

STAFF PAPER

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Purpose

1. The purpose of this paper is to provide members of the FASB-IASB Joint Transition Resource Group for Revenue Recognition (TRG) with an update on the actions of the Boards with respect to accounting for licenses of intellectual property (IP) under ASU 2014-09, *Revenue from Contracts with Customers*, and IFRS 15 *Revenue from Contracts with Customers* (collectively, the new revenue standard).

Background

2. TRG Agenda Paper No. 5 (from the October 31, 2014 TRG meeting) highlighted that, at the July 18, 2014 TRG meeting, TRG members had different interpretations about the scope of the guidance on sales-based and usage-based royalties for licenses of IP in paragraph 606-10-55-65 [B63] (the “royalties constraint”). Three interpretations were discussed at the July 18 meeting, and different TRG members expressed support for each of those three interpretations. The three interpretations about when the royalties constraint applies were:
 - (a) *Interpretation A* - Whenever the royalty is in a contract that includes a license of IP, regardless of whether (i) the royalty also relates to another nonlicense good or service or (ii) the license is a separate performance obligation

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- (b) *Interpretation B* - Only when the royalty relates solely to a license of IP and that license is a separate performance obligation
 - (c) *Interpretation C* - When the royalty relates (i) solely to a license of IP 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.
3. At the October 31, 2014 TRG meeting, the TRG discussed additional implementation questions related to licenses of IP (see TRG Agenda Paper No. 8). Those issues included when the guidance on determining the nature of a license of IP applies (for example, only when the license is distinct or, also, in additional circumstances) and how certain contractual restrictions affect the identification of the promised goods or services in the contract.
 4. However, the principal implementation question discussed was with respect to the implementation guidance in the new revenue standard on determining the nature of the entity's promise in granting a license as either a right to access the entity's IP (satisfied over time) or a right to use the entity's IP (satisfied at a point in time). Some stakeholders had suggested to the staff that, in order for a license to represent a right of access to the entity's IP, the contractual or expected activities of the licensor have to significantly change the form (that is, the design) or functionality (for example, the ability to process a transaction, perform a function or task, or be played or aired) of the underlying IP, while other stakeholders suggested that a license represents a right of access whenever the contractual or expected activities of the licensor significantly change the form, functionality, *or value* of the IP to which the customer has rights.
 5. The following interpretations were discussed by the TRG members at the October 31, 2014 meeting:
 - (a) *Interpretation A*: For activities to significantly affect the IP to which the customer has rights, those activities must be expected to change the form and/or functionality of that IP. Changes that solely affect the value of the IP do not significantly affect the IP to which the customer has rights.

- (b) *Interpretation B*: For activities to significantly affect the IP to which the customer has rights, those activities only need to significantly affect (that is, change) the value of the IP to the customer. Those activities also could significantly affect the form and/or functionality of the IP, but changes to form and/or functionality are not required to meet the criterion.
- (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 IP and, therefore, can significantly change or alter the character of that IP. Interpretation C would generally not view promotional or other activities related to IP that has significant functionality and value separate from those activities as ones that significantly affect the related IP.

6. Different group members noted several pieces of guidance in the standard that they think support both Views A and B. Several group members stated that View C is what they thought the Boards intended with their decisions about licenses, but they thought the language in the standard may not support that view.

Update

- 7. Following the October 31, 2014 TRG meeting, the Boards instructed the staff to perform additional research and outreach related to the licenses implementation questions described above. The focus of the additional research and outreach is to understand whether there are specific improvements to the new revenue standard or other activities the Boards should consider to address the concerns raised at the TRG meeting.
- 8. The FASB staff organized outreach with preparers and auditors that were held in December 2014. Staff from the FASB and the IASB and at least one board member from each board attended this outreach. The preparers were from industries particularly affected by the licenses guidance, including entertainment and media, software, and life sciences. Stakeholders were from public and private entities.

9. The staff developed two articulations of potential improvements to the guidance about licenses in the new revenue standard that were intended to better reflect the notions underlying Interpretation C (*see paragraph 5c above*). The purpose of the two drafts was to facilitate a dialogue with stakeholders to provide the Boards with input. The potential improvements would, under either of the two articulations, attempt to more clearly communicate that:
- (a) A license is satisfied over time when the licensor’s promise to the customer in granting a license includes undertaking activities that significantly affect the *utility* of the IP to the customer. “Utility” was drafted so as to clearly encompass changes to form, functionality, *and/or* value.
 - (b) "Significantly affects the utility of the IP to which the customer has rights" is a high threshold that would generally not encompass solely promotional or other support activities when the underlying IP has significant standalone functionality (for example, the ability to process transactions, perform a function or task, or be played or aired). When IP has significant standalone functionality, a substantial portion of its utility is derived from that functionality, and is unaffected by an entity's activities that do not change that functionality.
10. Articulation A would continue to focus on defined criteria similar to those in paragraph 606-10-55-60 [B58] in order to determine when the contract requires, or the customer reasonably expects, that the licensor will undertake activities (that do not transfer a promised good or service to the customer) to change, support, and/or maintain the IP to which the customer has rights under the license.
11. Articulation B, rather than identifying contractually-required or otherwise expected activities, would, in general, focus on the type of IP being licensed. Articulation B would classify IP into one of two categories, and that category would define whether the licensor’s promise in granting a license to that IP includes undertaking activities to continue to support and maintain the IP. An entity’s promise to grant a license to “symbolic” IP (for example, brand or trade names, logos, franchise rights) would include undertaking activities to continue to support and maintain that IP

during the license period. An entity's promise to grant a license to "functional IP" (for example, software, completed media content, drug formulas) would not. Distinct licenses to functional IP could still be recognized over time if the actual IP (that is, its form or functionality) were expected to change as a result of activities or actions of the licensor and the customer has rights only to the most recent version of the IP.

12. The potential improvements developed by the staff also included more minor possible revisions that would be intended to clarify the other issues raised with respect to licenses in TRG Agenda Paper No. 8. Those possible revisions would clarify:
 - (a) That, 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.
 - (b) That contractual restrictions of a license (for example, a restriction that content can be aired once per year on a specified date) are attributes of the license and, therefore, do not affect the identification of the promised goods or services in the contract.
13. The staff are in the process of developing alternatives for the Boards to consider to improve the articulation of the scope and application of the royalties constraint (see paragraph 2).
14. The staff expect to bring the issues discussed in this update to a public Board meeting in February 2015 to discuss the feedback from the TRG, as well as the staff's research and outreach. Any improvements made to the guidance in the new revenue standard would be subject to each Board's due process, including an exposure document for public comment.