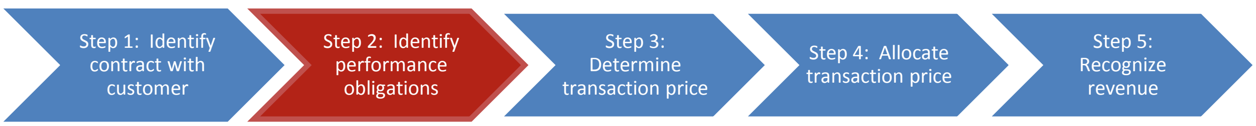
Updated Revenue Guidance for Performance Obligations & Licenses

On April 14, 2016, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2016-10, *Revenue from Contracts with Customers (Topic 606): Identifying Performance Obligations and Licensing.* The amendments clarify how companies should identify performance obligations and account for licenses of intellectual property (IP) under the new revenue recognition standard. The amendments do not change the core principles of the revenue rules but rather are intended as clarification to reduce diversity in practice and reduce cost and complexity at transition and on an ongoing basis.



Performance Obligations

Before an entity can identify its performance obligations in a contract with a customer, it must first identify the promised goods or services in the contract. The amendments modify the following guidance.

Immaterial Items

FASB did not expect entities to identify significantly more performance obligations than the deliverables identified today. However, concerns arose since the standard's basis for conclusions noted the current U.S. Securities and Exchange Commission guidance on inconsequential or perfunctory performance obligations were intentionally not incorporated into the new standard. The amendments clarify entities would be allowed to disregard promises deemed immaterial in the context of the contract with a customer. If revenue is recognized on such transactions before the immaterial goods or services are transferred to the customer, an entity should accrue the related costs to transfer those goods or services. In addition, such items would not be required to be aggregated and assessed for materiality at the entity level for auditing purposes. It should be noted an entity cannot apply this to a customer option to acquire additional goods or services that provides the customer with a material right.

The cost accrual requirement only applies to items that are promises to the customer in the contract. Items not promised to a customer in the contract would not be subject to the guidance. For example, an entity typically would not be required to accrue costs for answering general questions about a product, since this service is broadly available and does not fulfill a specific promise to a customer.

Shipping & Handling

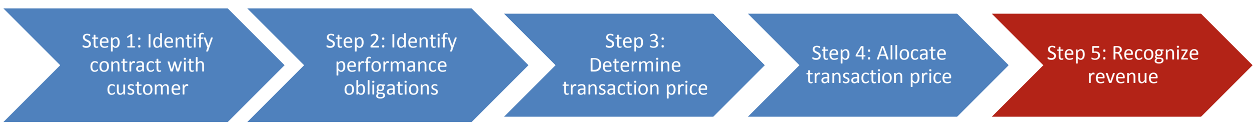
Under existing revenue guidance, many entities do not account for shipping of their sold goods as an additional deliverable. To reduce the cost and complexity of applying the new standard, the ASU would allow entities to elect to account for the cost of shipping and handling performed after control of a good has been transferred to the customer as a fulfillment cost, *i.e.*, an expense. The election would be applied consistently to similar transactions; it is not an entitywide election since companies can have multiple customer arrangements. If revenue is recognized for the related good before the shipping and handling activities occur, the related costs of those shipping and handling activities would be accrued.

Distinct

The updates clarify when a promised good or service is separately identifiable, *i.e.*, distinct within the context of the contract. The amendments improve the guidance by:

- Improving the articulation of the principle for determining whether promises to transfer goods or services to a customer are separately identifiable. An entity would determine whether the nature of its promise in the contract is to transfer each of the goods or services, or whether the promise is to transfer a combined item, or items, to which the promised goods and/or services are inputs
- Revising the related factors so they align with the improved articulation of the separately identifiable principle
- Adding examples to the standard

Licenses

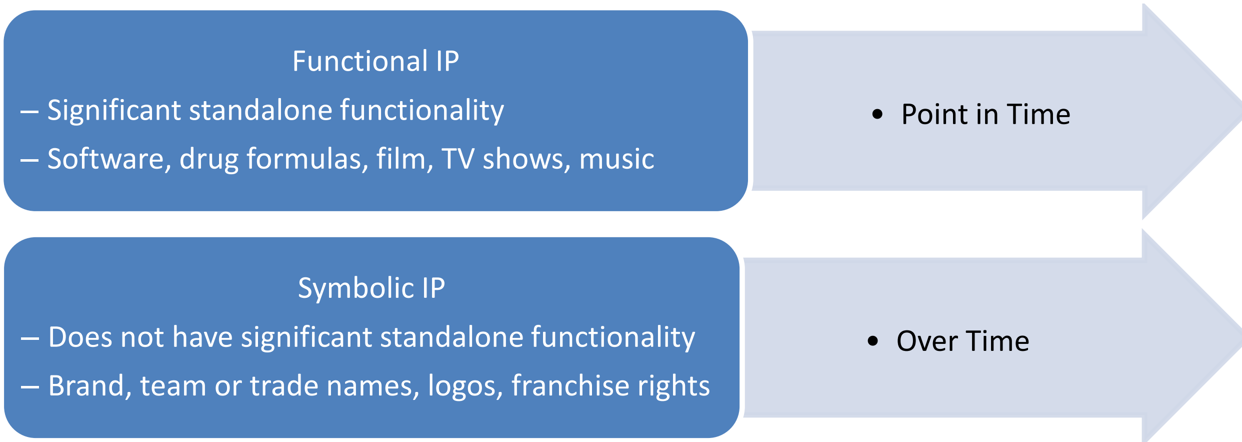


The type of license determines the timing of revenue recognition and is a challenging analysis requiring management judgment, even under current guidance. The amendments clarify how an entity should evaluate the nature of its promise in granting an IP license and amends the guidance to address how entities should apply the exception for sales- and usage-based royalties to IP licenses when licenses are not separate performance obligations. The ASU includes a flowchart to assist in the evaluation of the nature of an IP license (see Appendix A).

IP Licenses

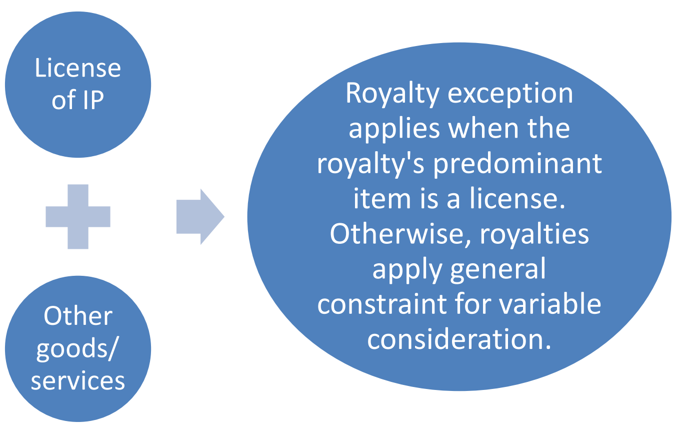
Entities would classify IP in one of two categories:

- **Functional IP** – This IP has significant standalone functionality. Because functional IP has significant utility independent of the licensor's past or ongoing activities, and the functionality is not changing because of the licensor's ongoing activities, the license is satisfied at the point in time the IP is made available for the customer's use. If the functionality is expected to change, and the customer will be required or compelled to use the latest version of the IP, revenue for the license would be recognized over time.
- **Symbolic IP** – This is IP without significant standalone functionality. The benefit from licenses of symbolic IP depends on the IP's continuing support and maintenance. For example, a license to a sports team's name and logo typically would have limited residual value if the team stops playing games, *e.g.*, Hartford Whalers or Tampa Bay Devil Rays. Symbolic IP grants the customer an access right satisfied over time as the entity fulfills its promise to both:
    - Grant the customer's right to use and benefit from the IP
    - Support and maintain the IP



Sales- & Usage-Based Royalties

Licenses are frequently bundled in a single contract with other goods and services. Several companies asked for clarification on the proper accounting treatment when licenses are bundled. In a case where the only consideration is a royalty based on the customer's subsequent product sales using the IP, does the general constraint on variable consideration, the royalty exception or some combination of the two based on the different promises, in the contract apply? The ASU clarifies when the exception for IP licenses subject to a sales- and usage-based royalty, *i.e.*, the sales-based royalty constraint, would apply. An entity would not be required to split a royalty into the portion subject and not subject to the royalty exception. The sales-based royalty constraint would be applied to the overall royalty stream when the sole or predominant item within the arrangement is the IP license; otherwise, the general constraint on variable consideration would apply to the entire arrangement. FASB acknowledges judgment will be required to determine when a license is the predominant item related to a sales-based or usage-based royalty.



Contractual Restrictions

Contractual restrictions on use, *e.g.*, limits during certain windows of time or to a geographic area, are attributes of a license that define the scope of a customer's rights under the license. However, they do not define whether the entity satisfies its performance obligation at a point in time or over time and do not create an obligation for the entity to transfer any additional rights to use or access its IP. In addition, a promise to defend a patent right is not a promised good or service.

Transition & Effective Date

The amendment's effective date and transition requirements are the same as the new revenue standard's deferred effective date and transition requirements. Public entities should apply the amendments for annual reporting periods beginning after December 15, 2017, including interim reporting periods therein, *i.e.*, January 1, 2018, for a calendar-year entity. All other entities have an additional year.

BKD continues to monitor the revenue recognition standard process. Visit our Hot Topics Page to learn more.

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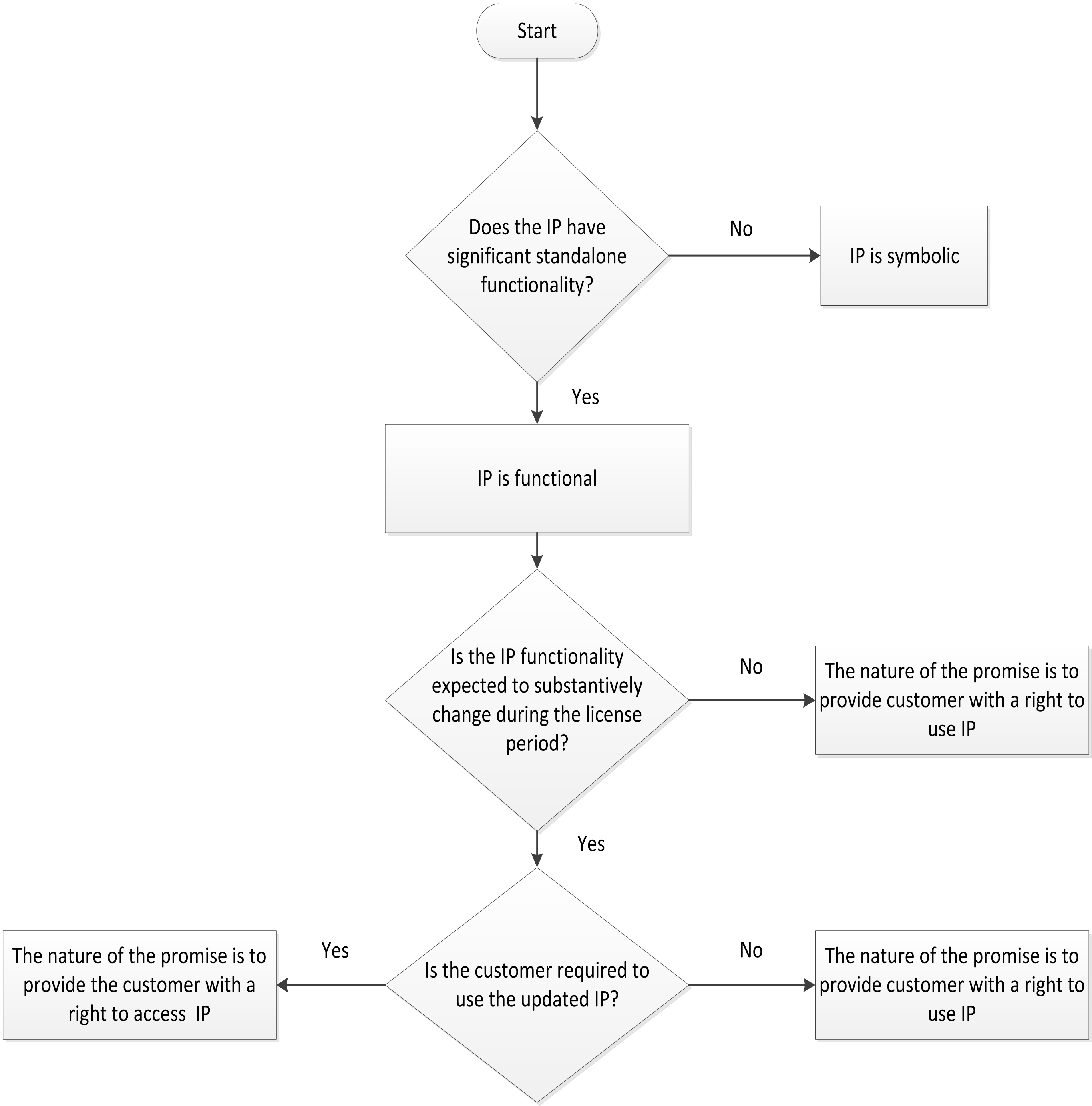
Appendix A


Start
Does the IP have significant standalone functionality?
No
IP is symbolic
Yes
IP is functional
Is the IP functionality expected to substantively change during the license period?
No
The nature of the promise is to provide customer with a right to use IP
Yes
Is the customer required to use the updated IP?
Yes
The nature of the promise is to provide the customer with a right to access IP
No
The nature of the promise is to provide customer with a right to use IP