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April 2016, No. 16-13

FASB Amends Performance Obligations and Licensing Guidance in Revenue Standard

The FASB recently issued an Accounting Standards Update (ASU) that amends the revenue guidance on identifying performance obligations and accounting for licenses of intellectual property (IP).[1] The ASU changed the FASB's previous proposals on renewals of right-of-use licenses and contractual restrictions.[2]

Key Facts

The ASU changes the guidance on **performance obligations** to:

- Clarify the guidance related to whether goods or services are distinct within the context of the contract and therefore are a performance obligation;
- Specify that an entity is not required to identify as a performance obligation goods or services that are immaterial in the context of the contract; and
- Allow an entity to elect a policy to account for shipping and handling services that it provides after control of the goods transfers to the customer as either a fulfillment activity or a performance obligation.

The ASU also changes the guidance on **IP licenses** to:

- Clarify the timing and pattern of revenue recognition for IP licenses, including the application of the sales- and usage-based royalties exception; and
- Provide guidance about how to evaluate contractual restrictions of an IP license when determining whether the promise to the customer is for a single license or multiple licenses.

Key Impact

- For an entity that licenses IP, the amount or timing of revenue recognition may be significantly different from current practice. Additionally, an entity will need to evaluate which contractual restrictions are attributes of a license and which give rise to separate performance obligations.

Contents

Performance Obligations 2

IP Licenses 2

Next Steps 5

KPMG Resources 5

[1] FASB Accounting Standards Update No. 2016-10, Identifying Performance Obligations and Licensing; and FASB Accounting Standards Update No. 2014-09, Revenue from Contracts with Customers, available at www.fasb.org.

[2] FASB Proposed Accounting Standards Update, Identifying Performance Obligations and Licensing, May 12, 2015, available at www.fasb.org.

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Performance Obligations

Immaterial Performance Obligations

The first step in identifying a performance obligation is to identify the goods or services promised in the contract. The ASU specifies that an entity is not required to identify goods or services that it will transfer to the customer and that are immaterial in the context of the contract. Unlike financial statement materiality, this materiality assessment will be made at the contract level. An entity does not have to consider whether the individual materiality determinations at the contract level aggregate to a significant amount at the financial statement level.

An entity that determines that the promises are immaterial in the context of the contract and records revenue before those goods or services are transferred, must also accrue the related fulfillment costs when it recognizes revenue.

Distinct in the Context of the Contract

The process of identifying performance obligations requires an entity to determine which goods and services are distinct if they are material *in the context of the contract*. The ASU amends the original guidance on distinct in the context of the contract by clarifying why the determination needs to be made, revising factors to consider, and providing additional illustrations to guide preparers when determining whether promises to transfer goods or services to a customer are separately identifiable.

Accounting for Shipping and Handling Services

The ASU allows an entity to account for shipping and handling either as a fulfillment cost or as a promised service when transfer of control of the goods occurs before they are shipped. An entity that accounts for these costs as a fulfillment activity must accrue costs associated with shipping and handling activities when control of the related goods has transferred to the customer. If control of the promised goods transfers to the customer ***after*** the shipping and handling activities are performed, shipping and handling activities always constitute a fulfillment activity, not a performance obligation.

IP Licenses

Determining the Nature of an IP License

The revenue recognition standard provides implementation guidance about whether revenue related to a distinct IP license is recognized over time or at a point in time. The ASU requires an entity to classify IP as either functional or symbolic. Revenue related to functional IP will generally be recognized at a point in time, while revenue related to symbolic IP will be recognized over time.

When an IP license is not distinct from other goods or services in a contract, it may be necessary to determine the nature of the license to decide whether the combined performance obligation is satisfied over time or at a point in time.

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Accounting for Sales- and Usage-based Royalties

The revenue recognition standard includes an exception to the guidance on estimating variable consideration for sales- and usage-based royalties on IP licenses. The ASU clarifies that when an IP license includes other goods or services, an entity applies either the royalties exception or the general guidance on variable consideration (including the constraint). The royalties exception must be applied when the royalty is given in exchange for a distinct IP license or when the IP license is the predominant item to which the royalty relates. The ASU does not define predominant.

Renewals of Right-of-use Licenses

The ASU specifies that revenue related to a renewal of a point-in-time license is not recognized until the beginning of the renewal period. This clarification was not included in the FASB's exposure draft.

Under current U.S. GAAP, renewals of software licenses are generally recognized when the parties agree to the renewal or extension. Under the ASU, an entity recognizes revenue from license renewals when the renewal term begins.

Example 1: Recognition of Right-of-Use License Renewals

Company A and Licensee B enter into a three-year term license that begins on January 1, 20X1. On June 30, 20X3, both parties agree to extend the license for two years effective January 1, 20X4.

Current U.S. GAAP. In general, if other applicable revenue recognition criteria have been met, the license fee is recognized as revenue on June 30, 20X3.

ASU. The renewal license fee is recognized on January 1, 20X4, when the two-year extension begins.

Contractual Restrictions

The ASU revised the guidance related to contractual restrictions of a promised license, specifically, whether those restrictions create multiple licenses and, therefore, affect the timing of revenue recognition.

Licenses are, by nature, a bundle of rights to IP that are often limited in duration and scope (e.g., geographical and usage). An explicit or implicit provision that requires the entity to transfer additional rights to use or access IP that the customer does not already control generally constitutes an additional promise for the entity to fulfill and, therefore, is a separate license. Conversely, if a customer controls the rights provided by a license, those rights are attributes of a promised license (and define the scope of that promised license) but do not represent a separate license within the arrangement.

For example, a license that allows a television station to broadcast a movie on four specific dates during the license term generally will be a single license and the specific dates constitute attributes of the license promised to a customer. However, if the entity is required to transfer additional rights that the customer

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does not control, such as allowing significant time between the broadcast dates, and the licensor can license the movie to other media outlets in the interim, multiple licenses may exist. Significant judgment will be required to make these distinctions.

As noted, a substantial break between periods during which a customer is able to use the IP might mean that those two separate time periods represent separate licenses, even if the rights conveyed during each period are the same. This scenario often arises in the media industry and is referred to as a *broken windows* scenario. The facts and circumstances will need to be considered when deciding whether a broken windows scenario constitutes a single license or multiple licenses.

Example 2: Multiple Licenses

On January 1, 20X1, Film Studio enters into a three-year contract with Broadcaster granting Broadcaster the exclusive right to air ABC Movie in the United States and Canada during the term of the contract. However, because of an overlapping contract with a Canadian competitor, the rights to air ABC Movie in Canada do not begin for 6 months (i.e., the license period begins July 1, 20X1). Film Studio provides a copy of ABC Movie to Broadcaster, and Broadcaster has the right to immediately air the movie in the United States.

Film Studio considers whether the contract grants the customer a single license, subject to a use restriction, or two licenses. Film Studio concludes that the provision in the contract preventing Broadcaster from airing ABC Movie in Canada for the first six months of the contract term requires Film Studio to transfer additional rights on July 1, 20X1. Broadcaster does not control these additional rights because it cannot use and benefit from them in Canada before that date.

Film Studio concludes that the contract includes two promised licenses of functional IP. Revenue allocated to the U.S. and Canada licenses is recognized on January 1, 20X1, and July 1, 20X1, respectively.

Example 3: Attributes of a Promised License

Assume the same facts as Example 2, except that the rights to air ABC Movie in the United States and Canada both commence on January 1, 20X1. However, the terms of Broadcaster's rights to air ABC Movie in the United States and Canada extend only to eight broadcasts in each territory during the three-year period. Also, as part of the contract, Broadcaster agrees not to air certain types of advertisements during airings of the movie.

The term of the license (three years), the geographical scope of the license (Broadcaster's U.S. and Canadian networks only), and the usage limitations (limited to eight showings per territory and restrictions on advertisements during the airings of ABC Movie) define the scope of Broadcaster's rights. None of those provisions require Film Studio to transfer additional rights to the IP after January 1, 20X1, which is when Broadcaster can begin to use and benefit from the rights conveyed by the contract. Therefore, Film Studio

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Example 3: Attributes of a Promised License
concludes that this is a single license of functional IP and recognizes revenue on January 1, 20X1.

Next Steps

The FASB's amendments to its principal-agent guidance was issued in March.[3] The FASB completed its redeliberations on the remaining substantive amendments to the new revenue standard. We expect the FASB to issue an ASU on narrow-scope improvements and practical expedient amendments during the second quarter.[4]

An exposure draft about narrow technical corrections to the new standard is expected to be issued in the second quarter. The exposure draft is expected to propose an amendment to pre-production cost guidance for long-term contracts, address the scope for fixed-odds wagering contracts, and make other technical corrections. It is also expected to propose disclosure relief related to remaining performance obligations for certain types of variable consideration.

The FASB's amendments are not fully converged with the IASB's more limited amendments. The Boards expressed hope that the differences in wording and illustrative examples will not result in significantly different outcomes, excluding areas in which the FASB has provided policy elections (e.g., shipping and handling).[5]

KPMG Resources

For further information about the amendments to the new revenue standard's licensing of IP and identifying performance obligations, see these KPMG publications.

- Defining Issues No. 15-46, *FASB Redeliberates Revenue Guidance on Licensing and Performance Obligations*
- Defining Issues No. 15-21, *FASB Proposes Clarification to License and Performance Obligation Guidance for Revenue*

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[3] FASB Accounting Standards Update No. 2016-08, Principal versus Agent Considerations (Reporting Revenue Gross versus Net), available at www.fasb.org

[4] KPMG's Defining Issues No. 16-5, FASB Reaffirms Amendments to Revenue Standard; Discusses Potential Disclosure Relief, available at kpmg.com/us/frn.

[5] Clarifications to IFRS 15, April 2016, available at www.ifrs.org.

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