accounting outcomes for the same set of facts and circumstances, and because the staff thinks substantive improvements can be developed and enacted in a reasonable timeframe that will significantly mitigate those interpretive issues, the staff recommends that the FASB add a project to its technical agenda to enact improvements to the guidance on licenses of intellectual property that would address each of the issues outlined above.



### *Effects on Convergence*

16. The staff is aware that the IASB may or may not add a project to its technical agenda to enact revisions to the guidance in the new revenue standard on licenses of intellectual property in the short term. The IASB also might decide to add a project to its agenda, but not include all of the issues identified above. Lastly, even with respect to issues that both the IASB and the FASB agree to include within the scope of a project on licenses of intellectual property, the IASB might adopt a different revision than that selected by the FASB.
17. It is important to understand that the staff thinks the revisions proposed in this paper represent *clarifications* to the new revenue standard, rather than any fundamental change to the decisions that underlie the standard. Therefore, the staff does not think enacting those clarifications represents de-convergence in financial reporting outcomes.
18. Because the staff proposal for revisions to the guidance on determining the nature of the entity's promise in granting a license represent clarifications to enhance operability and understandability of the issued guidance, rather than a revision to the underlying principle, an entity applying IFRS should, in most cases, come to the same conclusions as an entity applying the staff proposal for revisions to Topic 606. The staff further notes that, under IFRS (IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*), entities are allowed to look to other GAAP in applying the principles in IFRS so long as that guidance does not conflict with IFRS. Therefore, some entities may look to the guidance in Topic 606 if it enhances the operability of the new revenue standard in this area.
19. The Boards (if each adds a project to its respective technical agendas) might decide on non-converged *language* even if they adopt the staff proposal on approach (for any issue in this paper). The staff thinks convergence should not be judged by the similarity of the words, but rather by the consistency of the accounting outcomes. The staff notes that the Boards have implicitly acknowledged this in deciding to use different quantitative terms to explain the

- constraint on variable consideration. The FASB used the term “probable”, while the IASB used the term “highly probable” to effect similar accounting outcomes.
20. The staff does not think the issued guidance truly represents a converged answer, if an entity can validly come to one conclusion based on the guidance and another entity (whether a U.S. or an international entity) can validly come to the opposite conclusion. In other words, the staff does not think convergence is achieved just because both constituencies (U.S. and international) have similar interpretive issues and inconsistencies in application, especially if it is possible (or likely) that practice and/or regulatory intervention/guidance might resolve the interpretive issues differently in different jurisdictions. Therefore, a change to the words does not necessarily mean the accounting will be less converged than prior to enacting the revisions.

### ***Determining the Nature of the Entity’s Promise in Granting a License***

#### ***Premise Underlying the Licenses Guidance***

21. Implicit to the licenses implementation guidance in the new standard (and is retained in the staff clarification proposal outlined later in this paper) is that intellectual property is inherently different from other goods or services because of its uniquely divisible nature. The licenses guidance in the new revenue standard recognizes that intellectual property can be licensed to multiple customers at the same time (for example, franchise rights or rights to use an entity's brand name or logo can be licensed to multiple customers concurrently), and/or can continue to be used by the entity during the license period for its own benefit (for example, a sports team continues to use its team name and logo throughout the license period so that it can continue to play games and sell tickets or television rights to those games). Therefore, a customer, in entering into a license contract, may reasonably expect the entity to undertake activities from which it (that is, the customer) would expect to derive substantial benefit, and that significantly affect its license, but that do not transfer a promised good or service specifically *to that customer* (that is, the activities also benefit the entity and/or its other licenses).

22. The licenses implementation guidance is premised on the view that the entity's promise to undertake activities to continue to support and maintain the intellectual property is an inseparable component of its larger promise to the customer in granting the license *when those activities have the potential to significantly affect the customer's ability to benefit from the license*. The notion that the promise to undertake the activities that *significantly* affect the customer's ability to benefit from the license are inseparable from the entity's promise to transfer the license is, in the staff's view, broadly consistent with the overall separation guidance in Step 2 of the new revenue model. The core separation guidance would similarly indicate that where the customer's ability to benefit from each component of the entity's overall promise in granting the license (that is, both making the underlying intellectual property available for the customer's use *and* undertaking activities to support and maintain the licensed intellectual property) is significantly affected by the other, that those components of the promise are inseparable.

#### *Interaction with Remainder of the Revenue Model*

23. The staff thinks it is important to remember that whether licensing revenue is recognized over time or at a point in time will often depend on aspects of the new revenue model *other than* the guidance on determining the nature of the entity's promise in granting the license.
24. In particular, there are two aspects of the new revenue model that would often result in the consideration transferred in exchange for a license being recognized over time regardless of the entity's determination as to the nature of its promise in granting a license of intellectual property.
25. First, the separation model (that is, applying Step 2 of the revenue model) will often result in the conclusion that a license is not separable from a service obligation that is satisfied over time. In those cases, the combined performance obligation (that is, the performance obligation that includes the license and the service) would be satisfied over time. For example:

- (a) Example 55 in the new revenue standard (paragraphs 606-10-55-364 through 55-366 [IE278 through IE280]) illustrates a scenario in which the entity's promise in granting a license to the customer is inseparable from the entity's promise (an additional service in the contract) to provide updates/upgrades "that may be developed" to the customer. In that example, the nature of the entity's promise in granting the license does not matter; the *two* promises (that is, to provide the license and to provide updates/upgrades to the licensed intellectual property) are a single performance obligation that is satisfied over time because the customer consumes and receives benefits from that performance obligation over the license period.
- (b) Example 11 (Case B) in paragraphs 606-10-55-146 [IE54] through 55-150 [IE58] illustrates a scenario in which the entity's promise in granting a software license is inseparable from the entity's promise to significantly customize the customer's instance of that software (in this example, the customizations will add new functionality). In that example, the two promises (that is, to provide the license and to significantly customize the functionality of that software for the customer) are a single performance obligation. Example 11 (Case B) does not conclude whether the single performance obligation would be satisfied over time; it only refers to guidance in other parts of the revenue model. However, the staff thinks that in most scenarios of this nature, the entity will conclude the single performance obligation is satisfied over time either (i) because the customer controls the asset (that is, the license) as it is being modified/customized or (ii) because the entity's performance does not create an asset with alternative use to the entity and the entity has an enforceable right to payment for performance completed to-date. The staff further notes that even if the single performance obligation did not qualify to be recognized over time, the *point in time* at which the single performance obligation would be satisfied would not be the upfront point in time that the initial

license is granted; it would likely be the point in time when the customization services were complete.

- (c) Example 56 (Case A) in paragraphs 606-10-55-368 [IE282] through 55-370 [IE284] illustrates a scenario in which the entity's promise in granting a pharmaceutical license is inseparable from the entity's promise to manufacture the drug product for the customer. In that example, the two promises (that is, to provide the license and to provide specialized manufacturing services) are a single performance obligation. Similar to Example 11 (Case B), this example does not conclude whether the single performance obligation would be satisfied over time; it only refers to guidance in other parts of the revenue model. However, the staff thinks it is likely the entity in this example would conclude that the customer will simultaneously consume and receive benefit from the entity's performance in satisfying the single performance obligation; and therefore, that the entity would recognize revenue from satisfying this performance obligation over time.
26. In addition to the examples included in the new revenue standard, the staff thinks there are many other instances in which an entity's promise to grant a license of intellectual property will not be separable from other promises the entity makes *to the customer* in the contract. In those cases where the license is inseparable from other promises to the customer in the contract, as in the examples from the new revenue standard outlined above, the entity might not recognize license revenue upfront at the point in time it makes the underlying intellectual property available for the customer's use and benefit.
27. Second, the royalties constraint (discussed further later in this paper) would often result in consideration promised in exchange for a license being recognized over time. If the consideration promised in exchange for a license is in the form of a sales- or usage-based royalty, then the consideration is recognized as revenue over time as the customer's subsequent sales or usage occur.

*Staff Proposal (which would be enacted through Articulation A or Articulation B)*

28. The staff proposal does not revisit the core premise of the accounting approach to licenses of intellectual property included in the new revenue standard, and it does not change the fact that, under the new revenue guidance, some licenses would be recognized over time and some licenses would be recognized at a point in time. However, the staff proposal would attempt to more clearly articulate the guidance in the new revenue standard to enhance operability and to ensure a more consistent application to similar facts and circumstances.
29. The aim of the revised guidance would be to more clearly delineate (as compared to the guidance in the new revenue standard) when an entity's promise to the customer in granting a license is to *both*:
  - (a) Grant the customer rights to use and benefit from the entity's intellectual property by making its intellectual property available for the customer's use; and
  - (b) Continue to support and maintain the intellectual property to which the customer has rights.
30. The staff proposal would more clearly articulate, as compared to the issued implementation guidance, that the entity's promise to the customer in granting a license includes undertaking activities (*that do not transfer a good or service to the customer* – for example, the service of providing updates/upgrades in Example 55 to the new revenue standard or the software customization services in Example 11 are not “activities” to evaluate when determining the nature of the entity's promise in granting a license because they are promised services to the customer in each contract) to continue to support and maintain the licensed intellectual property when the *utility* (that is, the ability to fulfill a desired role or function) of that intellectual property is *significantly* affected by the performance or non-performance of those activities. In that case, the customer's ability to derive benefit from the license is highly dependent on the entity's continuing activities to support and maintain the intellectual property.

31. Because the entity's ongoing activities to support and maintain the intellectual property (which are not themselves *another* promise to the customer in the contract) *significantly* affect the utility of the intellectual property to the customer, its promise to continue to support and maintain its intellectual property is an inseparable component of its promise to the customer. Therefore, the entity satisfies that integrated promise over time as it fulfills the totality of its promise to the customer in granting the license.
32. The staff proposal would also clarify that an entity's ongoing activities to support or maintain its intellectual property do *not* significantly affect the utility of the intellectual property to which the customer has rights when that intellectual property has significant standalone functionality (that is, the ability to process a transaction, perform a function or task, or be played or aired). When intellectual property has significant standalone functionality, a substantial portion of its utility is derived from that functionality, and that utility is unaffected by an entity's activities that do not *change* that functionality. In contrast, the utility of intellectual property that has minimal, or no, standalone functionality, and is therefore principally "symbolic" in nature (for example, a brand, a trade name, or a logo), is typically derived from, and maintained by, the entity's ongoing activities that support and maintain the intellectual property. Therefore, the entity's activities that support and/or maintain "symbolic" intellectual property significantly affect the utility of that intellectual property.
33. Appendix A is a flowchart outlining how the staff proposal would be applied in determining the nature of the entity's promise in granting a license. Appendix A demonstrates how the staff proposal would be applied under either articulation of the staff proposal.
34. The staff thinks that the clarifications to the issued guidance would address the following key concerns that many stakeholders have raised about the licenses guidance and would reduce the amount of judgment necessary to apply the licenses requirements:

- (a) The basis for the “line” between those licenses that are satisfied over time and those that are satisfied at a point in time is unclear. This is because it is unclear whether, under the issued guidance, an entity’s ongoing activities have to significantly affect (i) the form and/or functionality of the intellectual property or (ii) the form, functionality, and/or value of the intellectual property to result in revenue recognition over time. The revisions that would be enacted under the staff proposal would clarify that the entity’s promise to the customer includes a promise to support and maintain the intellectual property to which the customer has rights when that promise significantly affects the utility of the intellectual property to the customer. The notion of utility would be drafted so as to clearly encompass effects on form, functionality, *and/or* value. This clarification would better **define** the “line.”
- (b) It is unclear when the entity’s expected activities “significantly affect” the intellectual property to which the customer has rights and, therefore, where the “line” exists between licenses that are satisfied over time and those that are satisfied at a point in time. The revisions outlined above that would be enacted under the staff proposal would more clearly **delineate** where the “line” is between expected activities that *significantly* affect the utility of the intellectual property and other activities that do not *significantly* affect the utility of the intellectual property. The staff thinks licensors would generally know whether their intellectual property that is licensed to the customer does, or does not, have significant standalone functionality, and that determination will guide the over time versus point in time conclusion.
- (c) The premise of the licenses guidance would be more clearly focused on the extent of the entity’s promise to the customer (that is, does the promise to the customer include both a promise to grant a license and to undertake activities to continue to support and maintain the underlying intellectual property).



## Articulation A

35. This articulation of the staff proposal would make more minor changes to the wording of the licenses guidance in the new revenue standard. This articulation would continue to focus on defined criteria that are substantially unchanged from those in paragraph 606-10-55-60 [B58] in order to determine when the contract requires, or the customer reasonably expects, that the entity will undertake activities (that do not transfer a promised good or service to the customer) to change, support, and/or maintain the intellectual property to which the customer has rights under the license.
36. This articulation would:
- (a) Introduce the term “utility” to the guidance and would define that term as “the ability to fulfill a desired role or function” to enhance consistency in application. The criteria in paragraph 606-10-55-60 [B58] would evaluate whether the contract requires, or the customer reasonably expects, that the entity will undertake activities (that do not, themselves, transfer a promised good or service to the customer – as defined in paragraphs 606-10-25-16 [24] through 25-18 [26]) that significantly affect the *utility* of the intellectual property to which the customer has rights.
  - (b) Introduce explanatory guidance, such as that already included in paragraph 606-10-55-61 [B59] about when a customer would reasonably expect that an entity will undertake activities, to clarify when expected activities of the entity “significantly affect” the utility of intellectual property. As outlined above, this explanatory guidance would clarify that an entity’s ongoing activities do *not* significantly affect the utility of the intellectual property to which the customer has rights when that intellectual property has significant standalone functionality (that is, the ability to process a transaction, perform a function or task, or be played or aired), unless those activities will change that functionality (and the customer is directly exposed to those

changes because it only has rights to the current version of the intellectual property).

- (c) Realign the “principle” of the licenses guidance around the notion of identifying the extent of the entity’s promise in granting the license. The staff thinks this articulation of the “principle” would follow, and explain, the criteria in paragraph 606-10-55-60 [B58], rather than precede it. The staff thinks this would more appropriately emphasize the criteria as the basis for the “line.”

### Articulation B

- 37. Rather than specifically identifying contractually-required or otherwise expected activities through the paragraph 606-10-55-60 [B58] criteria, this alternate articulation would classify intellectual property into one of two categories, and that category would define whether the entity’s promise in granting a license to that intellectual property includes undertaking activities to continue to support and maintain the intellectual property:

- (a) *Functional Intellectual Property* – Intellectual property that derives a substantial portion of its utility from its standalone functionality (as defined above). 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). A licensor's ongoing activities (that do not transfer a promised good or service to the customer) may affect the utility of functional intellectual property, but because of the intellectual property's inherent (or built-in) functionality, would not be considered to *significantly* affect that utility. 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 license. As a result, the license 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 (that is, 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 brand, team, or trade names; logos; and franchise rights. 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 license to a sports team’s name and logo will typically have limited residual value if the team quits playing games). Therefore, consistent with the overall premise of the staff proposal (and the issued guidance in the new revenue standard), the entity's promise to the customer is to both grant the customer rights to use and benefit from the entity's intellectual property and make that underlying intellectual property available for the customer’s use *and* to continue to support and maintain the intellectual property. As a result, a license to symbolic intellectual property is satisfied over time as the totality of its promise to the customer is fulfilled.
38. The staff conducted outreach meetings in December 2014 with respect to the staff proposal, and gave stakeholders included in our outreach (accounting practitioners and preparers from highly-affected industries such as entertainment and media, life sciences, and software, including public and private stakeholders) with initial drafting of each of the two articulations outlined above. Nearly all of the outreach participants expressed the view that the staff proposal, under either articulation, represented an improvement and would be clearer to apply than the implementation guidance in the new revenue standard. No participants expressed

the view that the issued guidance is easier to apply or clearer than the staff proposal.

39. The outreach participants were asked whether the proposed revisions better *defined* the line (that is, whether it resolved the issue of form and/or functionality only versus form, functionality, *and/or* value), as well as whether the proposed revisions better *delineated* the line (that is, set out more clearly where the line exists such that it would be clearer which license arrangements would reside on either side of that line).
  - (a) *Defining the line* - Outreach participants expressed that they understood, under either articulation, how to define the line (that is, the participants thought it would now be clear that changes, or potential changes, in value factored into the evaluation of whether the entity's promise includes a promise to support and maintain the intellectual property to which the customer has rights).
  - (b) *Delineating the line* – Outreach participants expressed the view that the staff proposal delineated the line more clearly than the issued licenses guidance. However, most participants (including the minority that had an overall preference for Articulation A), expressed the view that Articulation B would more clearly delineate the line and, therefore, would be more operational than Articulation A and result in less judgment in application and more consistent results among entities.
40. Stakeholders have communicated that the principal challenges in applying the issued licenses guidance are:
  - (a) Identifying the activities that a customer might “reasonably expect” the entity to undertake; and
  - (b) Determining whether those activities “*significantly* affect the intellectual property.”
41. Most of the outreach participants expressed the view that Articulation B would be more operational to apply than Articulation A because the presumptions created

under Articulation B that are based on the type of intellectual property being licensed (that is, either “functional” or “symbolic”) would remove the judgments in (a) and (b) above for most licensing contracts. Once the entity defines its intellectual property as functional or symbolic, the nature of its promise in granting licenses to that intellectual property would be “fixed.” Articulation A, while clarifying the issued licenses guidance, would still require a contract-by-contract analysis of whether the entity is expected to undertake activities and whether those activities significantly affect the utility of the licensed intellectual property.

42. The staff acknowledges that Articulation B would still require an entity to consider whether the intellectual property itself (that is, its form and/or functionality) is expected to change because that directly affects whether the customer controls a license when it is granted; however, stakeholders have generally not communicated that it would be difficult to identify those activities that would change the form and/or functionality of the intellectual property. That population of potential activities is much narrower than the population of activities that could affect the value of the intellectual property to the customer. In addition, the staff thinks an entity ordinarily would more readily know whether it expects to undertake activities that will change the IP itself as part of its management of the business. It is identifying the “indirect” activities that may, or may not, have a significant effect on the *value* of the intellectual property that has been communicated as much more challenging, and this process would largely be eliminated under Articulation B.
43. Overall, most of the outreach participants expressed a preference for Articulation B, primarily for the operability reasons outlined above. However, some outreach participants preferred Articulation A. This preference appeared to be principally conceptual in nature. Those participants expressed the view that the contract is the unit of account in the new revenue standard and, therefore, establishing the nature of the entity’s promise based, not on the contract with the customer, but based on the type of intellectual property being licensed, would be inconsistent with the revenue model. Those participants also noted, despite the fact that the

expected differences in outcomes between Articulation A and Articulation B are *very* minimal in terms of the number of possible licensing arrangements in which a different answer would result, that in those few instances, they did not agree with the outcome under Articulation B.

### *Staff Recommendation*

44. If the FASB decides to add a project to its technical agenda, the staff recommends the FASB clarify the licenses guidance in the new revenue standard in accordance with the staff proposal. The staff recommendation is based on the following:
  - (a) The staff’s outreach with practitioners and preparers significantly affected by the licenses guidance has demonstrated that the staff proposal can resolve the operability and understandability issues stakeholders have raised about the licenses guidance in the new revenue standard (that is, the staff proposal can improve how the “line” is *defined* and *delineated*). The staff views the proposal as a “targeted” solution that resolves the issues that have been raised without re-opening the accounting for licenses as if the final standard were another exposure draft.
  - (b) The staff thinks the proposal reasonably reflects when an entity’s promise to the customer in granting a license encompasses more than just a promise to make the underlying intellectual property available for the customer’s use. The staff understands that not everyone will agree on when that is the case, but think the staff proposal provides a reasonable, and operable, basis upon which to make that determination.
45. The staff recommends that the FASB adopt the staff proposal in the manner of Articulation B. While the staff thinks (and it would be their intention) that differences in outcomes between Articulation A and Articulation B would be *very* minor, the staff thinks (and heard this confirmed through outreach with primarily U.S. stakeholders) that Articulation B will more adequately address U.S. needs for clarity and consistent application.

### ***Sales-Based and Usage-Based Royalties***

46. This section addresses the following two issues with respect to the royalties constraint:
- (a) First, whether the FASB thinks an entity should split a single royalty into a portion subject to the royalties constraint and a portion that is not subject to the royalties constraint (and, therefore, would be subject to the general guidance on variable consideration).
  - (b) Second, how the FASB wants to define when “a sales-based or usage-based royalty is promised in exchange for a license of intellectual property” (that is, the scope of the royalties constraint).

### ***Splitting a Royalty***

47. Some stakeholders have interpreted the royalties constraint guidance in the new revenue standard as requiring an entity to split a single royalty (for example, a single royalty would be when an entity will earn CU10 for each transaction processed, unit produced, or unit sold by its customer) into a portion subject to the royalties constraint and a portion that is not subject to the royalties constraint. Other stakeholders do not think that was the Boards’ intent. Both groups of stakeholders think the new revenue standard is unclear in this respect.
48. Accounting for a portion of a royalty in accordance with the royalties constraint and the remainder in accordance with the general guidance on variable consideration would be more complex than accounting for that payment stream entirely in accordance with either one of those requirements. By way of example, assume a single usage-based royalty stream of CU10/unit produced by the entity’s customer. Assume that single payment is for (a) a license with a standalone selling price of CU600,000 and (b) a significant additional good with a standalone selling price of CU400,000. Both the license and the good are transferred to the customer at contract inception and are separate performance obligations. If the entity were to split the royalty, the staff thinks the accounting would be as follows:

- (a) At contract inception, the entity would be required to estimate the amount of royalties to which it expects to be entitled (assume CU1,000,000) and would then consider the *general* constraint on variable consideration. Assume the entity concludes that CU500,000 of estimated variable consideration should not be constrained.
  - (b) Upon transfer of the license and the good, the entity would recognize CU200,000 in revenue for the good performance obligation (CU500,000 unconstrained transaction price x [standalone selling price of the good/standalone selling price of the good and the license in aggregate]).
  - (c) As the customer's subsequent production occurs, the entity would recognize CU6 (60% of CU10 royalty earned) in revenue for the license performance obligation in accordance with the royalties constraint, while concurrently evaluating whether that production (or other events or circumstances) change the transaction price. The transaction price could change because the production or other events/circumstances might either, or both, change the entity's estimate of variable consideration to which it will be entitled *or* the amount of that estimate that should be constrained. If the entity were to conclude that the unconstrained amount of variable consideration to which the entity expects to be entitled is CU600,000 at the end of the reporting period, it would recognize an additional CU40,000 in revenue allocated to the good.
49. The staff does not think this additional complexity (that is, accounting for a single variable consideration arrangement in accordance with *two* recognition models) would provide more useful information to financial statement users than would result from accounting for the variable consideration solely in accordance with either recognition model. The Boards observed in the Basis for Conclusions (BC415) that the general guidance on variable consideration would not result in relevant information to users for contracts in which the sales-based or usage-based



royalty is paid over a long period of time. However, some stakeholders think *any* constraint (the general constraint or the royalties constraint) will result in delayed revenue recognition to later periods, thereby disassociating reported revenue from the entity's performance in satisfying a performance obligation. A split royalty, such as in the example outlined above, will satisfy neither constituency. This is because the amount recognized at contract inception will reflect neither (i) the amount to which the entity expects to be entitled based on its performance, nor (ii) amounts to which the entity has become legally entitled during the period.

50. Some have suggested that if the entity were to account for the entire royalty in the example above in accordance with the royalties constraint, then the entity would recognize a loss at the point of sale of the good (no recognition of revenue while recognizing cost of sales for the good), which does not reflect the margin it actually is entitled to for that sale. The staff understands the point, but notes that this outcome generally would not be possible under either approach to determining *when* a royalty is promised in exchange for a license proposed by the staff in the next section. It would generally not be possible, under the alternatives proposed, to conclude that the royalties constraint would apply to a royalty that relates to a *significant* good. Thus, the general variable consideration guidance, rather than the royalties constraint, would apply to any sale of a significant good. However, the staff notes a negative margin would still be recognized at the time of sale under the general variable consideration guidance if it was not probable [highly probable] that the estimated variable consideration would not later be reversed.
51. In summary, the staff does not think splitting a royalty will provide better information for users, but would introduce significant additional cost and complexity for preparers. Therefore, the staff recommends the FASB clarify that with respect to a single royalty, it is either within the scope of the royalties constraint or it is not.

### *When a Royalty is Promised in Exchange for a License*

52. If the FASB agrees with the staff recommendation *not* to split a royalty (that is, the FASB concludes that a royalty should not be split into a portion subject to the royalties constraint and a portion that is not subject to the royalties constraint), the staff proposes the following two alternatives for determining when a royalty is “promised in exchange for a license of intellectual property”:
- (a) *Alternative 1* – The royalties constraint would apply only when the royalty relates to a license that is a separate performance obligation.
  - (b) *Alternative 2* – The royalties constraint would apply whenever the predominant item to which the royalty relates is a license of intellectual property.

#### Staff Analysis

53. Alternative 1 requires less judgment in determining the applicability of the royalties constraint to the royalty arrangement. This is because Alternative 2 includes the additional requirement to determine whether a license is the predominant component of a combined performance obligation (that is, a performance obligation that includes a license and another non-license good or service), and that evaluation might be subjective.
54. In contrast, Alternative 2 would result in application of the more operable royalties constraint, rather than the general variable consideration guidance, to more contracts. Alternative 1 would more frequently result in entities having to estimate variable consideration resulting from sales- and usage-based royalties over significant license periods.
55. The staff does not propose to add significant guidance to the standard to define when a license is the “predominant” item to which the royalty relates, but the staff thinks that the FASB *could* provide examples to demonstrate application of the concept and/or could clarify that, in general, a license would be considered the predominant item to which the royalty relates when the customer would ascribe

significantly more value to the license than to the other goods or services to which the royalty relates.

### Staff Recommendation

56. The staff recommends Alternative 2. The staff thinks the accounting for a royalty in accordance with the royalties constraint is inherently less complex than accounting for a royalty in accordance with the general variable consideration guidance. Therefore, the staff thinks that Alternative 2 is favorable because it would result in entities applying that more operable guidance to more licensing arrangements, which is part of the reason the Boards included the exception in the new revenue standard. More importantly, Alternative 2 would appear to provide more useful information to financial statement users. BC415 in the new revenue standard states that the royalties constraint would generally provide more useful information to users in licensing arrangements that contain sales- or usage-based royalties; therefore, the staff thinks that applying the royalties constraint to those royalty arrangements in which the license is the *predominant* feature to which that royalty relates would provide more useful information to those users that are likely to view these arrangements *as* licensing arrangements.
57. The staff acknowledges that applying Alternative 2 would require the use of more judgment than Alternative 1 when determining whether the royalties constraint applies (that is, the scope of this exception). However, the staff thinks estimating the sales- or usage-based royalty in a combined performance obligation that includes a license often would require significantly more judgment than applying Alternative 2. In other words, both Alternatives 1 and 2 would require an entity to apply judgment to account for the contract, and in the staff's view, significantly more judgment often would be needed to account for a contract if the Board selects Alternative 1 than Alternative 2.
58. The following example demonstrates how the staff thinks our recommendation with respect to scope and application of the royalties constraint would apply:

**>>> Example —Sales-Based Royalty in a Contract that Includes a License and Other Goods or Services**

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 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 license and the additional promotional goods and services, 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 does not evaluate whether the license and the other promotional goods and services are distinct, or 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. 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 license, the entity concludes that the license to show Movie XYZ is the predominant component to which the sales-based royalty relates. The entity concludes that there is significantly more value to the customer from the license than from the promotional activities. Therefore, the entity will recognize 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.

**Other Clarifications on Licenses**

59. In addition to enacting the changes outlined above with respect to determining whether an entity's promise in granting a license is satisfied over time or at a point in time and accounting for sales- and usage-based royalties, the staff recommends that the FASB also address the concerns outlined earlier in this paper about (i) *when* an entity must determine the nature of its promise in granting a

license and (ii) whether contractual restrictions in a license affect the entity's identification of its promises in the contract. Specifically, the staff recommends that the revisions enacted to the licenses guidance clarify that:

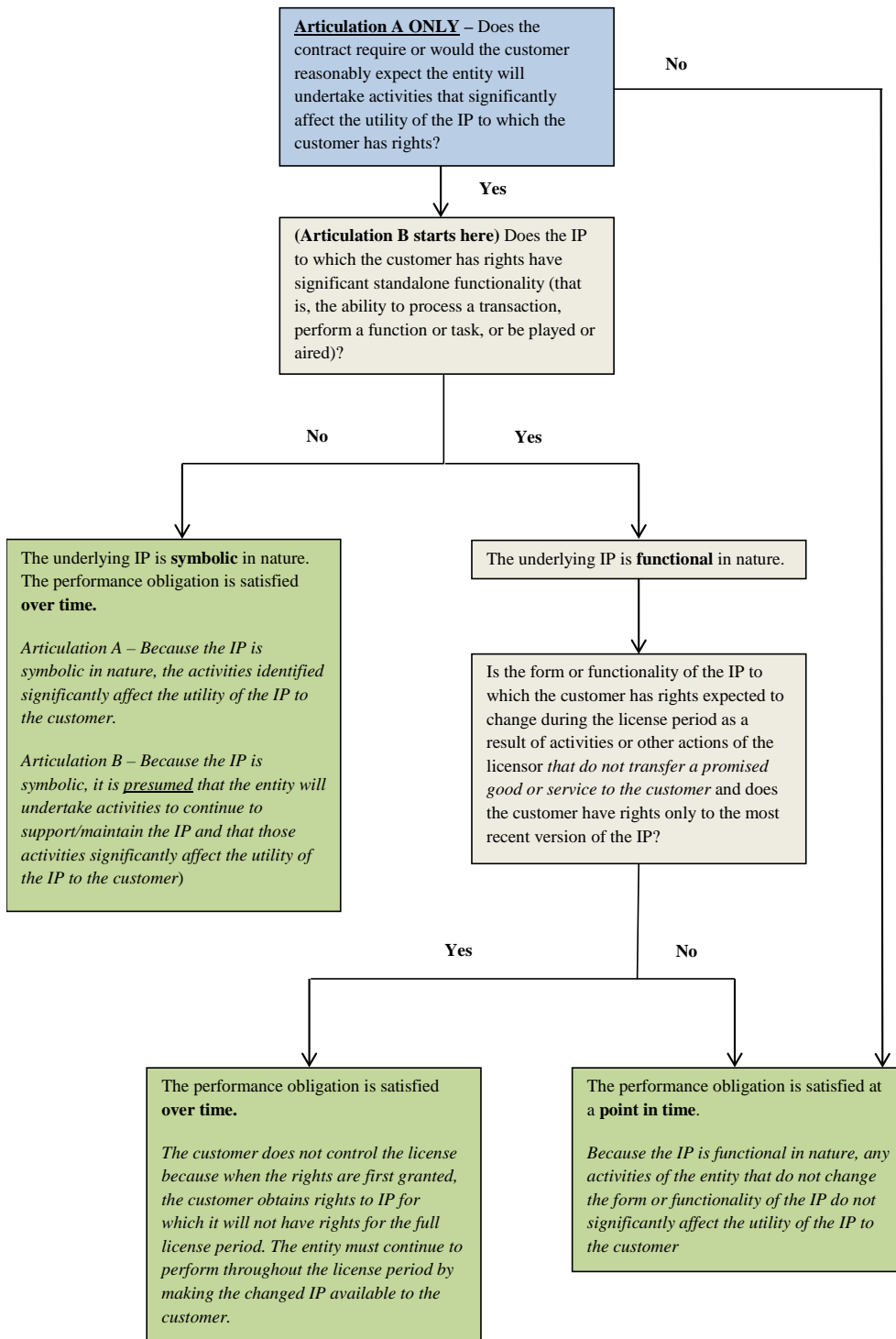
- (a) In some cases, an entity would need to determine the nature of a license that is not a separate performance obligation in order to appropriately apply the general guidance on whether a performance obligation is satisfied over time or at a point in time and/or to determine the appropriate measure of progress for a combined performance obligation that includes a license. For example, if an entity grants a ten-year license that is not distinct from a one-year service arrangement, it would not be appropriate to conclude that the combined performance obligation is satisfied over the one-year service period if the nature of the entity's promise in granting the license would be that of a right of access (that is, satisfied over time) if the license were a separate performance obligation.
  - (b) Contractual restrictions (for example, restrictions on how frequently or when a movie can be aired) of the nature described in paragraph 606-10-55-64 [IFRS 15, paragraph B62] are attributes of the license and do not affect the identification of promised goods or services in the contract. For example, an entity would not identify a different number of promised licenses in a contract that grants a customer unlimited rights to use specified intellectual property for a defined period of time than it would in a similar contract that restricts how often the intellectual property may be used during the license period. The Board should clarify that those restrictions define the scope of the license, rather than change the number of promises in the contract.
60. While those issues are more minor than the other two licensing issues discussed in this paper, the issues have been raised as important to certain industries and/or types of transactions. Therefore, if the FASB decides to add a project on licenses to its technical agenda, the staff recommends that the minor clarifications outlined

above be included in the proposed ASU. The staff notes that those clarifications can be enacted with only minor wording changes/additions to the issued guidance.

***Permission to Ballot***

61. The staff requests that the Board grant permission to draft a proposed ASU for vote by written ballot.
62. The staff thinks that the staff recommendations in this paper would benefit both preparers and users. The staff recommendations would reduce the costs of implementation and ongoing compliance/application of the new revenue standard for preparers by making the guidance more understandable and operational, while the enhanced consistency and comparability that should result from the clarifications proposed herein should ensure users receive more comparable financial information.
63. The staff thinks there are minimal, if any, costs to issuing the revised guidance because U.S. entities have not adopted this guidance. In fact, the staff thinks the guidance will decrease the implementation cost for entities that have significant license arrangements.
64. The transition requirements and effective date of any final guidance issued as a result of this potential project would be the same as the transition requirements and effective date of the new revenue standard.

## Appendix A - Flowchart Depicting Application of the Staff Proposal for Determining the Nature of the Entity’s Promise in Granting a License



## Appendix B – Licenses Guidance Currently in the New Revenue Standard

A1. The following implementation guidance (exclusive of the illustrative examples), and related Basis for Conclusions, is included in the new revenue standard (guidance references are to the U.S. GAAP guidance in Topic 606):

### > > Licensing

**606-10-55-54** A license establishes a customer's rights to the intellectual property of an entity. Licenses of intellectual property may include, but are not limited to, 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.

**606-10-55-55** In addition to a promise to grant a license to a customer, an entity may also promise to transfer other goods or services to the customer. Those promises may be explicitly stated in the contract or implied by an entity's customary business practices, published policies, or specific statements (see paragraph 606-10-25-16). As with other types of contracts, when a contract with a customer includes a promise to grant a license in addition to other promised goods or services, an entity applies paragraphs 606-10-25-14 through 25-22 to identify each of the performance obligations in the contract.

**606-10-55-56** If the promise to grant a license is not distinct from other promised goods or services in the contract in accordance with paragraphs 606-10-25-18 through 25-22, an entity should account for the promise to grant a license and those other promised goods or services together as a single performance obligation. Examples of licenses that are not distinct from other goods or services promised in the contract include the following:



- a. A license that forms a component of a tangible good and that is integral to the functionality of the good
- b. A license that the customer can benefit from only in conjunction with a related service (such as an online service provided by the entity that enables, by granting a license, the customer to access content).

**606-10-55-57** If the license is not distinct, an entity should apply paragraphs 606-10-25-23 through 25-30 to determine whether the performance obligation (which includes the promised license) is a performance obligation that is satisfied over time or satisfied at a point in time.

**606-10-55-58** If the promise to grant the license is distinct from the other promised goods or services in the contract and, therefore, the promise to grant the license is a separate performance obligation, an entity should determine whether the license transfers to a customer either at a point in time or over time. In making this determination, an entity should consider whether the nature of the entity's promise in granting the license 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 license period
- b. A right to use the entity's intellectual property as it exists at the point in time at which the license is granted.

**> > > Determining the Nature of the Entity's Promise**

**606-10-55-59** To determine whether an entity's promise to grant a license 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 should consider whether a customer can direct the use of, and obtain substantially all of the remaining benefits from, a license at the point in time at which the license is granted. A customer cannot direct the use of, and obtain substantially all of the remaining benefits from, a license at the point in time at which

the license is granted if the intellectual property to which the customer has rights changes throughout the license period. The intellectual property will change (and thus affect the entity's assessment of when the customer controls the license) 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 license provides the customer with a right to access the entity's intellectual property (see paragraph 606-10-55-60). In contrast, a customer can direct the use of, and obtain substantially all of the remaining benefits from, the license at the point in time at which the license is granted if the intellectual property to which the customer has rights will not change (see paragraph 606-10-55-63). In those cases, any activities undertaken by the entity merely change its own asset (that is, the underlying intellectual property), which may affect the entity's ability to provide future licenses; however, those activities would not affect the determination of what the license provides or what the customer controls.

**606-10-55-60** The nature of an entity's promise in granting a license 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 606-10-55-61).
- b. The rights granted by the license directly expose the customer to any positive or negative effects of the entity's activities identified in paragraph 606-10-55-60(a).
- c. Those activities do not result in the transfer of a good or a service to the customer as those activities occur (see paragraph 606-10-25-17).

**606-10-55-61** 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.

**606-10-55-62** If the criteria in paragraph 606-10-55-60 are met, an entity should account for the promise to grant a license 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 606-10-25-27(a)). An entity should apply paragraphs 606-10-25-31 through 25-37 to select an appropriate method to measure its progress toward complete satisfaction of that performance obligation to provide access.

**606-10-55-63** If the criteria in paragraph 606-10-55-60 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 license 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 license at the point in time at which the license transfers. An entity should 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 should apply paragraph 606-10-25-30 to determine the point in time at which the license transfers to the customer. However, revenue cannot be recognized for a license 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 license. For example, if a software license 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 recognize revenue before that code has been provided (or otherwise made available).

**606-10-55-64** An entity should disregard the following factors when determining whether a license 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 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.

### **> > > Sales-Based or Usage-Based Royalties**

**606-10-55-65** Notwithstanding the guidance in paragraphs 606-10-32-11 through 32-14, 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).

### **Licensing (Paragraphs 606-10-55-54 through 55-65)**

**BC402.** In the 2011 Exposure Draft, the Boards proposed that a license grants a customer a right to use, but not own, intellectual property of the entity. Consequently, the 2011 Exposure Draft viewed the nature of the promised asset in a license as a right to use an intangible asset that is transferred at a point in time. This is because the Boards' view at that time was that there is a point at which the customer obtains the ability to direct the use of, and obtain substantially all of the benefits from, the right to use the intellectual property. However, the 2011 Exposure Draft also explained that revenue may be recognized over time for some contracts that include a license if that license is not distinct from other promises in the contract that may transfer to the customer over time.

**BC403.** In light of the feedback received on the 2011 Exposure Draft, the Boards reconsidered whether the nature of the promised asset in a license is always a right that transfers at a point in time. In the examples they considered, the Boards observed that licenses vary significantly and include a wide array of different features and economic characteristics, which lead to significant differences in the rights provided by a license. In some of the examples, the Boards observed that the customer might be viewed as not obtaining control of the license at a point in time. This is because the intellectual property to which the customer has obtained rights is dynamic and will change as a result of the entity's continuing involvement in its intellectual property, including activities that affect that intellectual property. In those cases, the customer may not be able to direct the use of, and obtain substantially all of the remaining benefits from, the license at the time of transfer. In other words, what the license provides to the customer is access to the intellectual property in the form in which it exists at any given moment. (Those notions were supported by some respondents who opposed the proposal in the 2011

Exposure Draft that all distinct licenses represent the transfer of a right to use an intangible asset.)

**BC404.** Consequently, the Boards decided to specify criteria for determining whether the nature of the entity's promise in granting a license is to provide a customer with a right to access the entity's intellectual property as it exists throughout the license period or a right to use the entity's intellectual property as it exists at a point in time when the license is granted. The Boards noted that these criteria were necessary to distinguish between the two types of licenses, rather than strictly relying on the control guidance because it is difficult to assess when the customer obtains control of assets in a license without first identifying the nature of the entity's performance obligation.

**BC405.** However, the Boards observed that before applying the criteria, an entity should assess the goods or services promised in the contract and identify, as performance obligations, the promises that transfer the goods or services to the customer.

#### **Identifying the Performance Obligations**

**BC406.** The Boards observed that, as is the case with other contracts, contracts that include a license require an assessment of the promises in the contract and the criteria for identifying performance obligations (see paragraphs 606-10-25-19 through 25-22). This would include an assessment of whether the customer can benefit from the license on its own or together with other resources that are readily available (see paragraph 606-10-25-19(a)) and whether the license is separately identifiable from other goods or services in the contract (see paragraph 606-10-25-19(b)). The Boards observed that this assessment may sometimes be challenging because the customer can often obtain benefit from the license on its own (that is, the license is capable of being distinct). However, in many cases, the customer can benefit from the license only with another good or service that also is promised (explicitly or implicitly) in the contract; therefore, the

license is not separately identifiable from other goods or services in the contract. This may occur when:

a. A license forms a component of a tangible good and is integral to the good's functionality—Software (that is, a license) is often included in tangible goods (for example, a car) and in most cases, significantly affects how that good functions. In those cases, the customer cannot benefit from the license on its own (see paragraph 606-10-25-19(a)) because the license is integrated into the good (see paragraph 606-10-25-21(a)); that is, the license is an input to produce that good which is an output.

b. A license that the customer can benefit from only in conjunction with a related service—This may occur when an entity provides a service, such as in some hosting or storage services, that enables the customer to use a license such as software, only by accessing the entity's infrastructure. In those cases, the customer does not take control of the license and, therefore, cannot benefit from (or use) the license on its own (see paragraph 606-10-25-19(a)) without the hosting service. In addition, the use of the license is highly dependent on or highly interrelated with the hosting service (see paragraph 606-10-25-21(c)).

**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). 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 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.

### **Developing the Criteria for Licenses That Provide a Right to Access**

**BC408.** As noted in paragraph BC404, the Boards decided to specify criteria in paragraph 606-10-55-60 for determining if the intellectual property will change and, thus, if a license provides a customer with a right to access the entity's intellectual property. If those criteria are not met, the license provides the customer with a right to use an entity's intellectual property as that intellectual property exists (in the form and with the functionality) at the point in time when the license transfers to the customer. To ensure that all licenses are accounted for as either a right of access or a right to use, the Boards decided to specify criteria for only one type of license. In determining for which type of license they should develop criteria, the Boards observed that it was easier to determine when the intellectual property to which the customer has rights was changing (that is, was dynamic), rather than when it was static.

**BC409.** In developing the criteria, the Boards observed that the main factor that results in the intellectual property changing is when the contract requires, or the customer reasonably expects, that the entity undertakes activities that do not directly transfer goods or services to a customer (that is, they do not meet the definition of a performance obligation). The activities may be part of an entity's ongoing and ordinary activities and customary business practices. However, the Boards noted that it was not enough that the entity undertook activities, but also that those activities affected the intellectual property to which the customer has rights and, thus, exposes the customer to positive or negative effects. In those cases, the customer essentially will be using the most recent form of the intellectual property throughout the license period. The Boards observed that when the activities do not affect



the customer, the entity is merely changing its own asset, which, although it may affect the entity's ability to provide future licenses, would not affect the determination of what the license provides or what the customer controls.

**BC410.** The Boards noted that the assessment of the criteria would not be affected by other promises in the contract to transfer goods or services (that is, performance obligations) that are separate from the license. This is because the nature and pattern of transfer of each (separate) performance obligation in a contract would not affect the timing of other promised goods or services in the contract and, thus, would not affect the identification of the rights provided by the license. This is because, by definition, a performance obligation is separate from the other promises in the contract. Consider a contract to provide a car and ongoing maintenance services—that is, two distinct goods or services (and thus two separate performance obligations). In this case, it seems counterintuitive to include the promise to provide a (separate) maintenance service when determining the nature and timing of the entity's performance related to the transfer of the car. A similar example can be drawn from a contract that includes a software license and a promise to provide a service of updating the customer's software (sometimes included in a contract as post-contract support), in which the post-contract support is identified as a distinct good or service. This is because the entity would not consider the post-contract support when determining when control of the software transfers to the customer. In other words, a promise to transfer separate updates to the license would not be considered in the assessment of the criteria in paragraph 606-10-55-60 and, furthermore, would be specifically excluded by criterion (c) in that paragraph.

**BC411.** The Boards also noted that an entity would exclude the factors specified in paragraph 606-10-55-64 for the following reasons:

a. Restrictions of time, geographical region, or use that define the attributes of the asset conveyed in a license—An entity would not consider restrictions of time, geographical region, or use because they define attributes of the rights transferred rather than the nature of the underlying intellectual property and the rights provided by the license. Consider, for example, a term license 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 (that is, six showings of the movie), rather than the nature of the underlying intellectual property (that is, the underlying movie).

b. Guarantees provided by the entity that it has a valid patent to intellectual property and that it will defend and maintain that patent—Guarantees that the entity has a valid patent would not be included in the assessment of the criteria for determining the rights provided in a license because those promises are part of the entity's representation that the intellectual property is legal and valid (this notion was previously included in the 2011 Exposure Draft).

**BC412.** In developing the criteria, the Boards considered, but rejected, differentiating licenses based on the following factors:

a. Term of the license—The length of a license term is a restriction that represents an attribute of the asset transferred and does not provide information on the nature of the underlying intellectual property or on the nature of the entity's promise. For those reasons, the license term does not depict when a customer obtains control of the promised license.

b. Exclusivity—The 2010 Exposure Draft proposed to distinguish between licenses (that is, whether they were a performance obligation satisfied over time or at a point in time) on the basis of whether the license was exclusive. Many respondents to the 2010 Exposure Draft explained that a distinction based on exclusivity was inconsistent with the control principle because exclusivity

does not affect the determination of the entity's performance. In addition, respondents stated that a distinction based on exclusivity would not be operational because it would require the Boards to provide more clarity on how the term exclusive would be interpreted. The Boards observed that exclusivity is another restriction that represents an attribute, or the asset transferred, rather than the nature of the underlying intellectual property or the entity's promise in granting a license.

c. Consumption of the underlying intellectual property—The Boards also considered but rejected an approach that would differentiate between licenses on the basis of the amount of the underlying intellectual property that was used up, or consumed by, a license. This is because the intellectual property can be divided in many ways such as by time, geographical region or other restriction on use, and the rights can be provided to more than one customer at the same time through different licenses. Consequently, it would be difficult for an entity to determine how much of the intellectual property was consumed by a particular license.

d. Payment terms—The Boards decided not to use payment terms to differentiate between licenses. This is because payment terms are not indicative of whether the license provides the customer with a right to access or right to use the intellectual property of the entity and thus when the performance obligation is satisfied. Instead, payment terms will be agreed by the customer and the entity and will reflect other economic factors such as credit risk and potential cash flows of the asset.

**BC413.** The Boards also considered whether to include a criterion that differentiated the nature of an entity's promise when the promised consideration is dependent on the customer's sales from, or usage of, the license (often referred to as a sales-based or a usage-based royalty). As a criterion for differentiating licenses, this would have resulted in all of the promised

consideration being recognized over time for such licenses, including any fixed amount. The Boards decided not to include royalties as a criterion for differentiating licenses because the existence of a sales-based or a usage-based royalty does not solely define performance over time. However, the Boards observed that, in some cases, the existence of a sales-based or a usage-based royalty can indicate a “shared economic interest” between the entity and the customer in the intellectual property being licensed and therefore the customer could reasonably expect that the entity will undertake activities that affect the intellectual property to which the license relates. The Boards also decided, however, to include an exception for the revenue recognition pattern of sales-based or usage-based royalties (see paragraphs BC415–BC421).

#### **When Is the Performance Obligation Satisfied?**

**BC414.** The Boards observed that when the license provides the customer with access to the entity’s intellectual property, the promised license represents a performance obligation satisfied over time because the customer will simultaneously receive and benefit from the entity’s performance as the performance occurs—that is, the criterion in paragraph 606-10-25-27(a) will be met. However, when the license provides the customer with a right to the entity’s intellectual property, the Boards decided that the performance obligation will be satisfied at a point in time. In those cases, an entity would need to assess the point in time at which the performance obligation is satisfied (that is, when the customer obtains control of the license) by applying paragraph 606-10-25-30. The Boards also decided to specify that control of a license could not transfer before the beginning of the period during which the customer can use and benefit from the licensed property. If the customer cannot use and benefit from the licensed property then, by definition, it does not control the license. The Boards noted that when viewed from the entity’s perspective, performance may

appear to be complete when a license has been provided to the customer, even if the customer cannot yet use that license. However, the Boards observed that the definition of control in paragraph 606-10-25-25 focuses on the customer's perspective, as explained in paragraph BC121.

### **Consideration in the Form of Sales-Based or Usage-Based Royalties**

**BC415.** The Boards decided that for a license of intellectual property for which the consideration is based on the customer's subsequent sales or usage, an entity should not recognize any revenue for the variable amounts until the uncertainty is resolved (that is, when a customer's subsequent sales or usage occurs). The Boards had proposed a similar requirement in the 2011 Exposure Draft because both users and preparers of financial statements indicated that it would not be useful for an entity to recognize a minimum amount of revenue for those contracts. This is because that approach inevitably would have required 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. The Boards observed that this would not result in relevant information, particularly in contracts in which the sales-based or usage-based royalty is paid over a long period of time.

**BC416.** In redeliberating the 2011 Exposure Draft, the Boards observed that because the restriction for a sales-based or usage-based royalty on a license of intellectual property was structured to apply to only a particular type of transaction, other economically similar types of transactions might be accounted for differently. For example, the restriction would not apply to tangible goods that include a significant amount of intellectual property and instead, any variable consideration to which the entity is entitled in exchange for those tangible goods would be considered under the

general guidance on constraining estimates of variable consideration. Some respondents questioned the conceptual rationale for including a restriction that could in some cases result in an outcome that was not consistent with the requirement to recognize some or all of an estimate of variable consideration. Others asked whether they could apply the restriction by analogy if the promised good or service had characteristics similar to a license of intellectual property and the consideration depended on the customer's future actions. Consequently, the Boards considered whether they should do either of the following:

- a. Expand the scope of paragraph 606-10-55-65 to constrain all estimates of variable consideration when that consideration depends on the customer's future actions
- b. Develop a general principle that could be applied to all contracts that would achieve broadly the same outcomes.

#### **Expand the scope**

**BC417.** The Boards considered whether to expand the restriction for a sales-based or usage-based royalty on a license of intellectual property, whereby revenue recognition would be constrained to zero for any performance obligation when the amount that an entity is entitled to is based on a customer's future actions. However, the Boards decided not to introduce this principle into Topic 606. This is because it would have prevented an entity from recognizing any revenue when the goods and services were transferred in cases in which the entity could estimate the variable consideration and meet the objective of constraining estimates of variable consideration.

**BC418.** The Boards also observed that expanding the scope to constrain revenue when consideration is based on the customer's future actions also would have increased complexity. It would have required the Boards to create another exception to maintain the guidance for accounting for customer rights of return, which

also results in consideration that is dependent on the customer's future actions.

### **Develop a general principle**

**BC419.** The Boards also considered whether the restriction for a sales-based or usage-based royalty on a license of intellectual property could be incorporated into a general principle. The Boards considered various ways of articulating this principle, including doing so on the basis of the timing of satisfaction of a performance obligation—that is, whether the performance obligation is satisfied over time or at a point in time. Specifically, if the performance obligation to which the variable consideration related was satisfied at a point in time, an entity would include an estimate of variable consideration in the transaction price 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. Conversely, if the performance obligation to which the variable consideration related was satisfied over time, an entity could include any estimate in the transaction price (even a minimum amount) provided that the objective of constraining estimates of variable consideration could be met.

**BC420.** This approach was based on the rationale that for a performance obligation satisfied at a point in time, recognition of revenue that could be adjusted up or down would not be a meaningful depiction of the consideration for the related goods or services and, furthermore, any future adjustments to the transaction price (and therefore revenue) would have little correlation with the entity's performance in that period. Conversely, when a performance obligation is satisfied over time, the initial recognition of some but not all of the estimate of variable consideration would be affected by the entity's future performance, so future adjustments to the transaction price would provide useful information because they explain whether the

entity's subsequent performance was beneficial (that is, the minimum amount is increased) or detrimental (that is, the minimum amount is subject to an unexpected reversal). However, the Boards rejected this approach because it would have added complexity to the model that would outweigh the benefit.

**BC421.** Consequently, the Boards decided against applying the restriction for sales-based or usage-based royalties on intellectual property more broadly. Although the Boards acknowledge that the guidance in paragraph 606-10-55-65 constitutes an exception that might not be consistent with the principle of recognizing some or all of the estimate of variable consideration, they decided that this disadvantage was outweighed by the simplicity of this guidance, as well as by the relevance of the resulting information for this type of transaction. The Boards also noted that because this is a specific requirement intended for only limited circumstances, entities should not apply it by analogy to other types of promised goods or services or other types of variable consideration.