KPMG
cutting through complexity

Defining Issues®

November 2015, No. 15-49

Contents

Revenue TRG Discusses Optional Purchases, Licenses, Pre-production Activities, and Fixed-odds Wagers

The Joint Transition Resource Group for Revenue Recognition (TRG) held its most recent meeting on November 9, 2015.[1]

Key Facts

- The TRG's discussions may be helpful to preparers when making the critical judgment about whether additional goods and services in a revenue contract should be treated as customer options or as variable consideration.
- TRG members generally agreed that significant judgment will be required to determine whether a contract that includes rights to intellectual property has a single license or multiple licenses when evaluating restrictions on the use of a license and renewals of existing licenses.
- Entities must consider whether pre-production activities provide goods or services to a customer in applying the revenue standard. The FASB will consider whether the existing narrow U.S. GAAP guidance on deferring pre-production costs associated with long-term supply arrangements should be eliminated.
- The FASB will consider whether to make a technical correction to scope fixed-odds wagering contracts into the revenue standard without considering whether they meet the definition of a derivative.

Key Impact

- The TRG discussion highlighted that preparers will need to exercise considerable judgment when applying the revenue standard to common transactions in a variety of industries, including aerospace and defense, contract manufacturers, and media. The FASB is considering whether further clarification can be provided in the final ASU related to licensing.

[1] The Transition Resource Group's staff papers are available at www.fasb.org and www.ifrs.org. FASB Accounting Standards Update No. 2014-09, Revenue from Contracts with Customers, available at www.fasb.org, and IFRS 15, Revenue from Contracts with Customers.

Optional Purchases

Customer Options or Variable Consideration

Different outcomes and disclosure requirements can arise depending on whether an entity concludes that purchases of additional goods and services by a customer are customer options or variable consideration. Future purchases that are options will be evaluated to determine whether they include a material right. Future purchases that are variable consideration are included in the initial identification of performance obligations, determination of the transaction price, and may lead to additional estimation and disclosure requirements.

The TRG members generally agreed that distinguishing between options and variable consideration will require significant judgment. The TRG members generally supported the staff view that an entity begins by assessing the nature of its promise to the customer and by evaluating the presently enforceable rights and obligations of the parties to the arrangement.

- ***Options for Additional Goods or Services.*** The customer has a present contractual right to purchase *additional* distinct goods or services. Each exercise of an option is a separate purchase decision when the customer is not currently obligated under the contract to do so. Prior to the customer's exercise of the option, the vendor is not obligated to provide those goods or services and does not have a right to receive consideration. The customer options would be evaluated to determine whether they provide the customer with a material right.
- ***Variable Consideration.*** The contract with the customer obligates the vendor to stand ready to transfer the promised goods or services, and the customer does not make a separate purchase decision for the additional goods or services to be provided by the vendor. The future event that results in additional consideration occurs as the performance obligation is being satisfied (i.e., control of the goods or services is transferred).

Example: Optional Purchases

ABC sells a piece of equipment to a customer and will sell consumables for $1 per unit upon receiving purchase orders. Prior to receiving a purchase order, ABC is not obligated to transfer consumables and is not entitled to consideration for consumables. Although ABC may be the only entity capable of providing consumables and it may be highly probable that the customer will order consumables, ABC has no presently enforceable rights that obligate the customer to order consumables. Customer must make a separate purchase decision about whether to buy additional consumables.

This is an example of customer options. ABC would evaluate whether the option to purchase consumables represents a material right to the customer.

In contrast, Transaction Processor (TP) enters into a contract to process a customer's credit card transactions for $0.01 per transaction for a specified period of time, and there is a substantive contractual penalty in the event

the customer terminates the contract before the end of its stated term. TP is obligated to process each customer transaction and becomes entitled to $0.01 for each transaction processed. The customer does not make a separate purchase decision about whether TP will process each transaction, and whether transactions are processed or not is outside the customer's control.

This is an example of variable consideration. TP considers whether it has a stand-ready performance obligation for which it can apply the practical expedient to record revenue as billed for a time-based application and, if not, the series guidance, or whether it must estimate the consideration to which it expects to be entitled to determine the transaction price.[2]

Customer Termination Rights and Penalties

In some industries – such as telecommunications – there are questions about how to determine the term – i.e., duration – of a contract. The term establishes when the contract begins and ends, driving the accounting outcome in some cases. TRG members generally agreed that judgment will be required to determine the contract term when the customer has a unilateral right to cancel the contract on payment of a penalty. In those cases, the nature and amount of the termination penalty compared with expected consideration will provide important evidence about the contract term.

The existence of a substantive termination penalty typically will suggest that the contract term includes the entire stated duration when a customer can unilaterally cancel a contract. Although substantive is not defined, the TRG members generally agreed that facts and circumstances must be evaluated to determine whether a termination penalty creates enforceable rights and obligations throughout the contractual term. When the termination penalty is not substantive, a cancellation right may essentially function like a renewal option that should be evaluated to determine whether a material right exists. TRG members agreed that economic penalties and other forms of exclusivity or economic compulsion do not give rise to enforceable rights and obligations.

License Restrictions and Renewals

TRG members generally thought that the renewal of a time-based right-to-use license ought to be recognized *when the parties agree to the extension* rather than *when the renewal period begins*. However, there were a number of questions about how this could be supported under the standard, the consistency with other licensing outcomes for other types of restrictions, and the Boards' related exposure drafts on licenses of intellectual property. This issue is one of several discussed by the TRG about the effect that restrictions on time, geography, and use have on determining the number of licenses and the accounting for renewals of licenses.

[2] See Defining Issues No. 15-31, Revenue Transition Resource Group Discusses Nine Issues, available at www.kpmg-institutes.com.

The TRG also discussed contracts that grant or renew a license that provides a licensee with increasing rights to use the intellectual property during the license term; for example, allowing for more users of the license or the ability to deploy the license in additional geographies.

Example: License with Staggered Rights

Movie Production Company grants a TV network the right to show a movie on its U.S. network for three years beginning on January 1, 20X2, until December 31, 20X4. The license also allows the network to show the movie on its network in Europe for two years beginning on January 1, 20X3, until December 31, 20X4. Total consideration for the license is $50,000. The performance obligation(s) is satisfied at a point in time.

The FASB and IASB staff paper stated that the contract includes two distinct licenses because the staff believes that the Step 2 guidance in the revenue standard – identifying performance obligations – would lead to a conclusion that the staggered rights give rise to two distinct licenses. Many of the TRG members questioned this based on the guidance that geographic restrictions are attributes of what they believe is a single license to specific intellectual property. Similar to the staggered rights discussion, some questioned whether additional rights granted by modifying a license create distinct rights under the guidance on contract modifications.

Some TRG members stated that it might be helpful for the Boards to consider whether further clarifications are necessary through examples to the forthcoming amendments on licenses. However, other members expressed a view that additional examples may not be helpful and favored allowing practice to evolve. Based on the discussion, it is unclear whether the Boards will provide additional clarifying guidance, and in the absence of clarification, whether diversity in practice may result.

Accounting for a Customer's Option to Purchase or Use Additional Copies of Software

Software licenses often give a customer a right to use software for a specified number of employees (i.e., seats). The customer is able to give additional employees the right to use the license for an additional fee. Some stakeholders have questioned whether the guidance on customer options or the guidance on sales- and usage-based royalties (variable consideration) applies to these arrangements.

Similar to the optional purchases discussion above, we believe an entity should focus on the present enforceable rights and obligations of the parties to the arrangement. The contract includes customer options if the customer must make an independent purchase decision to expand its right to use the software. This would be different from a circumstance in which the customer has an enforceable right to use the software, and due to circumstances outside its control, such as transactions processed by the software or actions of employees, incurs an additional fee as the result of using its existing rights.

Pre-production Activities

An entity may undertake pre-production activities related to products that it will produce under supply arrangements. For example, an entity may construct tooling or perform engineering and design (E&D) work before transferring control of the products manufactured using the E&D. In some cases, these activities are performed before a contract with the customer is obtained.

Pre-production Goods or Services

TRG members generally agreed that if a contract with a customer exists, an entity first must determine whether tooling or E&D activities are performance obligations under the contract. If so, the entity must determine whether control of the tooling or E&D transfers to a customer after it is completed or as it is being developed based on an evaluation of the nature of the promise and the over-time criteria. If it is determined that a point in time performance obligation exists for tooling or E&D, title passage might not determine whether control passes to the customer or the timing of revenue recognition because title is only one indicator of when control transfers.

Pre-production Costs

TRG members generally agreed that accounting for costs is a separate analysis from determining whether the activities transfer goods or services to the customer. The fulfillment cost guidance in the revenue standard applies only when the costs are not in the scope of another codification topic. However, a number of U.S. TRG members and some FASB Board members suggested that the pre-production costs guidance for long-term supply contracts should be superseded because it is inconsistent with the new fulfillment cost and revenue guidance.[3]

Pre-production Costs Incurred in Construction-type and Production-type Contracts

In contrast to the pre-production cost guidance discussed above, the cost guidance for long-term construction-type and production-type contracts was superseded.[4] Thus, an entity will follow the cost guidance in the revenue standard.[5] The FASB staff will consider whether a technical correction is necessary to make this scope question clear.

Fixed-odds Wagering Contracts

Gaming entities (casinos) participate in fixed-odds wagering contracts (e.g., slot machines, card games, and sports betting). The revenue guidance for casinos in current U.S. GAAP will be superseded when the new standard is effective.[6]

---

[3] FASB ASC Subtopic 340-10, Other Assets and Deferred Costs – Overall, available at www.fasb.org.

[4] FASB ASC Subtopic 605-35, Revenue Recognition, Construction-Type and Production-Type Contracts, available at www.fasb.org.

[5] FASB ASC Subtopic 340-40, Other Assets and Deferred Costs – Contracts with Customers, available at www.fasb.org.

[6] FASB ASC Subtopic 924-605, Entertainment—Casinos—Revenue Recognition, available at www.fasb.org.

Because these contracts may be derivatives, the FASB will consider whether a technical correction is necessary to clearly specify that these contracts should be accounted for under the revenue guidance rather than the derivatives guidance.

The staff paper explained that, prior to the issuance of the revenue standard, the IFRS Interpretations Committee noted that if a gaming institution takes a position against a customer, the unsettled position meets the definition of a derivative under IFRS and, therefore, those contracts would be excluded from the scope of the revenue standard.

Next Steps

The FASB currently is evaluating certain changes to its revenue recognition standard:

- Potential technical corrections on pre-production cost guidance for contract manufacturers and long-term contractors and the scoping of fixed-odds wagering contracts.
- Potential additional examples about renewals and contractual restrictions to the forthcoming amendments on licenses.
- Narrow-scope improvements and practical expedients – comments are due November 16, 2015.[7]
- Principal versus agent guidance – the comment period has ended. The FASB is expected to discuss the comments this year.[8]
- Performance obligations and licensing – the FASB has discussed comments received on its exposure draft.[9] A final standard is expected this year.

The next TRG meeting is not yet scheduled, but is expected to take place in the first half of next year.

Contact us: This is a publication of KPMG's Department of Professional Practice 212-909-5600

Contributing authors: Brian K. Allen, Paul H. Munter, Yusuke Imai, and Todd T. Ravin

Earlier editions are available at: http://www.kpmg-institutes.com

[7] FASB Proposed Accounting Standards Update, Narrow-Scope Improvements and Practical Expedients, September 30, 2015, available at www.fasb.org.

[8] FASB Proposed Accounting Standards Update, Principal versus Agent Considerations (Reporting Revenue Gross versus Net), August 31, 2015, available at www.fasb.org.

[9] FASB Proposed Accounting Standards Update, Identifying Performance Obligations and Licensing, May 12, 2015, available at www.fasb.org.