



FASB Redeliberates Revenue Guidance on Licensing and Performance Obligations

On October 5, 2015, the FASB redeliberated and, in general, tentatively decided to adopt its proposed revenue guidance on accounting for licenses of intellectual property and identifying performance obligations.¹ The redeliberations were held in response to comment letters on the FASB’s proposed Accounting Standards Update (ASU) and its staff’s outreach efforts.

Key Facts

The Board tentatively decided to:

- Clarify the timing of recognition for revenue from licenses of intellectual property (IP), including the guidance for sales- and usage-based royalties;
- Amend the criteria for determining whether goods or services are performance obligations;
- 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;
- Add a policy election to account for shipping and handling services provided after control of the goods transfers to the customer as a fulfillment activity; and
- Retain the requirement that goods and services that meet specified criteria be accounted for as a series (i.e., a single performance obligation).

Key Impacts

- The FASB’s amendments are not fully converged with the IASB’s proposed amendments. However, the Boards hope that the wording differences will not result in significantly different outcomes in practice, excluding areas where the FASB has provided additional practical expedients (e.g., shipping and handling).² The IASB is proposing more limited clarifications to its standard. The comment deadline on the IASB’s exposure draft is October 28, 2015.
- For entities that license IP, the timing of revenue recognition may be significantly different from current practice.

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¹ FASB Proposed Accounting Standards Update, Identifying Performance Obligations and Licensing, May 12, 2015, available at www.fasb.org.

² IASB Exposure Draft ED/2015/6, Clarifications to IFRS 15, available at www.ifrs.org.

Determining the Nature of an Intellectual Property License



The Board's clarifications to determining the nature of an IP license are consistent with the proposed ASU.

The revenue recognition standard provides implementation guidance on whether revenue related to a distinct IP license is recognized over time or at a point in time.³ A license that provides a right to access the entity's IP as it exists throughout the license period is an over-time performance obligation. A license that provides a right to use the entity's IP as it exists when the license is granted to the customer is a point-in-time performance obligation.

The Board tentatively agreed to amend the implementation guidance on IP licenses to require an entity to classify IP into one of two categories.

- **Functional IP.** IP is functional if the customer derives a substantial portion of the overall benefit from the IP's stand-alone functionality. Functional IP would generally include software, biological compounds, drug formulas, and completed media content (e.g., films, television shows, and music). Consideration for functional IP would generally be recognized as revenue at the point in time when control of the IP transfers to the customer. However, if the functionality of the IP is expected to substantively change during the license period as a result of activities of the entity, and the customer is contractually or practically required to use the updated IP, then the consideration would be recognized as revenue over time.
- **Symbolic IP.** IP is symbolic if it does not have significant stand-alone functionality, and substantially all of the customer's benefit is derived from its association with the licensor's ongoing activities. Symbolic IP would generally include brands, trade names such as sports team logos, and franchise rights. Consideration for symbolic IP would generally be recognized as revenue over the license period using a measure of progress that reflects the licensor's pattern of performance.

KPMG Observations

Some comment letter respondents suggested eliminating the guidance on over-time recognition of revenue for functional IP. The Board decided to retain the guidance because the customer may not obtain substantially all of the remaining economic benefits of the IP at the beginning of the license term. The Board's decision will require an entity to first decide whether the licensed IP is functional or symbolic. If the IP is functional, an entity will then need to apply additional criteria to determine whether revenue related to functional IP is recognized over time. Although over-time revenue recognition for functional IP is not expected to occur frequently, application of the guidance will require judgment.

³ FASB ASC paragraphs 606-10-55-59 to 55-64, available at www.fasb.org.

Other respondents pointed out that symbolic IP does not always involve ongoing activities to support the IP. In those cases, the customer is able to obtain substantially all of the remaining economic benefits of the IP at the beginning of the license term. Although the Board considered adding an exception to the guidance on symbolic IP, it decided not to do so because of concerns about complexity. Consequently, all symbolic IP would result in over-time revenue recognition.

Applying the Sales- and Usage-based Royalties Exception



The Board's clarifications to the royalties exception are consistent with the proposed ASU. The Board did not define predominant and did not expand the exception to sales or in-substance sales of IP.

The revenue recognition standard includes an exception to the guidance on estimating variable consideration for sales- and usage-based royalties on IP licenses. The standard prohibits an entity from estimating these forms of variable consideration. Instead, it specifies that an entity can only recognize revenue for a sales- or usage-based royalty for an IP license at the later of (a) when the subsequent sale or usage occurs, or (b) the performance obligation has been satisfied or partially satisfied. The FASB discussed the fact that the *later of* guidance was intended to ensure that revenue is not recognized prior to the satisfaction of the performance obligation.

When an IP license includes other goods or services, the Board agreed to clarify that an entity either applies, in its entirety, 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 FASB has not proposed providing guidance on the definition of predominant, but has acknowledged that determining when a license is the predominant item may require significant judgment. For arrangements that contain both an IP license and other non-IP goods or services, this determination may give rise to significant judgments about the amount of the transaction price and timing for the recognition of variable consideration that relates to a sales- or usage-based royalty.

The Board discussed expanding the scope of the royalties exception to sales of intellectual property. However, the Board decided not to expand the royalties exception beyond the guidance discussed above. The Board decided that the royalties exception should apply to all licenses, even if in-substance it is a sale (e.g., a worldwide, perpetual, or exclusive license). The legal form of the arrangement will be the driving factor to determine whether the royalties exception applies.

Other Clarifications on Licenses

When to Determine the Nature of an Intellectual Property License

The Board reaffirmed its previous tentative decision that 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 determine whether the performance obligation (a bundle of goods or services including the license) 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 may need to consider the nature and term of the license when determining the pattern for revenue recognition of the bundled arrangement.



The Board's clarifications on when to determine the nature of an IP license are consistent with the proposed ASU.

KPMG Observations

The Board's tentative decision on when to apply the licensing guidance for a bundled performance obligation is based on the notion that an entity is always supposed to consider the nature of its promise when determining an appropriate method for measuring progress. The amendment clarifies the original revenue standard, which specified that the licensing guidance only applies to distinct licenses of intellectual property. The Basis for Conclusions in the original revenue standard, however, noted that in some cases the combined good or service may have a license as its primary or dominant component. Some believed that it is appropriate to apply the licensing guidance to bundled arrangements only when the license is the primary or dominant good or service in the contract. The amendments would make the licensing guidance for determining whether to recognize revenue at a point in time or over time more broadly applicable to arrangements where the license is not the primary or dominant good or service. An entity would not have to apply the licensing guidance to every performance obligation that includes IP. Rather, an entity would consider whether the licensing guidance is necessary to understand the nature of the entity's promise and the period over which the performance obligation is satisfied.

In addition, the guidance is different than the guidance on sales- or usage-based royalties, which is expected to be amended to specify that the royalties exception applies to bundled arrangements only if the royalty predominantly relates to an IP license.



The Board's clarifications to contractual restrictions are consistent with the proposed ASU.

Contractual Restrictions

The Board also tentatively agreed to clarify that contractual restrictions on time, geography, or a licensee's ability to use or access the underlying IP are attributes of the license and do not impact the number of performance obligations in the contract. These restrictions define the scope of the license rather than the number of distinct licenses in the arrangement. For example, a license that allows a television station to broadcast a movie on four specific dates during the license term would generally be a single performance obligation. However, some contractual restrictions are not restrictions on the licensee's ability to use or access the IP. For example, if the licensee has the right to use or access the IP for two distinct periods of time, the period between the license periods is substantive, and the licensor has the ability to grant the right to use or access the IP to another party during that intervening period, then the contract would include more than one performance obligation.

KPMG Observations

The Board acknowledged that there have been a number of questions raised about applying the guidance on contractual restrictions. Specifically, the questions have centered around which contractual restrictions are attributes of the license and which restrictions give rise to separate performance obligations. The Board decided that it would move forward with the amendments in the proposed ASU. However, it plans to discuss those amendments with the Transition Resource Group for Revenue Recognition (TRG) at the next TRG meeting on November 9, 2015. If the TRG members have significant concerns with the operability of the proposed guidance, then perhaps the Board would consider making further changes to this guidance. However, the Board plans to proceed with the other amendments and clarification even if further changes on contractual restrictions are deemed necessary.



The Board's clarifications to identifying promised goods or services are consistent with the proposed ASU. However, the Board will also provide cost guidance for services that are immaterial in the context of the contract.

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 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.⁴

⁴ FASB ASC paragraphs 606-10-25-16 to 25-17, available at www.fasb.org.

The Board tentatively agreed to amend the standard to specify that an entity is not required to identify as a performance obligation those goods or services to be transferred to the customer that are immaterial in the context of the contract. This guidance was provided in an attempt to make implementation of the revenue standard less costly for some preparers.

The Board emphasized that immaterial in the context of the contract is a qualitative and quantitative assessment based on what may be important to the customer. This is a different concept than materiality that is applied to the financial statements as a whole, which focuses on information that is important to financial statement users.

KPMG Observations

Several comment letter respondents indicated that the term immaterial could lead to complexity when applying the guidance because it would introduce a new materiality concept. It is as yet unclear to what degree immaterial in the context of the contract includes other quantitatively small-dollar items that would not have been considered inconsequential or perfunctory, a commonly understood concept within legacy U.S. GAAP.⁵

The Board decided to provide guidance that will require costs associated with promises deemed to be immaterial in the context of the contract to be accrued when the goods or services are provided to the customer.

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 (*capable of being distinct*) and the promise to transfer the good or service is separately identifiable (*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.⁶

The Board tentatively agreed to amend the guidance on distinct in the context of the contract, consistent with the proposed ASU.

- Explanatory language will be provided to better articulate the principle. The revised language will indicate that the objective when considering whether promised goods or services are separately identifiable is to determine whether the nature of the entity's overall promise in the contract is to transfer (a) each of those separate goods or services, or (b) a combined item (or items) to which the promised goods or services are inputs.



The Board's clarifications to distinct in the context of the contract are consistent with the proposed ASU.

⁵ SEC Staff Accounting Bulletin Topic 13.A.3.c, available at www.sec.gov.

⁶ FASB ASC paragraph 605-25-25-5(a), available at www.fasb.org.

- The factors for determining what is distinct in the context of the contract will be revised to more closely relate to the 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.
- Examples will be added to demonstrate how the separation guidance should be applied.

KPMG Observations

In general, the rearticulated principle, related indicators, and additional examples represent an improvement to the revenue recognition standard. These changes should be helpful to stakeholders in determining whether goods or services are distinct within the context of the contract.

Series Guidance

The revenue standard requires that if promised goods or services are (1) distinct; (2) substantially the same; (3) transferred to the customer over time; and (4) the same measure of progress would be used for each individual good or service, then the aggregate promised goods or services in the contract *must* be accounted for as a single performance obligation (the series guidance).⁷

Applying the series guidance impacts the accounting related to the allocation of variable consideration, contract modifications, and changes in the transaction price. Some had previously informed the FASB that this guidance was overly complex for some arrangements.⁸ In the proposed ASU, the Board asked constituents whether they believe the series guidance should be optional.

Although some respondents favored making the series guidance optional, others indicated this would result in lack of comparability. Additionally, the IASB is not currently considering making its series guidance optional. The Board decided that it would *not* make the series guidance optional. That is, if the criteria for applying the series guidance are met, an entity must treat the series as a single performance obligation. The Board also instructed the FASB staff to ensure appropriate education was provided for the series guidance because the Board believes that many of the questions arose because of a lack of understanding.

The revenue standard also requires that an entity disclose the aggregate amount of the transaction price allocated to performance obligations that are unsatisfied or partially satisfied at the end of the reporting period and provide an explanation about when the entity expects to recognize this amount as revenue.⁹ The Board considered whether to exempt entities that are subject to the series guidance from this disclosure requirement. The Board determined that further analysis was needed before it could conclude that changes in the disclosure requirements are appropriate.

⁷ FASB ASC paragraph 606-10-25-14b, available at www.fasb.org.

⁸ See KPMG Defining Issues No. 15-13, Revenue Transition Group Discusses Consideration Payable to a Customer, Series Guidance, available at www.kpmg-institutes.com.

⁹ FASB ASC paragraph 606-10-50-13, available at www.fasb.org.

KPMG Observations

Although entities *must* apply the series guidance if certain criteria are met, the Board is aware of the difficulties associated with disclosing the amount allocated to unsatisfied performance obligations when an entity's performance obligation is a series and the variable consideration is allocated entirely to each distinct good or service.

However, the Board decided not to provide an exemption from the disclosure requirements until it obtains a more comprehensive understanding of preparers' concerns and potentially about other disclosure requirements in the standard. The Board emphasized that it is not interested in reopening a broad discussion on the disclosure requirements of the revenue standard. However, it is aware that many companies are just beginning to develop an understanding of the standard's disclosure requirements. Entities should consider sharing other concerns about disclosures either formally or informally with the Board because it may consider making some limited exemptions.

Accounting for Shipping and Handling Services



The Board's clarifications to shipping and handling are consistent with the proposed ASU. However, the Board will also provide cost guidance for shipping and handling.

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 fees when an entity charges separately for them.¹⁰ 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, which generally would include amounts charged for shipping and handling.

The more significant question is whether the entity is required to identify shipping and handling services as a performance obligation (whether or not it charges the customer for these services) when it concludes that it has transferred control of the goods to the customer before the product is shipped. The Board tentatively concluded that it will provide a policy election that would allow an entity to choose 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 the goods are shipped. The Board decided to provide guidance requiring costs associated with shipping and handling activities to be accrued when control of the related goods has transferred to the customer and the entity has determined that it will not account for shipping and handling as a separate performance obligation.

¹⁰ FASB ASC paragraphs 605-45-45-19 to 45-21, available at www.fasb.org.

Example: Shipping and Handling Services

An entity sells a product to a customer and ships the product with FOB shipping point terms. The entity has a customary business practice of replacing products if they are damaged in transit (synthetic FOB destination). The entity must determine whether control transfers at the shipping point or if control does not transfer until it arrives at the customer's location. If the entity concludes that control of the goods transfers at the shipping point, the entity could 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 performance obligation would be recognized as shipping occurs.

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 and accruing the cost of shipping.

If the entity concludes that control of the goods transfers when the goods arrive at the customer's location, then the entity would treat the shipping as a fulfillment cost, and recognize all of the revenue when the goods are delivered to the customer's location.

The FASB noted that the cost of shipping and handling that occurs *prior* to the customer obtaining control of the goods is a fulfillment cost rather than a performance obligation.

KPMG Observations

Under current U.S. GAAP entities may have arrangements with FOB shipping point terms that are accounted for as FOB destination arrangements (i.e., synthetic FOB destination) because the entity has determined that risks and rewards do not pass to the customer at shipping point (e.g., the entity has a business practice of covering damage to the product that occurs in the shipping process or providing the customer with a replacement product if the product is lost in transit). All entities will need to consider the indicators included in the revenue standard to determine when control transfers, which may require significant judgment and may lead to diversity in practice. In particular, entities that currently recognize revenue when the goods arrive at the customer location based on synthetic FOB destination terms may determine that under the revenue standard control transfers to the customer when the goods are shipped and will need to make a policy election to account for the shipping services as a fulfillment activity or a performance obligation. The IASB is not proposing a similar amendment. Consequently, this could be an area that results in divergent outcomes.

Next Steps

The FASB intends to issue an Accounting Standards Update covering these topics before the end of 2015.

The FASB recently issued an exposure draft on other narrow-scope improvements and practical expedients with comments due by November 16, 2015.¹¹ In addition, the FASB previously issued an exposure draft to amend the guidance on determining whether the entity is a principal or an agent with comments due by October 15, 2015.¹²

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

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¹¹ FASB Proposed Accounting Standards Update, Narrow-Scope Improvements and Practical Expedients, September 30, 2015, available at www.fasb.org.

¹² FASB Proposed Accounting Standards Update, Principal versus Agent Considerations (Reporting Revenue Gross versus Net), August 31, 2015, available at www.fasb.org.