cutting through complexity

Defining Issues®

February 2015, No. 15-5

Contents

FASB and IASB Propose Clarifications to Revenue Standard

At their joint February 2015 meeting, the FASB decided to propose amendments to the revenue recognition standard to clarify the guidance on accounting for licenses of intellectual property and identifying performance obligations.[1] However, the IASB decided to make more limited clarifications to its standard.[2]

Key Facts

- The FASB intends to issue an exposure draft in the near term with the objective of narrowing potential diversity in practice based on feedback received from constituents including the Transition Resource Group for Revenue (TRG).[3] The FASB did not specify the length of the comment period.
- The IASB indicated that it will wait until substantially all of the issues have been discussed before issuing an exposure draft to amend the standard. It is likely that the IASB's exposure draft will be issued later than the FASB's.

Key Impact

- Each Board discussed what implications their actions would have on convergence. Most Board members agreed that many of the benefits of a converged standard could still be retained if the outcomes of applying the two standards are broadly similar, even though their wording differs. The FASB's decisions aim to improve the understandability and operability of the standard, without making significant changes. Although the amended words are similar, different outcomes under U.S. GAAP and IFRS may be possible in some circumstances if the proposed changes are finalized.

---

[1] FASB Accounting Standards Update 2014-09, Revenue from Contracts with Customers, available at www.fasb.org.

[2] IFRS 15, Revenue from Contracts with Customers.

[3] See Defining Issues No. 15-4, Revenue Transition Resource Group Discusses Issues, Defining Issues No. 14-49, Revenue Transition Resource Group Discusses Five New Issues, and Defining Issues No. 14-33, Revenue Transition Resource Group Holds First Meeting, available at www.kpmg-institutes.com.

Determining the Nature of an Intellectual Property License

The revenue recognition standard provides implementation guidance on whether the consideration for a distinct license of intellectual property (IP) is recognized as revenue over time or at a point in time. A license that provides a right to access the entity's IP as it exists throughout the license period results in revenue recognition over time. A license that provides a right to use the entity's IP as it exists at a point in time results in revenue recognition at the point in time when control of the license transfers to the customer.

The FASB decided to propose clarifications to the implementation guidance on licenses by classifying all licenses of IP into one of two categories.

- *Functional IP* – customer derives a substantial portion of its benefit from its stand-alone functionality. Consideration for functional IP would be recognized as revenue at the point in time when control of the IP transfers to the customer. Functional IP would generally include software, biological compounds, drug formulas, and completed media content (e.g., films, television shows, and music). While a licensor's ongoing activities may affect the utility of functional IP to the customer, the initial functionality would indicate that these activities do not *significantly* affect that utility.
- *Symbolic IP* – does not have significant stand-alone functionality and substantially all of its benefit to the customer is derived from its association with the licensor's past or ongoing activities. Consideration for symbolic IP would be recognized as revenue over the license period using a measure of progress that reflects the licensor's pattern of performance. Symbolic IP would generally include brands, trade names such as sports team logos, and franchise rights. The lack of stand-alone functionality indicates that the licensor generally has promised to both grant the right to use the IP and continue to support and maintain the IP.

The FASB staff paper included a flowchart that could be used to conclude whether IP is functional or symbolic.[4]

IASB Decision on Determining the Nature of an Intellectual Property License

The IASB decided to propose an amendment that would add an explanatory paragraph to the application guidance in IFRS 15 to clarify that:

- Activities of an entity significantly affect the IP when those activities affect the utility of the IP. Utility of the IP is affected when either of the following conditions are met:
  - The activities of the entity change the form (i.e.. the design) or functionality (i.e., the ability to perform a function or task) of the intellectual property; or
  - The benefit to the customer of the IP is substantially derived from or dependent upon those activities. For example, the utility

[4] FASB Memo 1, Licenses of Intellectual Property, available at www.ifrs.org.

of a brand name is typically derived from, and dependent upon, the entity's ongoing activities.

- When IP has significant stand-alone functionality, a substantial portion of its utility is derived from that functionality, and is unaffected by the entity's ongoing activities as they do not change that functionality.

The Boards believe that while the guidance is different, the outcomes should be similar in most circumstances. However, the Boards acknowledged that differences may arise in the unique circumstance that an entity licenses symbolic IP for which the entity is not expected to undertake significant activities after the license is granted. For example, the logo for the Brooklyn Dodgers may be licensed (e.g., for the movie "42") but the licensor is not undertaking activities to change the form or functionality of the underlying IP. In this case the FASB's proposed guidance would result in the consideration being recognized over time while the IASB's guidance would result in point-in-time revenue recognition.

Applying the Sales-based and Usage-based Royalties Exception for Contracts Containing Licenses of Intellectual Property and Other Goods or Services

The standard includes an exception to the guidance on estimating variable consideration by specifying that an entity can only recognize revenue for a sales-based or usage-based royalty promised in exchange for a license of IP at the later of (a) when the subsequent sale or usage occurs, or (b) the performance obligation has been satisfied or partially satisfied.

When the arrangement includes a license of IP and other goods or services, the FASB decided to propose clarifications. The FASB intends that the royalty in its entirety should be either within or not within the scope of the royalties exception.

The FASB also intends to clarify that the royalties exception applies when the license of IP is the predominant item to which the royalty relates. The FASB acknowledged that determining when a license is the predominant item would require judgment. However, this may result in the royalties exception being applied to more contracts than under a narrow reading of the revenue recognition standard, which states that the royalties exception applies when the license is distinct. In general we expect that a license would be considered to be the predominant item when the customer ascribes significantly more value to the license than to other goods or services in the arrangement.

IASB Decision on Sales-based and Usage-based Royalties

The IASB agreed with the FASB's clarifications to the sales-based and usage-based royalties exception and will propose similar amendments to IFRS 15.

Other Clarifications to License Guidance

The FASB agreed to make two other clarifications to licenses of IP.

When to Determine the Nature of an Intellectual Property License

When a license of IP is not distinct from other goods or services in a contract, it may be necessary to determine the nature of the license in order to determine whether the performance obligation is satisfied over time or at a point in time. For example, if a license is bundled with goods or services that are provided over a period shorter than the license term, an entity would consider the nature and term of the license when determining the pattern for revenue recognition of the bundled arrangement.

Contractual Restrictions

Contractual restrictions on a licensee's ability to use the underlying IP are attributes of the license and would not impact the number of promises made in the contract. For example, a license that allows a television station to broadcast a movie within specified timeframes during the license term would be a single promise.

IASB Decision on Other Clarifications to License Guidance

The IASB decided not to make further clarifications to the guidance on licenses. However, the IASB generally agreed with the outcomes that will result from the FASB's amendments.

Identifying Promised Goods or Services

The first step in identifying performance obligations is to identify the goods or services promised in the contract. The standard states that promised goods or services are not limited to the goods or services that are explicitly stated in the contract. Rather, the contract with a customer may include promises that are implied by an entity's customary business practices, published policies, or specific statements if, at the time of entering into the contract, those promises create a valid expectation of the customer that the entity will transfer goods or services to the customer. However, administrative tasks an entity must undertake to fulfill a contract that do not transfer goods or services to the customer are not performance obligations.

The FASB agreed to propose a clarification that an entity is not required to identify goods or services to be transferred to the customer that are immaterial in the context of the contract. Some FASB members stated that they believe this would be consistent with the objective of identifying the nature of the entity's performance obligations and also consistent with how materiality is assessed in the context of evaluating whether a material right exists and whether a significant financing component exists. Some FASB members expressed concern about overriding the concept of materiality at the financial statement level. However, the Board ultimately concluded that the clarification should be made to reduce the costs and complexities of identifying promises that are considered to be insignificant.

IASB Decision on Identifying Promised Goods or Services

The IASB decided not to undertake any standard setting on identifying promised goods or services because members believe that the revenue standard is sufficiently understandable.

Distinct in the Context of the Contract

The process of identifying performance obligations requires an entity to determine which goods and services are distinct. A good or service is distinct if the customer can benefit from it on its own or with other resources that are readily available to the customer (referred to as "capable of being distinct") and the promise to transfer the good or service is separately identifiable (referred to as "distinct in the context of the contract"). While the first criterion is similar to the stand-alone value notion that exists in current U.S. GAAP, the second criterion is new.[5]

The FASB agreed to propose the following amendment to clarify the guidance on distinct in the context of the contract.

- Provide explanatory language to better articulate the principle. The proposed language will indicate that the objective when considering whether promised goods and/or services are separately identifiable is to determine whether the nature of the entity's promise to the customer primarily is to transfer (a) each of those separate goods and/or services, or (b) a combined item (or items) to which each of those goods and/or services are an input.
- Clarify the factors for determining what is distinct in the context of the contract. The factors would be amended to more closely relate to the rearticulated, separately identifiable principle. In addition, the factors will refer to the goods and services in the contract as a bundle to focus the analysis on when goods or services significantly affect each other.
- Provide additional examples to demonstrate how the FASB intends the separation guidance to be applied.

[5] FASB ASC paragraph 605-25-25-5(a), available at www.fasb.org.

IASB Decision on Distinct in the Context of the Contract

The IASB decided not to amend the guidance on distinct in the context of the contract. However, the IASB will propose the addition of nonauthoritative illustrative examples.

Accounting for Shipping and Handling Services

An entity may bill a customer for shipping and handling services in addition to the stated price of the goods or services. Unlike current U.S. GAAP, the revenue recognition standard does not provide specific guidance for the presentation of shipping and handling when an entity charges separately for them.[6] However, it defines the transaction price as the amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer.

Some stakeholders believe that shipping can be a promised service in the contract because the entity is providing a service of transporting the customer's asset to a location designated by the customer when transfer of control over the goods occurs before delivery (e.g., a freight-on-board (FOB) shipping point arrangement). Other stakeholders believe that shipping the goods is a fulfillment activity that supports the transfer of control of the goods to the customer. They view shipping and handling no differently than other fulfillment costs such as procuring inventory and manufacturing the goods. Because shipping and handling is not considered a deliverable under existing U.S. GAAP, a conclusion that shipping and handling is a promised service in some arrangements could be a significant change in practice for some entities.

The FASB agreed to propose a policy election that would allow entities to choose to account for shipping and handling either as a fulfillment cost or as a promised service when transfer of control over the goods occurs before the entity ships the goods. For example, an entity sells a product to a customer and ships the product with terms FOB shipping point. The entity concludes that it transfers control of the goods prior to shipping it. The entity could elect to treat the shipping as a separate performance obligation. This would result in recognizing revenue allocated to the goods when they are shipped, and revenue allocated to the shipping as the shipping takes place. Alternatively, the entity could elect to treat the shipping as a fulfillment cost. This would result in all of the revenue being recognized when the goods are shipped. In either case, the FASB agreed that the cost of shipping and handling that occurs prior to the customer obtaining control of the goods is a fulfillment cost.

IASB Decision on Shipping and Handling Services

The IASB will perform outreach to determine whether the accounting for shipping and handling is a significant implementation issue for IFRS stakeholders.

[6] FASB ASC paragraphs 605-45-45-19 – 45-21, available at www.fasb.org.

Next Steps

The FASB's comment period for its exposure draft on accounting for licenses of intellectual property and identifying performance obligations is likely to end during the second quarter of 2015. The IASB will continue performing outreach and will wait until substantially all of the issues have been discussed before issuing an exposure draft to amend the standard later in 2015.

The Boards will consider whether to defer the effective date of the standard in the early part of the second quarter of 2015.

The Boards are continuing research and outreach on gross versus net revenue presentation for sales of goods and services. Additionally, the Boards may need to consider additional issues that are identified in future TRG meetings.

Contact us: This is a publication of KPMG's Department of Professional Practice 212-909-5600

Contributing authors: Brian K. Allen, Prabhakar Kalavacherla, Paul H. Munter, Brian J. Schilb, and Ryan N. Marquez

Earlier editions are available at: http://www.kpmg-institutes.com