

INSIGHTS

*The Timing and Measurement of
Recognizing Revenue Under Topic 606*

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Recognizing Revenue under *Topic 606*

This publication is the second in a series of discussing the implementation of *Accounting Standards Codification Topic 606: Revenue from Contracts with Customers* ("**Topic 606**"). This publication elaborates on Step 5 of the Five-Step Framework covered in *Topic 606*; specifically the timing and manner of recognizing revenue.

Under **Topic 606**, the method and timing for recognizing revenue will depend on whether the related performance obligation is satisfied over time or at a point in time. For performance obligations satisfied over time, an entity will recognize revenue as it transfers control of the promised good or service to the customer by measuring its progress toward the complete satisfaction of the performance obligation. Appropriate methods for measuring progress include output and input methods. Performance obligations that are not satisfied over time are considered to be satisfied at a point in time. Revenue is recognized for performance obligations satisfied at a point in time when control of the good or service is transferred to the customer.

Topic 606 also provides implementation guidance solely applicable to promises to grant licenses for intellectual property (e.g. software as a service, franchises, trademarks, copyrights, etc.) to a customer. This guidance is important because it will be applied by entities across a broad spectrum of industries. When applying this implementation guidance, an entity will consider the nature of a promise to grant a license for intellectual property to a customer to determine whether the promise provides **the right to access** the intellectual property during the licensing period or **the right to use** the customer's intellectual property as-is at a point in time.

Refer to **Topic 606** and **our earlier publication** regarding the remainder of the Five-Step Framework and effective dates.

Overview

Under **Topic 606**, an entity recognizes revenue from a contract when or as a performance obligation is satisfied by transferring control of a promised good or service to the respective customer. A performance obligation may be completely satisfied over a period of time or at a point in time. The determination of whether an entity satisfies a performance obligation in a contract over a period of time or at a point is made at contract inception as part of STEP 5 of the Five-Step Framework in **Topic 606**, which is discussed in **our earlier publication**. The focus of this publication is on how an entity will recognize revenue in STEP 5, including the recognition of revenue from licenses for intellectual property. This publication is supplemental, and should be read in conjunction with **Topic 606** and **our earlier publication on revenue**.

Control

An understanding of the concepts underlying the principle of control in **Topic 606** is important in determining when an entity has transferred control of a good or service to a customer. The following bullet point list, which has been excerpted¹ from **Topic 606**, is included below to reinforce those concepts, and is important in the context of the following discussion.

- Control of an asset refers to the ability to **direct the use of** and **obtain substantially all of the remaining benefits from** the asset.
- Control includes the ability to prevent other entities from directing the use of and obtaining the benefits from an asset.
- Goods and services are assets, even if only momentarily, when they are received and used (as in the case of many services).

Transfer of Control

Topic 606 provides a binary choice for the timing of the recognition of revenue. If control is transferred over a period of time, then the timing of the revenue recognition will generally match that transfer. If not, then revenue is only recognized when the performance obligation is completed. To qualify for revenue recognition over a period of time, the performance obligation must meet any one of the following criteria²:

- a) The customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs.
- b) The entity's performance creates or enhances an asset (for example, work in process) that the customer controls as the asset is created or enhanced.
- c) The entity's performance does not create an asset with an alternative use to the entity **and** the entity has an enforceable right to payment for performance completed to date. This criterion has the following two parts, both of which must be satisfied in order for this criterion to be met: **(i)** the "no alternative use" part; and **(ii)** the "enforceable payment right" part. While the "no alternative use" part is generally assessed only at contract inception, the "enforceable payment right" part must be satisfied on an on-going basis.

See further analysis of the above criteria in **our earlier publication**.

Performance Obligations Satisfied Over Time

If an entity determines that a performance obligation is satisfied over time, then the entity must measure its progress toward the complete satisfaction of that performance obligation. The objective when measuring progress is to depict an entity's performance in transferring control of the promised goods or services, and as a result, recognize revenue over time in an amount equal to the portion of the transaction price that is commensurate with the entity's progress. Methods of measuring progress toward complete satisfaction of a performance obligation include **output methods** and **input methods**.

¹ See **ASC 606-10-25-25**.

² See **ASC 606-10-25-27**.

An entity will use judgment when determining an appropriate method of measuring progress, and must consider the nature of the promised good or service. Ultimately, the method should be the one that most faithfully depicts the transfer of control of the goods or services promised. Once an appropriate method has been determined, an entity must continue to use that method to measure progress until the complete satisfaction of the respective performance obligation. In other words, it would not be appropriate to change the method of measuring progress during the period over which the entity is satisfying the performance obligation. Furthermore, an entity must consistently apply such method of measuring progress to similar performance obligations and in similar circumstances.

If an entity is not able to reasonably estimate its progress toward complete satisfaction of the performance obligation, then it cannot recognize the revenue over time. However, in some circumstances, an entity may not be able to reasonably measure the outcome of a performance obligation, but expects to recover its costs incurred to satisfy the performance obligation. In those situations, entities can recognize revenue up to the extent of costs incurred until such time that it can measure the outcome of the performance obligation, unless the entity determines that it will incur a loss on the contract. This approach could be appropriate for certain early-stage contracts.

Author's Note: Under **Topic 606**, entities may recognize revenue even if they are not able to make reasonable estimates of their progress toward satisfying a performance obligation, but only if they expect to fully recover their costs incurred to satisfy such performance obligation. An example of this type of situation could be in the early stages of a contract in which the entity has incurred costs for uninstalled materials. If the entity expects to recover those costs, but is not yet able to reasonably estimate its progress toward the complete satisfaction of the respective performance obligation, then revenue may be recognized up to the cost of those materials. In other words, the costs of the uninstalled materials would also be recognized such that gross profit margin will be zero for that performance obligation. This contrasts with current U.S. GAAP (Topic 605), insofar as the accounting treatment for certain similar situations could result in the deferral of the related revenue until those materials are installed.

Regardless of the method, an entity will only include in its measurement the progress of goods or services whose control has been transferred to a customer. The inclusion of a good or service for which control has not been transferred to the customer would result in the overstatement of revenue recognized. Accordingly, when measuring progress, an entity must exclude goods or services if control of the excluded goods or services has not been transferred to the customer.

Measuring progress is not a static exercise. An entity will re-measure its progress toward the complete satisfaction of a performance obligation satisfied over time at the end of each reporting period. This could result in a cumulative adjustment at the date of re-measurement. Additionally, an entity's ongoing measurement of progress toward the satisfaction of a performance obligation satisfied over time will incorporate changes in circumstances that will have an impact on the outcome of the performance obligation. Unlike the re-measurement of progress, an entity will incorporate changes in the outcome of a performance obligation by updating its measure of progress prospectively as a change in accounting estimate³.

³ Refer to **Subtopic 250-10** regarding accounting changes and error corrections.

When applying **Topic 606** and in reading this publication, please keep in mind that progress is measured for each separate performance obligation⁴ that is satisfied over time. An entity's measurement of progress, and therefore revenue recognition, must be tailored specifically for each separate performance obligation and applied consistently. Failure to do so could result in an entity recognizing an incorrect amount of revenue.

As discussed above, there are two primary methods of measuring progress toward satisfaction of a performance obligation: **output methods** and **input methods**. These methods are discussed in the following sections.

Measuring Progress – Output Methods

Output methods are based on direct measurements of value delivered to the customer. When using an output method, revenue is recognized based on an **objective measure** of the value of goods or services delivered to the customer relative to the remaining promised goods or services to be delivered in satisfaction of the respective performance obligation. The entity will measure its progress toward satisfying its performance obligation over time using **a single measure of progress for each performance obligation** that depicts the transfer of control of the promised good or service to the customer.

Author's Note: We believe that the FASB included the term "objective measure" in the context of determining the value of goods or services delivered to a customer to ensure that the measurement of progress based on an output method is applied in a manner that meets the objective of measuring progress stated in **ASC 606-10-25-31**. In other words, revenue should ultimately be recognized in a manner that depicts an entity's performance toward completion of the respective performance obligation and by reference to the amount of transaction price allocated to the respective performance obligation. When measuring progress, value to a customer "should not be assessed by reference to market prices or standalone selling prices of the individual promised goods or services in the contract, nor is it intended to refer to the value that the customer perceives to be embodied in the goods or services".⁵

By way of example, an entity could measure cumulative revenue recognized at a point in time based on the objectively measured value of goods or services delivered to the customer in relation to the total value of goods or services promised under the performance obligation.

Examples of output methods include, but are not limited to: **(i)** units produced; **(ii)** units delivered; **(iii)** amount of time elapsed; **(iv)** milestones reached; **(v)** survey of performance completed to date; and **(vi)** appraisal of results achieved. The list below includes examples of performance obligations satisfied over time and for which an output method would likely be appropriate.

- Research and development arrangements
- Certain types of long-term manufacturing contracts
- New product and/or service offerings (as there would likely be a limited amount of available information about the related performance obligations and satisfaction thereof)
- Services that do not qualify for the "Right to Invoice" practical expedient (discussed below)

⁴ See **our earlier publication** regarding identifying performance obligations.

⁵ Excerpt from paragraph **BC165** in the FASB's *Basis of Conclusions* for **Topic 606**.

The “Right to Invoice” Practical Expedient⁶

In certain contracts, an entity has a right to the amount invoiced to the customer. In other words, the consideration to which the entity is entitled from a customer corresponds directly with the value of the entity's performance completed to date. An example would be an hourly service contract in which the customer is billed a fixed amount for each hour of labor. **An entity may elect to use this practical expedient only if it has strong evidence demonstrating that the amount invoiced directly corresponds with the value to the customer of the entity's performance completed to date.** By electing this practical expedient, an entity would recognize revenue in the amount for which it has the right to invoice (i.e. the invoiced amount).

Authors' Note: *The right to invoice practical expedient is significant because it could reduce an entity's considerations when performing the Five-Step Framework in **Topic 606**. Further, application of this practical expedient is limited, and entities must be careful when evaluating whether this practical expedient applies to them. Even when applicable, this practical expedient may not apply to all of an entity's distinct performance obligations. Entities are encouraged to consult with their auditors if they are considering applying this practical expedient.*

Conceptually, output methods should provide the most faithful depiction of progress toward the complete satisfaction of a performance obligation. However, an output method would not provide a faithful depiction of an entity's progress if it does not include goods or services for which the customer has obtained control. For example, an output method based solely on the number of completed units would not provide a faithful depiction of a manufacturer's progress toward satisfying a performance obligation satisfied over time in situations involving a significant amount of work-in process. In addition, an output method would not provide a faithful depiction of an entity's progress when control of an individual good or service is transferred to a customer prior to the entity providing a significant service of integrating that good or service. This may be the case, for example, in construction-type contracts in which construction occurs on land controlled by the customer. Accordingly, an entity would consider using an input method to measure progress in situations in which an output method does not faithfully depict its progress. Further, **an entity may use an input method instead of an output method if to do so is less costly and the input method provides a “reasonable proxy for measuring progress”.**⁷ For example, if an entity would incur undue to cost to obtain the information necessary to apply an output method, it may be necessary to instead use an input method.

Measuring Progress – Input Methods

Input methods are based on the inputs used by the entity in satisfying a performance obligation. When using an input method, an entity will recognize revenue based on inputs expended in proportion to the total inputs the entity expects to expend to completely satisfy the performance obligation. Examples of inputs that may be incorporated into an input method include labor hours expended, costs incurred, and machine hours used. When applying an input method, an entity identifies **a single measure of progress for each performance obligation** that depicts the transfer of control of the promised good or service to the customer.

⁶ See **ASC 606-10-55-18**.

⁷ See paragraph **BC164** in the FASB's *Basis of Conclusions* for **Topic 606**.

Author's Note: There could be situations in which the entity's inputs and efforts toward satisfying that performance obligation are expended evenly over time. In other words, the entity's inputs toward the satisfaction of the performance obligation occur at or near a constant rate over the period in which the performance obligation is satisfied (i.e. the performance period). In those situations, it may be appropriate for the entity to recognize the revenue attributable to the performance obligation on a straight-line basis evenly over the respective performance period.⁸

Required Adjustments to Input Methods

Topic 606⁹ points out that a shortcoming of input methods is that there may be a misalignment between the inputs used by an entity to measure the progress of a performance obligation satisfied over time and the entity's performance in transferring control of the promised good or service to the customer. **An entity will need to adjust its input method when there is not a direct relationship between the entity's inputs and the transfer of control of the promised good or service to the customer.** Accordingly, an entity would exclude the impact of any inputs from its measurement of progress that do not depict the transfer of control of the promised good or service to the customer. Adjustment of an input method would be required in these situations because inputs could be expended at a faster rate than that at which the entity is satisfying its performance obligation. Therefore and absent adjustment, revenue recognized using an input method in these situations would be overstated. **Topic 606** provides the following two examples⁹ of when an entity would need to adjust a cost-based input method:

a. When a cost incurred does not contribute to an entity's progress in satisfying the performance obligation.

A cost-based input method, such as percentage-of-completion, should incorporate the costs ultimately reflected in the contract price. In other words, the costs in a cost-based input method should be those that are directly related to the satisfaction of the performance obligation. The premise being that each incremental unit of cost results in incremental performance by the entity under the contract. Worth noting is that costs incurred that are associated with significant inefficiencies experienced by the entity would not generally be expected to have been reflected in the contract price.

To the extent that costs associated with inefficiencies are not priced into the contract, an entity must adjust its input method to exclude those costs. This adjustment would result in a reporting entity recognizing less revenue from the contract (as compared to if the adjustment had not been made). In addition, an entity would generally expense such costs as they are incurred.

A key takeaway here is that costs associated with significant inefficiencies are incurred to satisfy the respective performance obligation, but do not contribute to the incremental satisfaction thereof. Examples of such costs include the cost of wasted materials and unexpected labor costs.

Author's Note: Costs associated with inefficiencies do not contribute to the entity's progress and are therefore excluded from the measurement thereof. Such costs would therefore be recognized directly in the entity's income statement as they are incurred, without any corresponding revenue recognition.

⁸ See **ASC 606-10-55-20**.

⁹ See **ASC 606-10-55-21**.

b. When a cost incurred is not proportionate to the entity's progress in satisfying the performance obligation.

An entity would be required to adjust its cost-based input method if costs incurred do not proportionally progress satisfaction of the respective performance obligation. This could be the case, for example, in **(i)** contract combinations¹⁰; **(ii)** contracts involving multiple non-distinct promises; **(iii)** contracts involving significant uninstalled materials or components; or **(iv)** contracts involving the delivery of significant non-distinct goods and the subsequent performance of non-distinct services that are interrelated with those goods.

By way of example, an input method for measuring the progress of a distinct performance obligation to install a significant piece of equipment (i.e. significant in relation to the entity's total expected costs of satisfying the performance obligation) may require adjustment. If the performance obligation is not satisfied until the equipment is installed, it may not be appropriate for the entity to include the procurement cost of the equipment in its measure of progress based on cost-based inputs. To do so would likely overstate the entity's revenues for the reporting period in which the equipment was purchased, if the installation has not yet occurred or if installation has just begun.

If cost-based inputs are not proportionate to an entity's progress toward the satisfaction of the respective performance obligation, the best depiction of an entity's performance may be to recognize revenue only to the extent of the input expended. **Topic 606** provides the following guidance for when cost-based inputs are not proportionate to an entity's progress:¹¹

The best depiction of the entity's performance may be to adjust the input method to recognize revenue only to the extent of that cost incurred. For example, a faithful depiction of an entity's performance might be to recognize revenue at an amount equal to the cost of a good used to satisfy a performance obligation if the entity expects at contract inception that all of the following conditions would be met:

1. *The good is not distinct.*
2. *The customer is expected to obtain control of the good significantly before receiving services related to the good.*
3. *The cost of the transferred good is significant relative to the total expected costs to completely satisfy the performance obligation.*
4. *The entity procures the good from a third party and is not significantly involved in designing and manufacturing the good (but the entity is acting as a principal in accordance with paragraphs 606-10-55-36 through 55-40)¹².*

¹⁰ See *our earlier publication* for more information on the combination of contracts under **Topic 606**.

¹¹ Excerpt from **ASC 606-10-55-21(b)**.

¹² Principal versus agent considerations under **Topic 606** will be covered in a future publication.

Author's Note: When a significant non-distinct good or service is delivered prior to the entity performing a significant integration service that is interrelated with those goods, the best depiction of the entity's performance with respect to that significant non-distinct good or service would likely be to recognize revenue only to the extent of the cost of that good or service. This would result in a zero gross margin on the transfer of control of the significant non-distinct good or service to the customer. Accordingly, the actual gross margin ultimately realized that is attributable to that significant non-distinct good or service will effectively be recognized in subsequent periods based on the entity's progress as measured by its input method.

Performance Obligations Satisfied at a Point in Time

If a performance obligation is not satisfied over time, it is satisfied at a point in time, and revenue in the amount of the transaction price allocated to that performance obligation is recognized when control of the good or service is transferred. An entity will consider all relevant facts and circumstances to determine whether control has been transferred to the customer. The indicators listed below are reflective of circumstances that would be present when a customer has obtained control of a promised good or service. In other words, they are indicative of situations in which the customer has the ability to **direct the use of** and **obtain substantially all of the remaining benefits from** the good or service or has access to those benefits. **In particular, an entity must carefully consider customer acceptance** (see e. below). The existence of any of these indicators, or the lack thereof, would not automatically result in a conclusion that a customer has obtained control or not. Instead, they are intended to assist entities when applying the relevant guidance on the control principle¹³. This following list¹⁴ is not all-inclusive.

- a. **The customer is obligated to pay for the promised good or service.**
- b. **The customer has obtained legal title.**

Retention of legal title by the entity would not preclude the customer from obtaining control of a good or service, if the entity retained legal title solely as a means of mitigating credit risk.

- c. **The customer has physical possession of the good or service.**

In certain situations, however, physical possession would not result in control of a good or service. For example, a customer generally would not obtain control in consignment arrangements¹⁵ or transactions involving repurchase rights¹⁶ that are retained by the entity. For bill-and-hold arrangements, there are additional criteria that must be met in order for an entity to conclude that a customer has obtained control of the good.¹⁷

- d. **The entity has transferred the significant risks and rewards of ownership to the customer.**

¹³ See **ASC 606-10-25-23** through **25-26**.

¹⁴ List was derived from **ASC 606-10-25-30**.

¹⁵ See **ASC 606-10-55-60** for examples of factors that may indicate that an arrangement is a consignment of goods.

¹⁶ See **ASC 606-10-25-26**. Repurchase rights will be covered in a future publication covering disposal transactions with non-customers involving certain nonfinancial assets.

¹⁷ See **ASC 606-10-55-81** through **55-84** and **ASC 606-10-55-409** through **55-413** for bill-and-hold arrangements.

When evaluating the risks of ownership with respect to a promised good or service, risks associated with separate performance obligations should be excluded. For example, a separate performance obligation (such as maintenance contracts or product warranties) would not be considered by an entity when evaluating whether it has retained ownership risk.

Risks of Ownership

Examples of risks of ownership include exposure to potential loss from changes in the marketplace, business environment, obsolescence, or operational factors.

Rewards of Ownership

When considered whether the customer has obtained the rewards of ownership, an entity would consider restrictions on the customer's ability to direct the use, modify or sell the asset. In addition, an entity would consider the customer's ability to post the asset as collateral, and whether the customer would benefit from appreciation in the value of the asset.

e. Customer acceptance.

A contract with a customer may contain a customer acceptance clause. An example of a customer acceptance clause is a contractual provision that provides a customer with a form of remedy against the entity (such as the ability to cancel the contract) if the promised good or service does not meet agreed-upon specifications. The agreed-upon specifications on which the customer's acceptance is predicated could range from those that are standard given the type of promised good or service (i.e. weight, size, color, etc.) to highly unique in the case of customized high tech equipment or software. In addition, the customer could be provided with a period of time in which it will have the opportunity to inspect the good or service so as to ensure the agreed-upon specifications have been met.

Entities should carefully evaluate customer acceptance clauses and contractual provisions that could have similar effects on a transaction. An entity's evaluation of such contractual provisions should be performed in the context of **ASC 606-10-55-85** through **55-88**. These types of contractual provisions could result in the delay of the satisfaction of a performance obligation. The facts and circumstances of each individual transaction and respective acceptance provision(s) must be considered. In addition, an entity would consider its historical experiences with the same customer, transactions for similar goods or services with other customers, and customary practices in the respective industry and/or marketplace.

A customer acceptance clause that is merely a formality would not affect an entity's determination of whether control of the good or service has been transferred to the customer. **A customer acceptance clause would be a formality if the determination of whether the agreed-upon specifications have been met is objectively determinable.** However, an appropriate level of professional skepticism and judgment should be applied when evaluating provisions that are unusual or not customary given the type of transaction.

Topic 606 provides the following example of when a customer acceptance clause would represent a formality and would therefore not affect an entity's assessment with respect to whether the customer has obtained control of the promised good or service:¹⁸

¹⁸ Excerpt from **ASC 606-10-55-88**.

For example, if the customer acceptance clause is based on meeting specified size and weight characteristics, an entity would be able to determine whether those criteria have been met before receiving confirmation of the customer's acceptance. The entity's experience with contracts for similar goods or services may provide evidence that a good or service provided to the customer is in accordance with the agreed-upon specifications in the contract. If revenue is recognized before customer acceptance, the entity still must consider whether there are any remaining performance obligations (for example, installation of equipment) and evaluate whether to account for them separately.

To the contrary, if the determination of whether the agreed-upon specifications have been met is **not** objectively determinable, then an entity would not be able to conclude that it has transferred control of the promised good or service to the customer until customer acceptance has been obtained. In other words, the entity would defer recognition of the related revenue in such transactions until the customer accepts the good or service. **Topic 606** points out that the reason for this is that in such circumstances, *the entity cannot determine that the customer has the ability to direct the use of, and obtain substantially all of the remaining benefits from, the good or service*¹⁹. Similarly, control of a promised good or service would **not** have been transferred in situations in which the entity delivers such good or service for a customer trial. In those situations, control would not transfer to the customer until such time as the customer accepts the good or service, or the trial period lapses.

Recognizing Revenue from Licenses for Intellectual Property

There is specific implementation guidance²⁰ in **Topic 606** for licenses of intellectual property granted to customers. The licensing revenue implementation guidance is different from the recognition guidance for other types of promised goods and services, and **will impact how revenue is recognized in contracts that contain licenses for intellectual property**. However, an entity should not apply the license revenue implementation guidance by analogy, and should only apply it to contracts that convey licenses to certain types of intellectual property as discussed in the overview section below. An entity will apply the Five-Step Framework²¹ for all contracts with customers, including those that contain licenses for intellectual property.

Overview of the License Revenue Implementation Guidance

The **objective** of the license revenue implementation guidance, which will impact a licensor's application of STEP 5 of the Five-Step Framework, is to provide licensors with a way to **assess the nature of a license** for the purpose of determining whether the related revenue should be recognized over a period of time or at a point in time.

¹⁹ Excerpt from **ASC 606-10-55-89**.

²⁰ Guidance on licensing may be found in **ASC 606-10-55-54** through **55-65B** and implementation examples 54 through 61B found in **ASC 606-10-55-361** through **55-3990**.

²¹ See **our earlier publication** for more information on the Five-Step Framework.

Authors' Note: The rights granted by licenses can vary significantly, and licenses can include a wide array of features. It would therefore be difficult for a licensor to assess the nature of a license for intellectual property under the general revenue guidance. To address this, the license revenue implementation guidance has been included in **Topic 606**, and should be applied specifically to licenses of intellectual property. *The license revenue implementation guidance only applies to a promise to grant a license for the entity's in-scope intellectual property and will impact the determination of when the licensor recognizes the revenue allocated to that license.*

Application of the license revenue implementation guidance by a licensor involves the following:

- (1) Performing STEP 2 of the general Five-Step Framework to **determine whether a contract contains a promise to grant a license for intellectual property** (could be explicit or implicit) and whether such a promise meets the criteria for being distinct (i.e. is a separate performance obligation);
- (2) **Determining the nature of the license** in STEP 5 of the Five-Step Framework using the license revenue implementation guidance.

An entity assesses the nature of a license by evaluating whether the license provides²² **(a) the right to access** intellectual property during the licensing period or **(b) the right to use** intellectual property as-is at the point in time when the license is granted.

AND

- (3) **Measuring** (STEPS 3 and 4) **and recognizing revenue** (STEP 5) using the license revenue implementation guidance.

The above three steps are discussed in the following sections.

Determine whether a contract contains a promise to grant a license for intellectual property

Identifying whether a contract contains a promise to grant a license for intellectual property is a necessary first step to applying the license revenue implementation guidance. Incorrectly identifying a promise in a contract as a license, or as not being license, will result in the improper application of the remainder of the Five-Step Framework, and could result in errors in the amount and timing of revenue recognized. Unfortunately, the term **intellectual property** is not defined in US GAAP. Among other things, understanding the industry in which the entity operates will be integral to determining whether a contract embodies a promise or contains a performance obligation to grant a license for intellectual property.

²² See **ASC 606-10-55-58**.

Authors' Note: We believe entities should apply the following two-step approach when determining whether a promise in a contract embodies an obligation of the entity to grant a license for intellectual property:

- Assessing whether a promise represents a license by determining whether it meets the definition of an **intangible asset** by applying the guidance in **ASC 350**, as evaluated from the perspective of the customer. The reason for this is that a license would generally be expected to meet the definition of an intangible asset from the customer's perspective.
- Once the entity identifies that a promise is a license, it must evaluate the rights conveyed to determine whether the license revenue implementation guidance should be applied. This determination is made by evaluating those rights in the context of the scoping guidance found in **ASC 606-10-55-54** (see below).

The above approach is interpretative and is intended to serve as a guide for entities when determining whether a promise embodies the grants of intellectual property.

Entities should apply the license revenue implementation guidance only to contracts that convey licenses of intellectual property such as such as:²³

- **software subject to a hosting arrangement** for which²⁴ **(a)** the customer has the right to take possession **and (b)** it is feasible for the customer to run the software on its own hardware or on the hardware of a vendor;
- **media** such as movies and music;
- **franchises**;
- **biological compounds** and **drug formulas**;
- **patents, trademarks** and **copyrights**; and
- **intellectual property related to the design and production processes for a good**²⁵.

The license revenue implementation guidance applies to promises to grant a license for intellectual property, except for certain software subject to hosting arrangements that do not meet the specific criteria^{Error! Bookmark not defined.} found in **Topic 958**.

Authors' Note: A contract that explicitly states that it contains a license for intellectual property may in fact embody a promise to provide a service. While there is explicit guidance in **Topic 958**²⁴ for making this determination for promises involving software, there is no explicit guidance for making this determination for promises involving other types of intellectual property. Accordingly, we believe it would be appropriate to apply the guidance in **Topic 958**²⁴ by analogy to promises involving intellectual property other than software (e.g. media rights) for the purpose of distinguishing whether the promise includes a license or a service.

²³ This list was derived from **ASC 606-10-55-54** and is not all-inclusive.

²⁴ These are the criteria for determining whether the a contract contains a software islicense or the entity is providing "software as a service" or "SaaS". See **ASC 985-20-15-5**.

²⁵ See **Example 55** in **ASC 606-10-55**.

Determining Whether a License is Distinct

Entities will apply STEP 2 of the Five-Step Framework to determine whether a license is itself a single performance obligation or if should be bundled with other goods and service that collectively represent a single performance obligation. The criteria for determining whether a promise in a contract is a separate performance obligation are as follows:²⁶

- a. The customer can benefit from the good or service on its own or together with other readily available resources (i.e. **the good or service is capable of being distinct**); **AND**
- b. The entity's promise is separately identifiable from other promises in the contract (i.e. **the promise to transfer the good or service is distinct within the context of the contract**).

The following are examples from the guidance²⁷ of promises to grant licenses for intellectual property that are **not** distinct:

- A license that forms a component of and is integral to the functionality of a tangible good.
- A license that the customer can benefit from only in conjunction with a related service.

For licenses, the amount of revenue to be recognized is the portion of the transaction price (determined in STEP 3) that has been allocated (in STEP 4) to a distinct license or a distinct bundle of goods or services that includes a license. When a licensor has determined whether a license grants the right to access or the right to use intellectual property (which determination is discussed in more detail in the following sections of this publication), the licensor would use the applicable STEP 5 guidance to recognize revenue as or when the performance obligation is satisfied, respectively.

Authors' Note: *The license revenue implementation guidance is essentially an "overlay" to the Five-Step Framework. In other words, the Five-Step Framework is the foundation that must be applied to all contracts with customers. When a contract contains a license for intellectual property; and **regardless of whether the license is a separate performance obligation or not**, an entity will apply an approach that integrates the license revenue implementation guidance into the Five-Step Framework. Said in another way, the license revenue implementation guidance should be viewed as part of the Five-Step Framework for contracts that contain a promise to grant a license for intellectual property.*

As pointed out in the previous authors' note, entities should apply the license revenue implementation guidance regardless of whether a promise to grant a license for intellectual property is distinct (i.e. it is a single performance obligation) or is a non-distinct part of a bundle that includes other non-distinct promised goods or services.

²⁶ See **ASC 606-10-25-19**.

²⁷ See **ASC 606-10-55-56**.

Authors' Note: *In practice, whether a contract contains a license that is distinct or not will have a direct impact on how a licensor applies the Five-Step Framework. For example, an entity would consider the nature of a combined bundle of non-distinct promised goods or services that includes a license for intellectual property (i.e. because the non-distinct license and other non-distinct goods or services are a single performance obligation). If the combined bundle is primarily comprised of a license, then the entire bundle would follow the license revenue recognition guidance. If the combined bundle is primarily other non-license goods and services, then the entire bundle would follow the general revenue recognition framework. Both instances would require consideration of whether the bundle is satisfied over time or at point in time.*

*In contrast, a contract could convey a license for intellectual property that is distinct (i.e. a separate performance obligation) as well as other distinct promises to deliver goods or services other than licenses (i.e. other non-license performance obligations). In such a contract, an entity would, both by necessity and requirement, apply the entire Five-Step Framework. For example, the entity must allocate the transaction price to each performance obligation in those situations. In addition, the entity must apply the license revenue implementation guidance for assessing the nature of the entity's performance obligation to deliver a license for intellectual property, but must apply the general guidance in **Topic 606** for the non-license performance obligations in the contract.*

These are subtle but important points in the context of understanding why the license revenue implementation guidance distinguishes between distinct and non-distinct licenses for intellectual property. In addition, this distinction could affect the determination of whether a distinct bundle that includes a license for functional intellectual property represents a right to use or a right to access. Functional, as well as symbolic, intellectual property is discussed later on this publication.

A licensor must distinguish between contractual provisions in a contract that represent additional promised goods or services to the customer and those that define the attributes of a license for intellectual property. For example, provisions that restrict use, time, geographical region, or that provide exclusivity, are examples of contractual provisions that outline the scope of a customer's rights to the intellectual property. Such provisions do not affect whether a performance obligation is satisfied over time or at a point in time, nor do they affect the number of performance obligations in a contract.

Determining the nature of the license

As part of STEP 5, a licensor must assess the nature of a license to determine whether the license grants a **right to access** or a **right to use** intellectual property. The manner in which a licensor assesses the nature of a license for intellectual property is the same regardless of whether the license is a distinct performance obligation or a non-distinct portion of a bundle that collectively represents a single performance obligation.

The Right to Access Intellectual Property

A license that grants the right to access intellectual property for a period of time (i.e. the license period) is satisfied over time. The license period, for example, could be a period of time specified in the contract or the remaining economic life of the intellectual property. Accordingly, a licensor should account for a license that grants the right to access intellectual property as a performance obligation satisfied over time. This is because the licensee simultaneously receives and consumes the benefits from having access to the intellectual property as the licensor performs under its obligation

to provide such access. Refer to the respective earlier section of this publication for a discussion on the recognition of revenue from performance obligations satisfied over time.

The Right to Use Intellectual Property

The right to use intellectual property is satisfied at a point in time. Refer to the respective earlier section of this publication for a discussion on the recognition of revenue from performance obligations satisfied at a point in time.

Determining whether a license is a right to access or use intellectual property will depend upon whether the intellectual property is **symbolic** or **functional**.

Authors' Note: As discussed in the following paragraphs of the current section of this publication, a license for symbolic intellectual property grants the right to access the intellectual property over the license period. Accordingly, revenue from licenses for symbolic intellectual property is recognized over a period of time. On the other hand, a license for functional intellectual property generally grants the right to use the intellectual property. Therefore, revenue from licenses for functional intellectual property would generally be expected to be recognized at a point in time.

Symbolic Intellectual Property²⁸

Symbolic intellectual property is any intellectual property that is not functional (see below regarding functional intellectual property). Symbolic intellectual property does not have significant standalone functionality. Instead, a licensee derives substantially all the benefits from its access to symbolic intellectual property through association with the licensor's past or ongoing activities and support of the related intellectual property. In other words, the utility of a license for symbolic intellectual property lies in the ability of the licensee to benefit from the symbolism of the intellectual property (e.g. a licensee's ability to generate benefits from a license enabling it to print and sell t-shirts with an image of a well-known animated film character). Examples of symbolic intellectual property include brand names, franchise rights, logos, team names and trade names.

A license for symbolic intellectual property grants the licensee a right to access the licensor's intellectual property for a period of time, because the utility of symbolic intellectual property to a licensee depends on the licensor's continued support/maintenance of the intellectual property. Therefore, the licensor satisfies its performance obligation to provide access to its symbolic intellectual property over time as it fulfills its promises to **(a)** grant the customer the right to use and benefit from the intellectual property; and **(b)** support or maintain the intellectual property.

Authors' Note: A licensor supports or maintains symbolic intellectual property by continuing the activities from which the utility of the intellectual property is derived. Supporting symbolic intellectual property would include refraining from activities that would cause the demise of the intellectual property.

Functional Intellectual Property²⁹

²⁸ See ASC 606-10-55-59 through 55-63A.

²⁹ See ASC 606-10-55-59 through 55-63A.

As its name implies, functional intellectual property has significant stand-alone functionality and derives a substantial portion of its utility from its stand-alone functionality. Examples of functional intellectual property include software, biological compounds and drug formulas, television shows, music, films and patents for highly functional items such as a specialized manufacturing process.

A performance obligation to grant a license for functional intellectual property is generally satisfied at a point in time. This is because, unlike symbolic intellectual property, a licensor's activities do not substantively alter the functionality of the intellectual property, and therefore do not affect a licensee's rights to functional intellectual property. In other words, a licensor's performance obligation to grant a license for functional intellectual property would not include an obligation to support or maintain the intellectual property. This is because functional intellectual property has stand-alone value, and a licensee can benefit from the intellectual property as-is.

As previously indicated, a license for functional intellectual property generally grants a right to use intellectual property as it exists at a point in time. However, if **both** of the following criteria are met, a licensor would conclude that a license for functional intellectual property grants a right to access the intellectual property for a period of time:³⁰

- a. The stand-alone functionality is expected to change **substantively** as a result of the ongoing activities of the licensor that do not transfer a promised good or service. When assessing this criterion, a licensor would exclude additional promised goods or services such as customer rights to receive upgrades or access additional intellectual property.
- b. The customer is contractually or practically required to use the updated intellectual property resulting from the activities in the first criterion.

³⁰ See **ASC 606-10-55-62**.

Authors' Note: Because of the requirement to exclude additional goods or services when assessing the criterion in **ASC 606-10-55-62(a)**, we believe that it would be relatively infrequent for a distinct license for functional intellectual property to meet both criteria to be accounted for as a right to access. The reason being that a licensor's ongoing activities related to updating, maintaining and generally supporting the functional intellectual property to which a license relates would generally represent additional promised services. They would therefore be excluded from when assessing that criterion. Further, additional **promises**, as opposed to performance obligations, are excluded when assessing that criterion, therefore resulting in a wider range of activities that would be excluded.

However, the same expectation does not necessarily apply to a non-distinct license that is a portion of a distinct bundle that includes other non-distinct goods or services. In those situations, a licensor would consider the nature of the combined bundle of non-distinct promised goods or services. Therefore, the licensor could determine that the nature of the combined bundle is a right to access.

See **ASC 606-10-55-63A** for a flowchart to aid in determining whether a license is for a right to functional or symbolic intellectual property.

Measuring and recognizing revenue

For licenses, the amount of revenue to be recognized is the portion of the transaction price (determined in STEP 3) that has been allocated (in STEP 4) to a distinct license or a bundle of goods or services that includes a license. Once the transaction price has been allocated, the actual process for recognizing revenue is fairly straight forward. For rights to access intellectual property, revenue will be recognized generally ratably over the license period. For right to use intellectual property, revenue will be recognized generally at the inception of the license period. However, it must be noted that revenue cannot be recognized from a license for intellectual property until both of the following criteria³¹ have been met:

- a. An entity provides or makes available a copy of the intellectual property; **AND**
- b. The license period has begun, even if the entity makes a copy available to the licensee. For example, an entity would not recognize revenue from a license renewal until the beginning of the renewal period.

Royalties Based on Sales or Usage³² in Licenses of Intellectual Property

There is an exception to the requirement to estimate, constrain and re-measure variable consideration for certain licenses of intellectual property. The measurement of variable consideration is part of STEP 3, which is the point in the Five-Step Framework when an entity determines the transaction price. For licenses that meet the criteria to apply this exception (discussed below), a licensor must recognize revenue associated with sales- or usage-based royalties at the later of when **(a)** the subsequent sale or usage occurs; and **(b)** the full or partial satisfaction of the performance obligation to which some or all of the sales- or usage-based royalty

³¹ See **ASC 606-10-55-58C**.

³² See **ASC 606-10-55-65** through **55-65B**.

has been allocated. In other words, a licensor would not necessarily be required to estimate, constrain and reassess variable consideration associated with sales-based and usage-based royalties. Instead, if the criteria for applying this exception are met, revenue for sales- or usage-based royalties from licenses for intellectual property would be recognized when or as the related sales or usage occurs (i.e. revenue is recognized to the extent that the licensor's performance obligation is satisfied).

This exception is provided within the license revenue implementation guidance, and applies to licenses for intellectual property under which the licensee pays for the right to use or right to access the intellectual property through sales- or usage-based royalties (i.e. situations in which the royalty relates only to a license of intellectual property). This exception also applies to a non-distinct promise to grant a license for intellectual property when it is the predominant item to which the sales- or usage-based royalty relates.³³

Authors' Note: *The sales- or usage-based royalty exception discussed above is only applicable to licenses for intellectual property. Further and when the criteria for its use have been met, this exception must be applied wholly to the sales- or usage-based royalty. If a license for intellectual property does not meet the criteria for applying this exception, it would apply the general STEP 3 guidance for estimating, constraining and reassessing variable consideration.*

³³ As per **ASC 606-10-55-65A**, a license for intellectual property may be the predominant item to which the sales- or usage-based royalty relates if the licensor has a reasonable expectation that the licensee would ascribe significantly more value to the license than to the other goods or services to which the royalty relates.

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