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Heads Up

Retouching Revenue
FASB Clarifies Guidance on Licensing and Identifying Performance Obligations

by Mark Crowley and PJ Theisen, Deloitte & Touche LLP

Introduction

On April 14, 2016, the FASB issued ASU 2016-10,[1] which amends certain aspects of the Board's new revenue standard,[2] specifically the standard's guidance on identifying performance obligations and the implementation guidance on licensing. The amendments in the ASU reflect feedback received by the FASB-IASB joint revenue recognition transition resource group, which was formed to address potential issues associated with the implementation of the new revenue standard, as well as comments received from stakeholders on the FASB's proposed guidance.

ASU 2016-10 amends the guidance on 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* — Entities can elect to account for shipping or handling activities occurring after control has passed to the customer 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 new guidance refines the separation criteria for assessing whether promised goods and services are distinct, specifically the "separately identifiable" principle (the "distinct within 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) is classified as either functional or symbolic, and such classification should 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 applies whenever the royalty is predominantly related to a license of IP. The ASU therefore indicates that an "entity should not split a sales-based or usage-based royalty into a portion subject to the recognition guidance on sales-based and usage-based royalties and a portion that is not subject to that guidance."

[1] FASB Accounting Standards Update No. 2016-10, *Identifying Performance Obligations and Licensing*.
[2] FASB Accounting Standards Update No. 2014-09, *Revenue From Contracts With Customers*; issued as IFRS 15 by the IASB.

- *Restrictions of time, geographical location, and use* — The ASU's examples illustrate the distinction between restrictions that represent attributes of a license and provisions that specify that additional licenses have been provided.
- *Renewals of licenses that provide a right to use IP* — Revenue should not be recognized for renewals or extensions of licenses to use IP until the renewal period begins.

This *Heads Up* provides background on the ASU and summarizes its key provisions.

> **Editor's Note:** On April 12, 2016, the IASB issued clarifications to IFRS 15 that address (1) identifying performance obligations, (2) principal-versus-agent considerations, and (3) licensing. They also provide some transition relief for modified contracts and completed contracts. See the appendix of this *Heads Up* for a comparison of the IASB's and FASB's guidance. For more information about the IASB's clarifications to IFRS 15, see the IASB's Web site.

Identifying Performance Obligations Under Step 2 of the Revenue Standard

Immaterial Promised Goods or Services

Background

Under step 2 of 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 through BC90 of the new revenue standard's Basis for Conclusions, some stakeholders questioned whether the FASB and IASB 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, the revenue standard does not contain guidance on "inconsequential or perfunctory" items. In fact, the Basis for Conclusions notes that "the Boards decided not to exempt an entity from accounting for promised goods or services that the entity might regard as being perfunctory or inconsequential. Instead, an entity should assess whether those promised goods or services are immaterial to its financial statements."

Accordingly, questions arose about whether it was 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 could, unlike current U.S. GAAP, result in the treatment of certain marketing incentives as performance obligations rather than as expenses. In a meeting memo, the FASB confirmed that marketing incentives should be evaluated under the guidance on identifying performance obligations.

Key Provisions of the ASU

ASU 2016-10 states that an entity "is not required to assess whether promised goods or services are performance obligations if they are immaterial in the context of the contract with the customer." In addition, the ASU indicates that an entity should 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 should not apply to an entity's assessment of optional goods and services offered to a customer, which the entity must evaluate under ASC 606-10-55-42 and 55-43[3] to determine whether they give the customer a material right (i.e., an optional good offered for free or at

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

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).

Editor's Note: The ASU permits 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 (i.e., before the new revenue standard's effective date), 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 asked the FASB to clarify whether shipping and handling 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 should be accounted for under the new fulfillment cost guidance in ASC 340-40.

Key Provisions of the ASU

ASU 2016-10 permits 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 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 election to account for shipping and handling services as a performance obligation or a fulfillment cost typically should not apply to companies whose principal service offering is shipping or transportation. Further, we believe that such election (1) should be applied consistently and (2) is available to entities that recognize revenue for the sale of goods at either a point in time or over time.

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 the ASU, the entity can elect to account for the shipping activities as a promised service in the contract (a separate performance obligation) or as a fulfillment cost. If the entity elects to account for the shipping service as a separate performance obligation, 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).

If the entity elects to account for the shipping activity as a fulfillment cost rather than a promised service in the contract, the entity would 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 standard 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 requested that the FASB provide additional guidance on the second criterion that clarifies when a promise is "separately identifiable."

Key Provisions of the ASU

ASU 2016-10 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 ASU amends ASC 606-10-25-21 as follows (added text is underlined, and deleted text is ~~struck out~~):

> **606-10-25-21** In 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), the objective is to determine whether the nature of the promise within the context of the contract, is to transfer each of those goods or services individually or, instead, 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 ~~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 are 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. For example, in some cases, two or more goods or services are significantly affected by each other because the entity would not be able to fulfill its promise by transferring each of the goods or services independently. ~~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 ASU adds six 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 ASU's clarification of the "separately identifiable" principle, an entity must use judgment in identifying when promises represent performance obligations. For instance, Case A in the ASU's Example 11 concludes that an installation service that is "routinely performed by other entities" is distinct. However, services do not need to be provided by other parties for an entity to reach a conclusion under the revenue standard that they are distinct. Entities must therefore carefully assess situations in which other entities do not provide the same good or service.

Licensing Implementation Guidance

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

Background

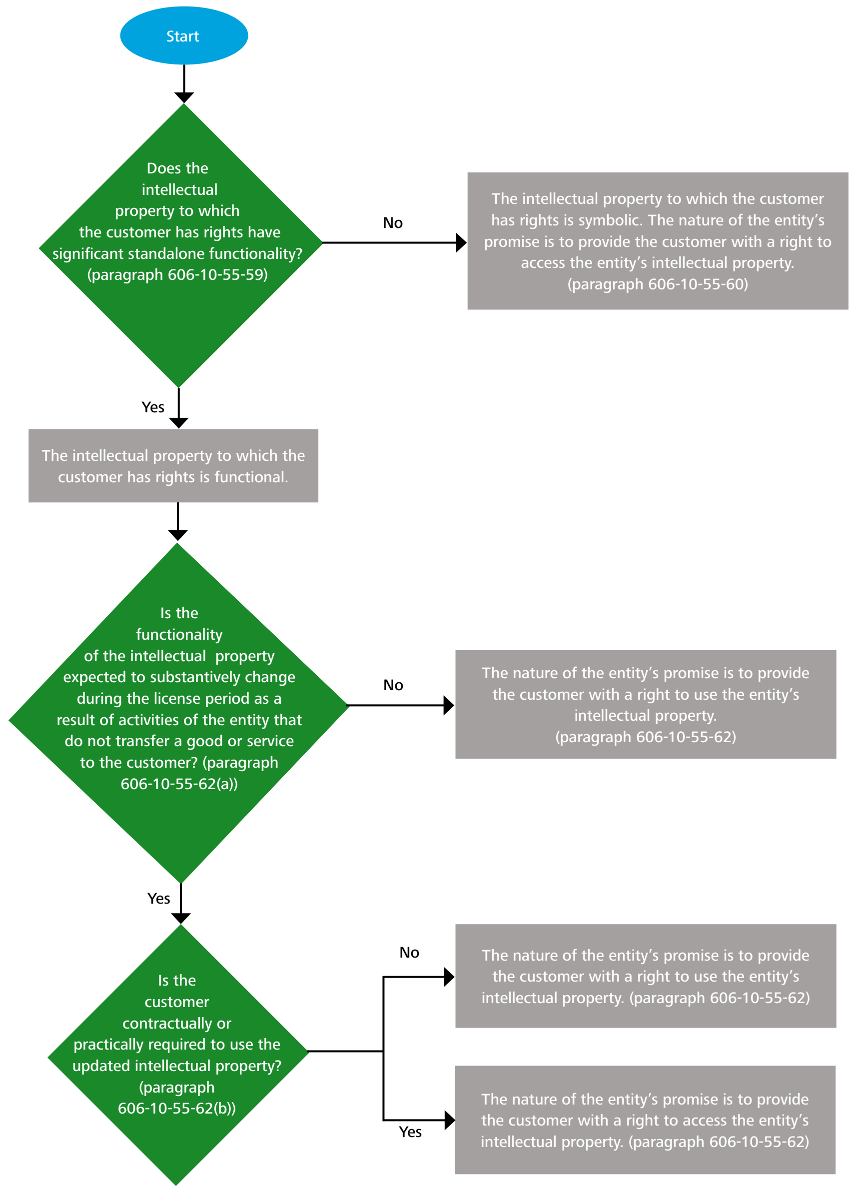
The new revenue standard contains implementation guidance on an entity's promise to grant a license of its IP[4] and requires entities to determine whether the license grants customers a right to use the underlying IP (which should result in point-in-time revenue recognition) or a right to access the IP (which should 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 focused mainly on (1) the nature of the licensor's activities that 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 ASU

The ASU revises 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 represents a right to use the IP and should be recognized at a point in time, whereas symbolic IP represents a right to access and should 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."

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

The flowchart below, which is reproduced from the ASU, depicts the decision process an entity should 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."[5] 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.[6]

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

Stakeholders expressed uncertainty about how to apply the royalty constraint when a license is bundled with other goods or services in a contract (e.g., franchise licenses with training services). Some 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.

Key Provisions of the ASU

The ASU indicates that the royalty constraint guidance should 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, the license of intellectual property may be the predominant item to which the royalty relates when the entity has a reasonable expectation that the customer would ascribe significantly more value to the license than to the other goods or services to which the royalty relates)." The ASU rejects the notion of splitting royalties, indicating that doing so would be complex and may not yield useful information. Note that this guidance applies only to licenses of IP and not sales of IP.

> **Editor's Note:** Entities 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. The change permits broader application of the royalty constraint and eliminates the potential need to apply variable consideration and royalty constraint guidance to different portions of a single royalty.

Restrictions of Time, Geographical Location, or Use

Background

After the issuance of the new revenue standard, stakeholders sought guidance on the effect of contractual restrictions on the accounting for licenses of IP under ASC 606. Their views differed about whether contractual restrictions could affect the number of licenses granted to the customer or whether such restrictions simply represented attributes of the license.

Key Provisions of the ASU

Examples in the ASU clarify that restrictions of time, geographical region, or use affect the scope of the customer's right to use or right to access the entity's IP (i.e., they are attributes of a license) and do not define the nature of the license (i.e., functional versus symbolic). However, restrictions should be distinguished from contractual provisions that, explicitly or implicitly, require the entity to transfer additional goods or services (including additional licenses) to the customer (e.g., an entity that promises a license to a song that can be used in one specific country during the first year of the license but, during the second year of the license, can be used throughout the entire world effectively promises to provide one license at the start of the first year and another license at the start of the second year).

Renewals of Licenses That Provide a Right to Use IP

Background

During the FASB's outreach on the proposed ASU, questions arose on the timing of recognizing revenue related to an extension or renewal of a license that provides a right to use an entity's IP (revenue recognized at a point in time). Since the IP is already available to the customer at the time the customer decides to renew, it was unclear whether revenue related to the renewal period should be recognized at the time the customer agreed to renew or at the beginning of the renewal period.

Key Provisions of the ASU

Under the proposed guidance, it would have been appropriate to recognize revenue for an extension of an original license in which the IP had already been delivered at the time the extension was agreed upon. However, the Board ultimately decided to require entities to recognize revenue related to a renewal when the renewal period begins. The Board noted that "a renewal license is subject to the same revenue recognition requirements as any other license that grants additional rights to the customer."

> **Editor's Note:** The ASU's guidance on renewals or extensions of licenses will be a change for certain entities that apply ASC 985-605-55-105 through 55-109 on renewals of software licenses. That guidance permits entities to recognize revenue for a right to use a license that is being extended or renewed for a preexisting, currently active license for the same product when the extension is agreed upon.

Transition and Effective Date

The ASU's effective date and transition provisions are aligned with the requirements in the new revenue standard, which is not yet effective.

Appendix — Comparison of the FASB's and IASB's Guidance

The following table compares the FASB's guidance on identifying performance obligations and its licensing implementation guidance under ASU 2016-10 with the IASB's guidance as a result of its recently issued clarifications to IFRS 15:

Topic	FASB's Guidance	IASB's Guidance	Comparison
Identifying Performance Obligations			
Immaterial promised goods or services	An entity is permitted to evaluate the materiality of promises at the contract level; if the promises are immaterial, the entity does not need to evaluate such promises further.	No changes to IFRS 15.	The ASU clarifies but does not change the revenue standard's guidance; therefore, divergence is 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.	No similar policy choice is available for shipping and handling activities after control is transferred.	The decision to not allow a policy election will result in divergence. Entities that adopt IFRSs will need to determine whether shipping and handling after control has transferred is a performance obligation.
Identifying when promises represent performance obligations	Reframes the separation criteria to focus on a bundle of goods or services. Adds illustrative examples.	Same as FASB's guidance.	Continued convergence is 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.	Clarifies the guidance on when an entity is expected to undertake activities that will significantly affect intellectual property and, if so, to characterize a license as a right to use.	The decisions are different and will result in divergence. Although the accounting for many licenses will be similar under both U.S. GAAP and IFRSs, some licenses may be accounted for differently.
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 guidance.	The decisions are the same; continued convergence is expected.
Restrictions of time, geographical location, and use	Distinguishes contractual provisions that require an entity to transfer additional licenses to a customer from those that define the attributes of a promised license.	No changes to IFRS 15.	The ASU clarifies but does not change the revenue standard's guidance; therefore, divergence is not expected.
Renewals of licenses that provide a right to use IP	Adds guidance and an example to clarify that a renewal or extension of a license is subject to the use and benefit guidance, which will result in revenue recognition at the beginning of the renewal period.	No changes to IFRS 15.	The decisions are different and will result in divergence. Therefore, depending on facts and circumstances, revenue for license renewals may be recognized sooner for entities that report under IFRSs.

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