Boards reach different decisions on some of the proposed changes to the new revenue standards

**What you need to know**

- The Boards agreed that changes to the new revenue recognition guidance on licences and identifying performance obligations are likely to be necessary, but they did not agree on the nature and breadth of some changes or on the timing.
- The new standards are currently converged, but if the Boards act on the views they expressed at the joint meeting, there may be some diversity in practice between US GAAP and IFRS preparers.
- Any changes made to either revenue standard would be subject to the due process procedures of each Board, including seeking public comment.

**Highlights**

The International Accounting Standards Board (IASB) and the US Financial Accounting Standards Board (FASB) (collectively, the Boards) agreed to clarify the requirements in their new revenue standards (IFRS 15 *Revenue from Contracts with Customers* /US Accounting Standards Update 2014-09 (largely codified in Accounting Standards Codification (ASC) 606)), *Revenue from Contracts with Customers* in respect of accounting for licences of intellectual property (IP) and identifying performance obligations. However, they did not agree on the nature and breadth of all of the changes, or the timing of when such changes may be finalised.

The IASB decided not to issue an exposure draft at this time. Instead, the IASB said it would wait until it determines whether additional clarifications are needed on other topics. The IASB indicated that an exposure draft could be issued in June and final amendments issued near the end of the calendar year.

The FASB added both topics to its technical agenda and directed its staff to begin drafting a proposed amendment based on the tentative decisions it made during the meeting. The FASB Chairman said the goal is to issue an exposure draft as soon as possible, and receive feedback from constituents by the end of June 2015, so that the FASB can finalise the amendments in the third quarter of 2015.
Licences of IP

Determining the nature of an entity’s promise in granting a licence

The Boards agreed to clarify the nature of an entity’s promise in granting a licence of IP, which will determine whether the promise is satisfied over time or at a point in time. Both Boards agreed that activities to be performed by the licensor that affect the ‘utility’ of the IP (which would mean its form, functionality and/or value) would require the licence to be recognised over time. If the IP has significant stand-alone functionality, the licensor’s ongoing activities will not significantly affect the utility of the IP, and revenue would be recognised at a point in time. However, the Boards reached different decisions on how this clarification should be made in their respective standards.

After debating two approaches at length, the IASB voted to propose a limited amendment to clarify and expand on the principles in its new standard, without adding a requirement to classify licences of IP into categories.

The FASB directed its staff to draft amendments that would require entities to classify IP in one of two categories:

- **Functional**: This IP would have stand-alone functionality (e.g., completed media content such as films, television shows and music). It would not change because of the licensor’s ongoing activities (e.g., marketing or promotional activities). Revenue for these licences would be recognised at the point in time that the IP is made available for the customer’s use and benefit.

- **Symbolic**: This IP would not have significant stand-alone functionality (e.g., brand, team and trade names and character images). The utility of symbolic IP would be derived from the licensor’s past or ongoing support (e.g., activities that support the value of character images licensed from an animated film). Revenue from these licences would be recognised over time, as the performance obligation is satisfied (e.g., over the licence period).

The Boards agreed that both of their approaches generally would result in consistent answers. However, the alternatives may result in differences between IFRS and US GAAP when entities license brand names that no longer have any related ongoing activities. Under the IASB approach, revenue would be recognised at a point in time if there are no ongoing activities. Under the FASB approach, a licence of a brand name would be classified as symbolic IP and revenue would be recognised over time, regardless of whether there are any related ongoing activities. FASB members commented that this approach would be more operational and less costly for entities to apply.

**How we see it**

We believe that both of the Boards’ approaches would enhance the operability of the guidance and result in more consistent application. However, the FASB’s tentative decision may require less judgement in this area.

Sales and usage-based royalties

The Boards agreed to amend their standards to clarify when the exception for licences of IP that are subject to a sales or usage-based royalty (i.e., the sales-based royalty exception) would apply. The standards say royalties received in exchange for licences of IP are recognised at the later of when: (i) the sale or usage occurs; or (ii) the performance obligation, to which some or all of the sales or usage-based royalty has been allocated, is satisfied (as a whole or in part).

 Constituents have questioned whether the sales-based royalty exception applies to royalties in arrangements in which the licence is not the only promise. For example, an arrangement may have two performance obligations, one of which is a distinct licence. A licence may also be bundled with another good or service within one performance obligation.
The Boards agreed that the sales-based royalty exception would be applied to the overall royalty stream when the predominant item within the arrangement is the licence of IP. The Boards also agreed to amend the standards to clarify that a sales-based royalty in these types of arrangements would not be partially within the scope and partially outside the scope of the exception.

**Other licence issues**
The Boards did not agree on whether to amend the licence guidance for two other matters. The IASB decided that IFRS 15 (including its Basis for Conclusions) and public discussions of these topics at this meeting, and the meetings of the Joint Transition Resource Group for Revenue Recognition (TRG), provide sufficient guidance on these matters and no clarification is necessary. The FASB directed its staff to draft revisions to its standard to clarify that: (i) in some cases, an entity would need to apply the licence application guidance for a combined performance obligation that includes a licence to help determine the pattern of revenue recognition; and (ii) contractual restrictions on use (e.g., limits on the use of licenced IP during certain windows of time) are attributes of a licence, but they do not affect the identification of promised goods or services.

**Identifying performance obligations**

**Identifying promised goods and services**
The Boards considered whether changes are needed to the requirements in Step 2 of the model, which describe how an entity would identify promised goods or services in a contract. The IASB voted not to change the requirements in IFRS 15 to avoid any risk of unintended consequences, since the requirements are sufficiently clear and because there may be broader implications to consider beyond the revenue standard. However, the FASB decided that changes were necessary. The FASB is trying to address constituents’ questions about whether the new standard requires the identification of promised goods or services that are not identified as deliverables today. The questions arose, in part, because the Boards said in the Basis for Conclusions that they intentionally did not include guidance like the current Securities and Exchange Commission staff guidance on inconsequential or perfunctory performance obligations in their new standards.

The FASB directed its staff to draft new language that would allow entities to disregard promises that are deemed to be immaterial to a contract. The FASB’s intent is to allow entities to disregard immaterial items at the contract level and not to require that they be aggregated and assessed at the entity level.

**Distinct within the context of a contract**
The Boards decided that their standards should be amended to clarify when a promised good or service is ‘separately identifiable’ from other promises in the contract (i.e., distinct within the context of the contract). However, the Boards reached different decisions on how this clarification should be made in their respective standards.

The IASB voted to consider adding only a limited number of examples (e.g., one or two). The FASB plans to propose a three-part change to: (i) refine the principle for determining distinct within the context of the contract to emphasise that the evaluation hinges on whether the multiple promised goods or services work together to deliver a combined item; (ii) align its standard’s three indicators for determining whether a good or service is separately identifiable with this principle; and (iii) add examples to its standard.
Shipping and handling
The Boards discussed transactions that involve shipping and handling. The IASB did not vote on whether to make any changes in this area. In contrast, the FASB directed its staff to draft language that would allow entities to elect to treat shipping and handling, performed after control of the good has been transferred to the customer, as a fulfilment cost (i.e., an expense). Without such an election, an entity that has free on board (FOB) shipping arrangements may determine that the act of shipping is a performance obligation under the new standard. Such an entity would be required to allocate a portion of the transaction price to the shipping service and recognise it over the period that the shipping occurs. Without this amendment, the FASB said entities may need to change practice under US GAAP in ways the FASB did not intend, and that adoption might increase costs for entities reporting under US GAAP that would outweigh any benefits to its investors.

Other technical corrections
The IASB did not discuss making any technical corrections to IFRS 15. Conversely, the FASB decided to pursue two technical corrections to the requirements for identifying performance obligations. The standard currently states that promised goods or services are not limited to explicit promises in a contract, but could be created by “valid customer expectation”. This term will be replaced in the US GAAP version of the standard with “reasonable customer expectation”, to avoid confusion because the standard states that promises to provide goods or services do not need to be enforceable (although the overall arrangement needs to be enforceable to be a contract, as defined under the standard). The FASB also decided to review its standard and make sure that the terms ‘promised goods or services’ and ‘performance obligations’ are used correctly in all instances.

Next steps
Any changes made to the new revenue standards will be subject to the due process procedures of each Board, including seeking public comment.

The FASB is expected to meet early in the second quarter of 2015 to discuss a possible deferral of the effective date of the new revenue standard. It is not yet clear whether the IASB will consider a similar deferral.