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In This Issue:

Shedding Some Light

FASB and IASB Tentatively Decide to Clarify the New Revenue Standard

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Introduction

In May 2014, the FASB and IASB issued a new revenue standard[1] that will replace most of the current guidance on revenue recognition. Since its issuance, however, stakeholders have raised a number of implementation questions, many of which have been discussed at meetings of the boards' joint transition resource group (TRG) on revenue recognition.[2]

For example, certain aspects of accounting for licenses of intellectual property (IP) and the identification of performance obligations have made repeat appearances on the TRG's meeting agendas. To better understand the issues related to these topics, the boards' staffs have undertaken research projects. At the January 2015 TRG meeting, the FASB staff noted that it would discuss its recommendations publicly with the FASB in February 2015.

The tables below summarize and compare the tentative decisions made at the boards' joint meeting on February 18, 2015, related to licenses of IP and identifying performance obligations. The appendix discusses the FASB staff's recommendations and the FASB's tentative decisions in greater detail. For more information, see the meeting materials on the IASB's Web site.

Tentative Decisions

The following table summarizes and compares the boards' tentative decisions related to IP:

Topic	FASB's Tentative Decision	IASB's Tentative Decision	Comparison
Determining the nature of an entity's promise in granting a license	The FASB tentatively agreed with its staff's recommendation to update the standard to include "Articulation B," which would require an entity to characterize the nature of a license as either functional or symbolic.	The IASB tentatively agreed with its staff's recommendation to update the standard to include "Articulation A," which would potentially require an entity to assess the utility of a license before characterizing it as functional or symbolic.	The decisions are different, but the differences are currently expected to affect only a small subset of licenses.
Sales-based and usage-based royalties	The FASB tentatively agreed with its staff's recommendation to update the standard to clarify 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 relates.	The IASB tentatively agreed with its staff's recommendation, which was the same as the FASB staff's.	The decisions are the same; continued convergence is expected.

[1] FASB Accounting Standards Update No. 2014-09 and IFRS 15, *Revenue From Contracts With Customers.*

[2] See the FASB's Web site for more information about the TRG. See also Deloitte's July 2014, October 2014, and January 2015 *TRG Snapshot* newsletters for summaries of the meetings and links to relevant meeting materials.

The following table summarizes and compares the boards' tentative decisions related to identifying performance obligations:

Topic	FASB's Tentative Decision	IASB's Tentative Decision	Comparison
Identifying promised goods or services	The FASB tentatively agreed with its staff's recommendation to amend the standard to permit entites to evaluate the materiality of promises at the contract level and that, if the promises are immaterial, the entity would not need to evaluate such promises further.	The IASB tentatively agreed with its staff's recommendation that no updates or standard setting should be undertaken.	The decisions are different but because they are intended to clarify the guidance, divergence is currently not expected.
Distinct in the context of the contract	The FASB tentatively agreed with its staff's recommendations to update the standard to (1) define the term "separately identifiable," (2) reframe the separation criteria to focus on a bundle of goods or services, and (3) add illustrative examples.	The IASB tentatively agreed with its staff's recommendation to add illustrative examples but otherwise not amend the standard's guidance.	The decisions are the same except for what were termed "minor" wording differences. As a result, divergence is currently not expected.
Shipping and handling services	The FASB tentatively agreed with its staff's recommendation to add guidance that (1) clarifies that shipping and handling activities that occur before control transfers to the customer are fulfillment costs and (2) allows entities to elect a policy to treat shipping and handling activities as fulfillment costs if they do not represent the predominant activity in the contract and they occur after control transfers.	The IASB tentatively agreed with its staff's recommendation that no updates or standard setting should be undertaken at this time because the staff was unclear about whether and, if so, the extent to which shipping and handling is an issue for IFRS constituents.	It is unclear whether the different decisions will lead to divergence because it appears that the boards may need further information to finalize their views. Specifically, the boards may later decide to make changes on the basis of future feedback from their constituents or the revised text.

Next Steps

The FASB directed its staff to draft a proposed Accounting Standards Update for possible ratification by the Board at a future meeting.

Editor's Note: While the IASB tentatively agreed to certain revisions of IFRS 15, it did not decide on the timing of a draft for exposure. However, on the basis of some of the discussions, a draft may be exposed in June or July of 2015.

Appendix — Additional Details About the FASB's Decisions

Licenses of Intellectual Property

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

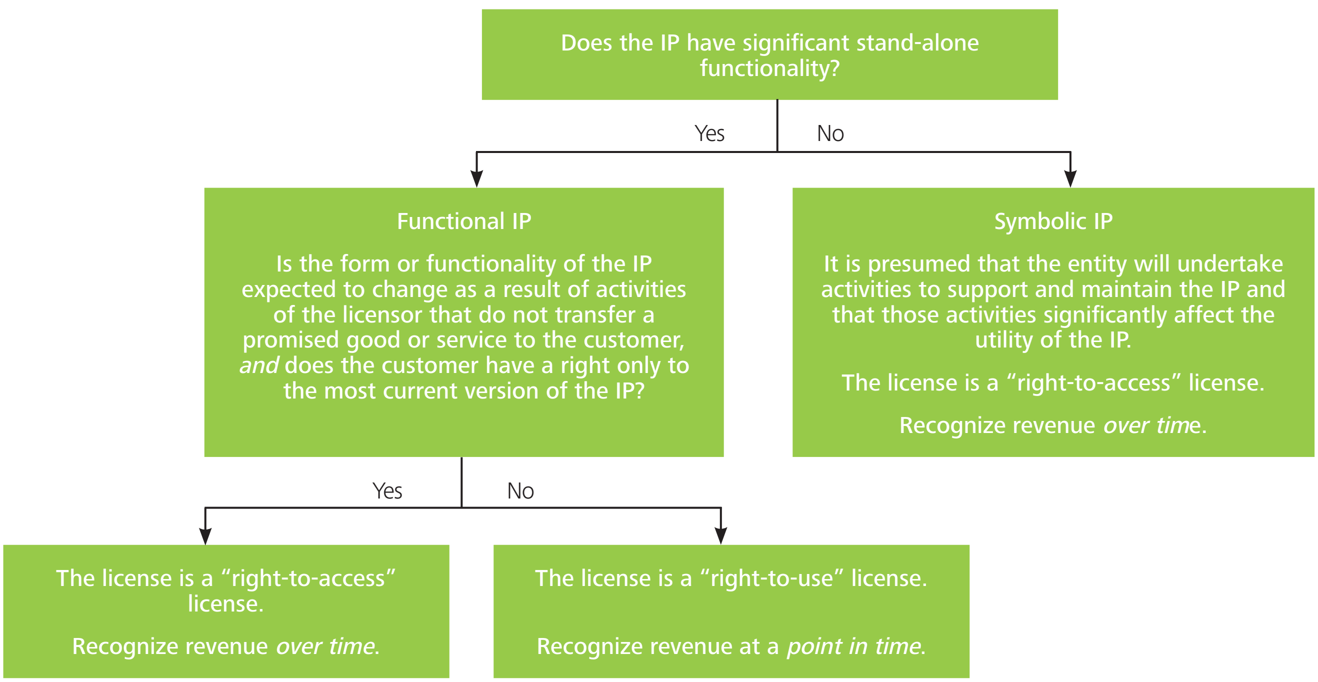
Summary of Implementation Issues and Staff Recommendations

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

In response, the staff developed two articulations. Articulation A focuses on utility (i.e., "the ability to fulfill a desired role or function")[2] of the underlying IP to the customer. Articulation B centers on the nature of the license as either "symbolic" or "functional." Under Articulation A, a licensor would first assess whether its activities will significantly affect the utility of the IP. If the answer is yes, only then would the licensor need to determine the nature of the underlying IP (in accordance with Articulation B). While stakeholders viewed both articulations as improvements to the standard, the FASB staff indicated its preference for Articulation B because it is generally considered to be more operational and conducive to consistent application.

FASB's Tentative Decisions

Using Articulation B as a model, the FASB decided to revise 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). The following flowchart illustrates the analysis entities would perform under this approach:



[1] ASC 606-10-55-54 through 55-64; paragraphs B52 through B62 of IFRS 15. (For titles of *FASB Accounting Standards Codification* (ASC or "Codification") references, see Deloitte's *"Titles of Topics and Subtopics in the FASB Accounting Standards Codification."*)

[2] As noted on page 17 of FASB Memo No. 1, "Revenue Recognition — Licenses of Intellectual Property."

Sales-Based and Usage-Based Royalties

Summary of Implementation Issues and Staff Recommendations

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."[3] For such arrangements, entities are required to record revenue 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.[4]

Questions have arisen regarding application of the royalty constraint when an IP license is offered with other goods or services in a contract (e.g., franchise licenses with training services). Namely, some stakeholders have suggested that under the new revenue standard, entities would need to split a royalty such that they would account for a portion by using the royalty constraint guidance and the remainder by using the variable consideration constraint guidance. The staff rejected the notion of splitting royalties, indicating that doing so would be complex and may not yield useful information. Instead, the staff indicated that the royalty constraint guidance should be applied either (1) when a license is a separate performance obligation or (2) when a license is the predominant "item to which the royalty relates."

FASB Tentative Decisions

The Board agreed to amend the new revenue standard in a manner consistent with the staff's recommendation.

Editor's Note: This change will require entities 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 relates. However, the change would permit broader application of the royalty constraint and would eliminate the potential need to apply variable consideration and royalty constraint guidance to different portions of a single royalty.

Identifying Performance Obligations

Identifying Promised Goods or Services

Summary of Implementation Issues and Staff Recommendations

Under the new revenue guidance, an entity is required (1) to 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 standard's Basis for Conclusions, some stakeholders have questioned whether the boards 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,[5] the revenue standard does not contain guidance on "inconsequential or perfunctory" items.

The staff presented two alternatives to the Board. The first was to add guidance on inconsequential or perfunctory items. The second was to continue to rely on the principle of materiality but update the standard to "explicitly refer to materiality in a similar context as that which applies to determining whether a customer option constitutes a material right or whether a significant financing component exists."[6] In other words, materiality of promises would be evaluated in the context of the contract. The staff recommended that the Board adopt the second alternative.

FASB Tentative Decisions

The Board tentatively decided to add guidance clarifying that an "entity is not required to identify goods or services promised to the customer that are immaterial in the context of the contract." The Board also tentatively decided that an entity would 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).

[3] ASC 606-10-55-65; paragraph B63 of IFRS 15.
[4] ASC 606-10-32-11 through 32-14; paragraphs 56 through 59 of IFRS 15.
[5] SEC Staff Accounting Bulletin Topic 13.A, "Selected Revenue Recognition Issues."
[6] Quoted text is from FASB Memo No. 1, "Revenue Recognition — Identifying Performance Obligations."

Editor's Note: The Board's tentative decisions permit entities to choose not to evaluate whether immaterial items or activities represent performance obligations. Thus, unlike an accounting convention that is not in accordance with GAAP but results in immaterial differences from GAAP, excluding such immaterial items or activities under the new revenue standard would not be considered departures from GAAP.

Distinct in the Context of the Contract

Summary of Implementation Issues and Staff Recommendations

The new revenue guidance 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 have requested that the FASB provide additional guidance on the second criterion that clarifies the meaning of a promise that is "separately identifiable."

The staff indicated that certain assessments requiring entities to identify separate deliverables or elements are often complex under current U.S. GAAP and will remain so, under certain circumstances, because entities would need to exercise judgment under the new standard. However, the staff recommended that the Board undertake a project to:

- Define "separately identifiable" and add examples to the standard's Basis for Conclusions.
- Reframe the criteria in ASC 606-10-25-21 (i.e., the "separately identifiable" criteria) to focus on the bundle of goods or services instead of individual goods or services.
- Add examples to the standard's implementation guidance (e.g., similar to the illustrations in the staff's memo).

FASB Tentative Decisions

The FASB decided to add guidance that is consistent with the staff's recommendations.

Shipping and Handling Services

Summary of Implementation Issues and Staff Recommendations

Under existing revenue guidance, 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 have asked the FASB to clarify whether shipping and handling services (collectively, "shipping 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 would be accounted for under the new fulfillment cost guidance in ASC 340-40.

Although the staff noted that it was unclear why entities would reach conclusions under the new revenue standard that are different from those they would reach under current U.S. GAAP, it believed that clarification would be helpful. Accordingly, the staff outlined three potential alternatives: (1) a practical expedient, (2) new implementation guidance that would apply to all entities and would not be subject to an election, and (3) the application of materiality (e.g., akin to the staff's recommendation related to identifying promised goods and services in a contract).

The staff suggested that the Board permit entities to use a practical expedient and add implementation guidance indicating that if shipping services are performed before the transfer of control of a product, the services do not constitute a promised service to the customer in the contract (i.e., they are a fulfillment activity). Conversely, if the shipping services do not represent the predominant activity in the contract and are performed after the transfer of control of a product, an entity may adopt an accounting policy election to account for the shipping services as a fulfillment cost.

FASB Tentative Decisions

The Board agreed with the staff's recommendations but may require additional information to finalize its views.

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