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Heads Up

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License to Clarify

FASB Issues Proposed Revenue ASU on Licensing and Identifying Performance Obligations

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Introduction

On May 12, 2015, the FASB issued a proposed ASU that would amend certain aspects of the Board's May 2014 revenue standard (ASU 2014-09[1]), specifically the guidance on identifying performance obligations and the implementation guidance on licensing. The amendments are being made in response to feedback received by the FASB–IASB joint revenue recognition transition resource group (TRG), which was formed to address potential issues associated with the implementation of ASU 2014-09.

The proposed amendments include the following:

- Identifying performance obligations:
  - *Immaterial promised goods or services* — Entities may disregard goods or services promised to a customer that are immaterial in the context of the contract.
  - *Shipping and handling activities* — A practical expedient would be added to allow shipping or handling activities occurring after control has passed to the customer to be treated as a fulfillment cost rather than as a revenue element (i.e., a promised service in the contract).
  - *Identifying when promises represent performance obligations* — The proposal would refine the separation criteria for assessing whether promised goods and services are distinct, specifically the "separately identifiable" principle (the "distinct in the context of the contract" criterion) and supporting factors.
- Licensing implementation guidance:
  - *Determining the nature of an entity's promise in granting a license* — Intellectual property (IP) would be classified as either functional or symbolic, and such classification would generally dictate whether, for a license granted to that IP, revenue must be recognized at a point in time or over time, respectively.
  - *Sales-based and usage-based royalties* — The sales-based and usage-based royalty exception would apply whenever the royalty is predominantly related to a license of IP. The proposed ASU therefore indicates that "[a]n entity would not split a sales-based or usage-based royalty into a portion subject to the guidance on sales-based and usage-based royalties and a portion that is not subject to that guidance."

[1] FASB Accounting Standards Update No. 2014-09, *Revenue From Contracts With Customers*.

This *Heads Up* provides background on the proposed ASU and summarizes its key provisions. Appendix A lists the proposed ASU's questions for respondents. Appendix B contains a table comparing the proposed ASU's provisions with the IASB's tentative decisions to date.

Comments on the proposed ASU are due by June 30, 2015.

Editor's Note: The IASB intends to issue a separate exposure draft, *Clarifications to IFRS 15* Revenue From Contracts With Customers*: Issues Emerging From TRG Discussions*, in the late second quarter of 2015. See the IFRS work plan for more information.

Identifying Performance Obligations (Step 2)

Immaterial Promised Goods or Services

Background

Under the new revenue standard, an entity must (1) identify the goods or services it has promised to the customer in a contract and (2) determine whether those promised goods or services are performance obligations (i.e., because they are distinct from each other). Because of the wording in paragraphs BC87–BC90 of the new revenue standard's Basis for Conclusions, some stakeholders have questioned whether the boards intended performance obligations that are not identified as deliverables under existing revenue guidance to be identified as performance obligations under the new standard. Unlike the SEC's guidance in SAB Topic 13.A.5, the revenue standard does not contain guidance on "inconsequential or perfunctory" items.

The issue raised was whether it is necessary for an entity to identify immaterial goods or services when identifying performance obligations.

Editor's Note: Constituents also were concerned that the new revenue standard, unlike current U.S. GAAP, could result in the treatment of certain marketing incentives as performance obligations rather than as expenses. In its meeting memo, the FASB confirmed that marketing incentives should be evaluated under the guidance on identifying performance obligations. Entities should submit comments to the FASB if they have concerns or additional views related to this matter.

Key Provisions of the Proposed ASU

The proposed ASU states that an entity would not be required to "identify goods or services promised to a customer that are immaterial in the context of the contract." In addition, the proposal indicates that an entity would consider materiality of items or activities only at the contract level (as opposed to aggregating such items and performing an assessment at the financial statement level). This change would not apply to an entity's assessment of optional goods and services offered to a customer, which the entity must evaluate under ASC 606-10-55-41 through 55-45[2] to determine whether they provide the customer with a material right (i.e., an optional good offered for free or at a discount, such as that provided through loyalty point programs, may not be material for an individual contract but could be material in the aggregate and accounted for as a material right).

[2] For titles of *FASB Accounting Standards Codification* (ASC) references, see Deloitte's "Titles of Topics and Subtopics in the *FASB Accounting Standards Codification*."

Editor's Note: The proposed ASU would permit entities to choose not to evaluate whether immaterial items or activities represent performance obligations. Thus, the exclusion of such immaterial items or activities under the new revenue standard would not be considered a departure from GAAP and need not be aggregated as a misstatement.

Shipping and Handling Activities

Background

Under existing revenue guidance, an entity generally does not account for shipping services that it provides in conjunction with the sale of its products as an additional deliverable. Stakeholders have asked the FASB to clarify whether shipping and handling services (collectively, "shipping services") that do not represent the predominant activity in the contract should be accounted for as a promised service (i.e., potentially a separate performance obligation to which a portion of the transaction price must be allocated) or as a fulfillment cost that would be accounted for under the new fulfillment cost guidance in ASC 340-40.

Key Provisions of the Proposed ASU

The proposed ASU contains a practical expedient that would permit an entity to account for shipping and handling activities that occur after the customer has obtained control of a good as fulfillment activities (i.e., an expense) rather than as a promised service (i.e., a revenue element). An entity may also elect to account for shipping and handling as a promised service. The proposed ASU also explains that shipping and handling activities performed before the control of a product is transferred do not constitute a promised service to the customer in the contract (i.e., they represent fulfillment costs).

Editor's Note: The practical expedient typically would not apply to companies whose principal service offering is shipping or transportation.

Example

An entity sells a product to its customer with free on-board shipping point terms on December 31, 20X8 (and determines that control is transferred to the customer as of that date). The product is shipped by a third-party carrier at the entity's direction. The product arrives at the customer's location on January 5, 20X9. Consideration paid by the customer is $1,000.

Under ASC 606, the entity might conclude that the shipping activities are a promised service in the contract and represent a separate performance obligation. In this case, the entity would be required to allocate the $1,000 of consideration between the product and the shipping services. The portion of the consideration allocated to the product would be recognized on December 31, 20X8 (when control of the product is transferred to the customer), and the portion allocated to the shipping services would be recognized as those services occur (most likely over the days the product was in transit).

Under the proposed ASU, the entity could apply the practical expedient and account for the shipping activity as a fulfillment cost rather than a promised service in the contract. That is, the entity could recognize the entire $1,000 as revenue and accrue any costs related to the shipping activity on December 31, 20X8 (i.e., when control of the product is transferred to the customer).

Identifying When Promises Represent Performance Obligations

Background

The new revenue guidance requires entities to identify distinct goods or services as performance obligations. A good or service is distinct if (1) "the customer can benefit from [it] on its own or together with other resources that are readily available to the customer" and (2) "the entity's promise to transfer the good or service to the customer is separately identifiable from other promises in the contract." The first criterion is similar to the concept of stand-alone value under current U.S. GAAP. However, stakeholders have requested that the FASB provide additional guidance on the second criterion that clarifies when a promise is "separately identifiable."

Key Provisions of the Proposed ASU

The proposed ASU clarifies the intent of the "separately identifiable" principle in ASC 606-10-25-21 by providing "three factors that indicate that an entity's promises to transfer goods or services to a customer are not separately identifiable" in a manner consistent with the notion of separable risks. Accordingly, the focus is now on the bundle of goods or services instead of individual goods or services. The proposed ASU would amend ASC 606-10-25-21 as follows (added text is underlined, and deleted text is ~~struck out~~):

> **606-10-25-21** The objective when assessing whether an entity's promises to transfer goods or services to the customer are separately identifiable in accordance with paragraph 606-10-25-19(b) is to determine whether the nature of the entity's overall promise in the contract is to transfer each of those goods or services or whether the promise is to transfer a combined item or items to which the promised goods or services are inputs. Factors that indicate that ~~an entity's~~ two or more promises ~~promise~~ to transfer ~~a good~~ goods or services ~~a service~~ to a customer ~~is~~are not separately identifiable ~~(in accordance with paragraph 606-10-25-19(b))~~ include, but are not limited to, the following:
>
> a. The entity ~~does not provide~~ provides a significant service of integrating the ~~good~~ goods or services ~~service~~ with other goods or services promised in the contract into a bundle of goods or services that represent the combined output or outputs for which the customer has contracted. In other words, the entity is ~~not~~ using the ~~good~~ goods or services ~~service~~ as inputs ~~an input~~ to produce or deliver the combined output or outputs specified by the customer. A combined output or outputs might include more than one phase, element, or unit.
>
> b. One or more of the goods or services significantly modifies or customizes, or is significantly modified or customized by, one or more of the other goods or services promised in the contract. ~~The good or service does not significantly modify or customize another good or service promised in the contract.~~
>
> c. The goods or services are highly interdependent or highly interrelated. In other words, each of the goods or services is significantly affected by one or more of the other goods or services in the contract. ~~The good or service is not highly dependent on, or highly interrelated with, other goods or services promised in the contract. For example, the fact that a customer could decide to not purchase the good or service without significantly affecting the other promised goods or services in the contract might indicate that the good or service is not highly dependent on, or highly interrelated with, those other promised goods or services.~~

To further clarify this principle and the supporting factors, the proposed ASU adds five new examples and amends other examples to demonstrate the application of the guidance to several different industries and fact patterns.

Editor's Note: Despite the proposed ASU's clarification of the "separately identifiable" principle, an entity must still use judgment in identifying when promises represent performance obligations. The Board continues to request input on this important topic, and entities should submit comments to the FASB if they have concerns or additional views related to this matter.

Feedback Requested on Series of Distinct Goods or Services

The Board also requested input (Question 1 in Appendix A) on whether the guidance on accounting for a series of distinct goods or services as a single performance obligation should be optional given that this guidance was meant to simplify accounting (akin to a practical expedient). Because this requirement potentially increases complexity for certain entities, at the March 30, 2015, TRG meeting, certain TRG members questioned whether the guidance should be mandatory or whether it may be better to have a practical expedient. See Deloitte's March 2015 *TRG Snapshot* for more information.

Licensing Implementation Guidance

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

Background

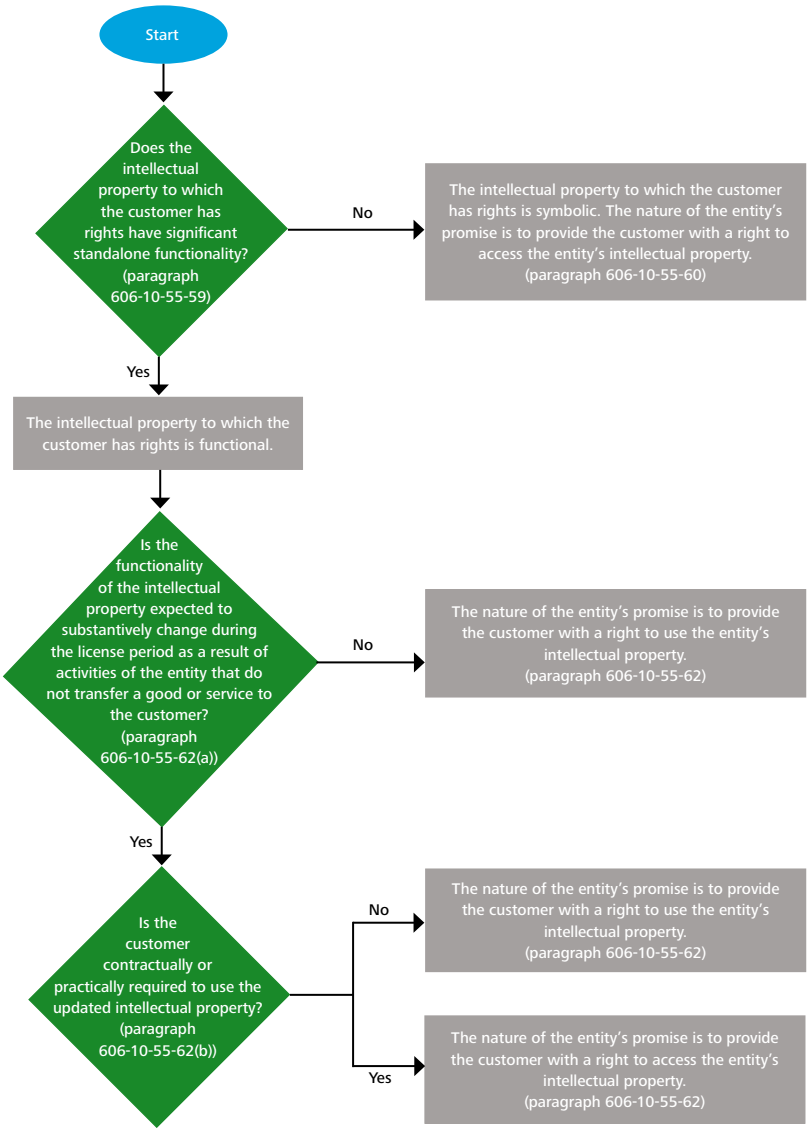
The new revenue standard contains implementation guidance on an entity's promise to grant a license of its IP[3] and requires entities to determine whether the license grants customers a right to use the underlying IP (which would result in point-in-time revenue recognition) or a right to access the IP (which would result in revenue recognition over time). This determination hinges on whether the licensor's ongoing activities are expected to significantly affect the underlying IP. Stakeholders' questions have focused mainly on (1) the nature of the licensor's activities that would affect the IP and (2) how entities should evaluate the impact of such activities on the IP (e.g., the effect on the IP's form and functionality, value, or both).

Key Provisions of the Proposed ASU

The proposed ASU would revise the guidance in ASC 606 to distinguish between two types of licenses: (1) functional IP and (2) symbolic IP, which are classified according to whether the underlying IP has significant stand-alone functionality (e.g., the ability to process a transaction, perform a function or task, or be played or aired). Functional IP would represent a right to use the IP and would be recognized at a point in time (unless there is a requirement to update the IP, in which case it would be accounted for as a right to access and would be recognized over time), whereas symbolic IP would represent a right to access and would be recognized over time. Examples of functional IP include "software, biological compounds or drug formulas, and completed media content (for example, films, television shows, or music)." Examples of symbolic IP include "brands, team or trade names, logos, and franchise rights."

[3] ASC 606-10-55-54 through 55-64; paragraphs B52 through B62 of IFRS 15.

The flowchart below, which is reproduced from the proposed ASU, depicts the decision process an entity could use in determining whether a license to IP represents a right to access or a right to use the IP.



Sales-Based and Usage-Based Royalties

Background

The new revenue standard contains specific guidance on sales- or usage-based royalties promised in exchange for licenses of IP, often referred to as the "royalty constraint exception."[4] In such arrangements, entities must record revenue at the later of when (1) the subsequent sale or usage occurs or (2) the related performance obligation has been fully or partially satisfied. Otherwise, entities would need to apply the general constraint guidance to estimate the amount of variable consideration to include in the transaction price (i.e., the amount of variable consideration that would not be subject to significant revenue reversal) and reassess it.[5]

Questions have arisen regarding application of the royalty constraint when a license is bundled with other goods or services in a contract (e.g., franchise licenses with training services). Some stakeholders have suggested that under the new revenue standard, entities would need to split a single royalty and account for a portion of it under the royalty constraint exception and the remainder under the general variable consideration constraint guidance.

[4] ASC 606-10-55-65; paragraph B63 of IFRS 15.
[5] ASC 606-10-32-11 through 32-14; paragraphs 56 through 59 of IFRS 15.

Key Provisions of the Proposed ASU

The proposed ASU indicates that the royalty constraint guidance would be applied either (1) when the royalty only pertains to a license of IP or (2) when a license of IP is the "predominant item to which the royalty relates (for example, when the customer would ascribe significantly more value to the license than to the other goods or services to which the royalty relates)." The proposed ASU rejects the notion of splitting royalties, indicating that doing so would be complex and may not yield useful information.

Editor's Note: Entities would need to use judgment to determine whether a license of IP — when "bundled" with other goods or services (i.e., the license is not a distinct performance obligation) — is the predominant item to which the royalty is related. However, the change would permit broader application of the royalty constraint and would eliminate the potential need to apply variable consideration and royalty constraint guidance to different portions of a single royalty.

Transition and Effective Date

The proposed ASU's effective date and transition provisions would be aligned with the requirements in ASU 2014-09, which is not yet effective.

Editor's Note: The FASB is seeking comments by May 29, 2015, for a separate proposed ASU, *Revenue From Contracts With Customers (Topic 606): Deferral of the Effective Date*. See Deloitte's April 29, 2015, *Heads Up* for more information.

Appendix A — Questions for Respondents

The proposed ASU's questions for respondents are listed below for reference.

Question 1: Paragraphs 606-10-25-14(b) through 25-15 include guidance on accounting for a series of distinct goods or services as a single performance obligation. Should the Board change this requirement to an optional practical expedient? What would be the potential consequences of the series guidance being optional?

Question 2: Paragraph 606-10-25-16A specifies that an entity is not required to identify goods or services promised to a customer that are immaterial in the context of the contract. Would the proposed amendment reduce the cost and complexity of applying Topic 606? If not, please explain why.

Question 3: Paragraph 606-10-25-18A permits an election to account for shipping and handling as an activity to fulfill a promise to transfer a good if the shipping and handling activities are performed after a customer has obtained control of the good. Would the proposed amendment reduce the cost and complexity of applying Topic 606? If not, please explain why.

Question 4: Would the revisions to paragraph 606-10-25-21 and the related examples improve the operability of Topic 606 by better articulating the separately identifiable principle and better linking the factors to that principle? If not, what alternatives do you suggest and why?

Question 5: Would the revisions to paragraphs 606-10-55-54 through 55-64, as well as the revisions and additions to the related examples, improve the operability of the implementation guidance about determining the nature of an entity's promise in granting a license? That is, would the revisions clarify when the nature of an entity's promise is to provide a right to access the entity's intellectual property or to provide a right to use the entity's intellectual property as it exists at the point in time the license is granted? If not, what alternatives do you suggest and why?

Question 6: The revisions to paragraph 606-10-55-57 that state an entity should consider the nature of its promise in granting a license of intellectual property when accounting for a single performance obligation. Does this revision clarify the scope and applicability of the licensing implementation guidance? If not, why?

Question 7: Would the revisions to paragraph 606-10-55-64 adequately communicate the Board's intent (a) that restrictions of time, geographical region, or use in a license of intellectual property are attributes of the license (and, therefore, do not affect the nature of an entity's promise in granting a license or its assessment of the goods or services promised in a contract with a customer) and (b) about determining when a contractual provision is a restriction of the customer's right to use or right to access the entity's intellectual property? If not, what alternatives do you suggest and why?

Question 8: Would paragraphs 606-10-55-65 through 55-65B and the related example clarify the scope and applicability of the guidance on sales-based and usage-based royalties promised in exchange for a license of intellectual property? If not, what alternatives do you suggest and why?

Appendix B — Comparison of Proposed ASU With IASB's Tentative Decisions

The following table compares the proposed ASU's guidance on identifying performance obligations and licensing implementation guidance with the IASB's tentative decisions on these topics:

Topic	Proposed ASU	IASB's Tentative Decision	Comparison
Identifying Performance Obligations			
Immaterial promised goods or services	An entity would be permitted to evaluate the materiality of promises at the contract level; if the promises are immaterial, the entity would not need to evaluate such promises further.	Updates should not be made, and no standard setting should be undertaken.	The decisions are different, but because the proposed ASU is intended to clarify the guidance, divergence is currently not expected.
Shipping and handling activities	Clarifies that shipping and handling activities that occur before control is transferred to the customer are fulfillment costs. Allows entities to elect a policy to treat shipping and handling activities as fulfillment costs if they occur after control is transferred.	At this time, no updates should be made or standard setting undertaken because the staff is unclear on whether and, if so, the extent to which shipping and handling is an issue for IFRS constituents.	It is unclear whether the different decisions will lead to divergence because the boards may need further information to finalize their views. Specifically, the boards may later decide to make changes on the basis of future feedback from their constituents.
Identifying when promises represent performance obligations	Reframes the separation criteria to focus on a bundle of goods or services. Adds illustrative examples.	Will add illustrative examples but otherwise not amend the standard's guidance.	The boards believe that the decisions are the same except for "minor" wording differences. As a result, divergence is currently not expected.
Licensing Implementation Guidance			
Determining the nature of an entity's promise in granting a license	Requires an entity to characterize the nature of a license as either functional or symbolic.	Potentially requires an entity to assess the utility of a license before characterizing it as functional or symbolic.	The decisions are different, but the differences are currently expected to affect only a small subset of licenses.
Sales-based and usage-based royalties	Clarifies that rather than splitting a royalty (and applying both the royalty and general constraints to it), an entity would apply the royalty constraint if the license is the predominant feature to which the royalty is related.	Same as FASB's proposed ASU.	The decisions are the same; continued convergence is expected.

Editor's Note: The proposed ASU states that "the FASB expects the proposed amendments would maintain or enhance the convergence" and that "the FASB does not expect that the [proposed amendments] would result in financial reporting outcomes that are significantly different from those reported under IFRS for similar transactions."

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