What you need to know

• The EITF will address two issues related to contract modifications for licenses of IP: (1) accounting for modifications that extend a license term but are not solely a renewal of the terms and conditions of the original license and (2) accounting for the revocation of a license, including the conversion of a term software license to a software-as-a-service arrangement.

• The objective of the project will be to address diversity in practice that has arisen as entities that have adopted the new revenue guidance in ASC 606 begin modifying IP licenses.

• While no changes to the guidance have been made yet, entities that account for licenses of IP under ASC 606 should be aware of the potential for standard setting as a result of the project. The EITF is scheduled to discuss research related to the project at its next meeting on 13 June 2019.

Overview

The Financial Accounting Standards Board (FASB or Board) has added a project on contract modifications of licenses of intellectual property (IP) to the agenda of the Emerging Issues Task Force (EITF) to address diversity in practice that has arisen under the new revenue standard.

In doing so, the FASB is responding to two agenda requests it received. The Board decided that the EITF should address the following two issues:

• Accounting for additional rights that are granted to the licensee
Accounting for the revocation of licensing rights (including conversion of a term software license to a software-as-a-service arrangement)

While the agenda requests focused on licenses of software, the issues apply to all licenses of IP, especially licenses of functional IP.

Key considerations

Accounting for additional rights that are granted to a licensee

The EITF will address modifications of licenses of IP that involve extensions of the original license term but are not solely renewals of the terms and conditions of the original license. The guidance in Accounting Standards Codification (ASC) 606, Revenue from Contracts with Customers, is not clear on when revenue should be recognized if a modification is not solely a renewal of the same terms and conditions of the original license. As a result, some entities believe that revenue for a license renewal should be recognized when the modification is approved by both the licensor and licensee, while others believe revenue should be recognized at the end of the original license term, which may be later than when the modification was approved.

This is because the licensing guidance\(^1\) states that “an entity would not recognize revenue before the beginning of the license period even if the entity provides (or otherwise makes available) a copy of the intellectual property before the start of the license period or the customer has a copy of the intellectual property from another transaction. For example, an entity would recognize revenue from a license renewal no earlier than the beginning of the renewal period.” (Emphasis added.) The guidance includes an example (Example 592) that illustrates the application of this guidance for a renewal of a license of IP under the same terms and conditions as the original license.

However, it is not clear whether an entity would be required to defer revenue recognition until the end of the original license term if a modification is not solely a renewal of the terms and conditions of the original license (e.g., the modification also adds other goods or services, or changes the pricing). As a result, entities in these situations may recognize revenue from a modification of a license of IP earlier than the entity in the example in the guidance.

The illustration below shows two possible interpretations of the guidance that may be acceptable today:

<table>
<thead>
<tr>
<th>Illustration 1 – Additional rights granted to licensee</th>
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<tr>
<td>Entity A enters into a contract on 1 January 2019 with Customer B to transfer a software license to 100 seats (i.e., rights for 100 users to access the software) of Product C for a two-year term for $200,000. The consideration is paid annually in two equal installments (i.e., $100,000 is due 30 January 2019 and the remaining $100,000 is due on 30 January 2020). The price reflects the standalone selling price (SSP) of Product C.</td>
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<td>On 1 January 2020, Entity A and Customer B modify the contract because the customer needs to acquire more seats to the license. As part of the modification, the old license is terminated, and the customer is granted a new license to 150 seats for a two-year term for $276,000, which represents the second $100,000 payment from the original contract plus an additional $176,000. That is, Customer B receives an 8% discount per seat from the original price because of the added volume.</td>
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<tr>
<td>Entity A determines that the additional seats are distinct from the original seats, and the additional seats are not priced at SSP because the price has decreased by 8%. Therefore, the modification is accounted for as a termination of an existing contract and a creation of a new contract.(^3)</td>
</tr>
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</table>
Under ASC 606, Entity A needs to evaluate when Customer B can use and benefit from the modified software license because that determines when Entity A should recognize revenue related to the modified software license. Entity A would also need to evaluate ongoing services, such as post-contract customer support, which could change the allocation of consideration to the performance obligations and, therefore, the timing of revenue recognition.

To illustrate the different interpretations that may be acceptable under today’s guidance, the analysis below focuses only on the modification itself:

**Interpretation 1**

Entity A determines that the modification is (1) the addition of 50 new seats for a two-year term (from 1 January 2020 through 31 December 2021), (2) a one-year renewal of the original 100 seats (from 1 January 2021 through 31 December 2021) and (3) a reduction of the price of the second year (from 1 January 2020 through 31 December 2020) of the original license by 8%.

Entity A allocates the $176,000 of additional consideration between the 50 new seats and the renewal of the original 100 seats. The consideration allocated to the new seats is recognized on 1 January 2020, while the consideration allocated to the renewal is deferred and will be recognized on 1 January 2021, which is the beginning of the license renewal period and the date when Customer B is able to use and benefit from the modified license.

**Interpretation 2**

Entity A determines that a new license for 150 seats for a two-year term has been granted. Entity A concludes that Customer B can use the software and benefit from the modified license immediately because the customer is not renewing a license with the same terms and conditions as the original contract due to the addition of 50 new seats and change in pricing. As a result, Entity A recognizes the entire $176,000 on 1 January 2020.

**Accounting for the revocation of licensing rights**

The EITF also will address the accounting for contract modifications in which rights conveyed by a license of IP are revoked. Questions have arisen about how to account for a modification that includes a reduction in the rights conveyed by the license (e.g., the number of users of a license) or when the license is revoked (e.g., a software license is converted into a software-as-a-service arrangement).

The FASB staff indicated that as part of its preliminary outreach, it has identified the following views related to the accounting for a revoked license:

- A return reserve that would reduce the amount of revenue recognized for the license of IP should be established at contract inception, if it is possible that the license will be revoked. The return reserve would be accounted for as variable consideration, with changes in the estimate of the return reserve recorded as an increase or decrease to revenue.

- A reversal of revenue occurs when the license rights are revoked (i.e., the potential for revocation does not result in variable consideration and does not require the establishment of a return reserve).

- A reversal of revenue does not occur when a license is revoked because the enforceable rights and obligations for the license of IP transferred at the outset of the contract have not changed.
How we see it

These questions have arisen now that entities that are applying the new revenue standard have begun to modify licenses of IP. While we have seen these questions arise in the technology industry, we believe that all entities that license IP and modify those licenses could face these questions. This includes entities in the media and entertainment and life sciences industries.

Endnotes:

1. ASC 606-10-55-58C(b).
2. ASC 606-10-55-389 to 55-392D.
3. ASC 606-10-25-13(a).