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FASB Revenue TRG Holds Last Scheduled Meeting

The FASB Transition Resource Group for Revenue Recognition (TRG) met on November 7 and discussed implementation issues raised by stakeholders.[1] The Board said that it does not expect additional standard setting before the effective date of the revenue standard beyond the technical corrections already in progress.[2]

Key Facts

- For licenses of intellectual property (IP), determining the pattern of revenue recognition when there are ***sales- or usage-based royalties with a minimum guarantee*** will require judgment.
  - ***Functional IP.*** The minimum guaranteed amount should generally be recognized as revenue at the point in time the entity transfers control of the license to the customer. Royalties in excess of the minimum will be recognized as subsequent sales or usage occurs.
  - ***Symbolic IP.*** Multiple approaches of accounting for sales- or usage-based royalties with a minimum guarantee may be acceptable.
- ***The amortization period for incremental costs of obtaining a contract*** will extend beyond the initial contract term when there is a history of renewals, unless the commission paid on renewals is commensurate with the commission on the initial contract. A renewal commission is commensurate with an initial commission if they are commensurate with the expected economic benefits from the respective contract.
- ***Nonrefundable upfront payments to customers*** should be capitalized and amortized as a reduction of revenue over a longer period than the contract term, if the payment meets the definition of an asset and it is probable that it will be recovered through future cash flows from anticipated subsequent contracts. In some instances, it may be appropriate to recognize the payments over the contract term only; or, in other cases, immediately if sufficient evidence does not exist to support recording an asset.
- ***Over time revenue recognition*** is required for many manufacturers of customized tangible products and other entities when specific criteria are met, even if they currently recognize revenue when the products are delivered.

Contents

[1] The Transition Resource Group's staff papers, and FASB ASC Topic 606, Revenue from Contracts with Customers, are available at www.fasb.org.

[2] FASB Proposed Accounting Standards Updates about technical corrections and improvements are available at www.fasb.org.

Sales- or Usage-based Royalties

The revenue standard requires that a sales- or usage-based royalty promised in exchange for a license of IP should not be recognized until the later of the subsequent sale or usage, or satisfaction or partial satisfaction of the performance obligation (the recognition exception).

A customer may guarantee a minimum royalty to the licensor. The TRG discussed how such a guarantee affects the revenue recognized for licenses of functional (point-in-time revenue recognition) and symbolic (over time revenue recognition) IP.

The TRG generally agreed that a guaranteed minimum or fixed amount is not subject to the recognition exception for sales- or usage-based royalties.

Minimum Royalties Associated with Functional IP

The TRG generally agreed that the minimum guaranteed amount should be recognized as revenue at the point in time at which the entity transfers control of the license, assuming a contract exists and there is no risk of concession. They also agreed that only payments above the minimum are subject to the recognition exception and recorded as the sale or usage occurs.

Minimum Royalties Associated with Symbolic IP

The TRG generally agreed that the revenue standard does not prescribe a single approach for recognizing revenue when a contract includes royalties with a minimum guarantee. Instead, judgment will be required, and the approach that an entity chooses must appropriately consider all of the principles in the revenue standard including the recognition exception, selecting measures of progress, and allocating variable consideration. For example, the FASB staff paper indicated that it would be inappropriate to apply a breakage model to the fixed consideration and another model to the variable consideration. The TRG discussed three potential approaches that may be acceptable.

A	Recognize revenue (including the minimum guarantee) as sales or usage occurs based on an output or value to customer basis.[3] This approach would be appropriate when an entity has evidence that it will exceed the minimum royalties, and the amount billed corresponds directly to the output or value transferred to the customer.
B	Estimate the total consideration and apply a measure of progress to the unconstrained estimate to recognize revenue. Apply the royalties recognition exception at the contract level so that the cumulative revenue recognized cannot exceed the amount the entity would be entitled to receive (including the minimum guarantee).
C	Recognize the minimum guarantee over the contract term based on an appropriate measure of progress and recognize variable amounts only when the royalties exceed the minimum. Apply the royalties recognition exception to the variable amounts only, and do not account for the variable amount before the uncertainty is resolved.

[3] FASB ASC paragraph 606-10-55-18, available at www.fasb.org.

The examples in TRG Paper 58 used a time-elapsed measure of progress in Views B and C. However, other measures could be appropriate.

Example – Symbolic IP

An entity licenses a trademark to a customer for five years. The customer must pay a sales-based royalty of 5% of its gross sales; however, the contract guarantees that the entity will receive a minimum of $5 million for the five-year period. The trademark is considered symbolic IP.

The customer's gross sales and the related royalties ($ in thousands) each year are below. This information is not known at the beginning of the contract.

	Y1	Y2	Y3	Y4	Y5	Total
Gross Sales	15,000	30,000	40,000	20,000	60,000	
Royalties	750	1,500	2,000	1,000	3,000	8,250

Approach A – Recognize revenue as sales or usage occurs on an output or value to the customer basis

	Y1	Y2	Y3	Y4	Y5	Total
Billings	750	1,500	2,000	1,000	3,000	8,250
Annual revenue	750	1,500	2,000	1,000	3,000	8,250
Cumulative revenue	750	2,250	4,250	5,250	8,250	

Approach B – Estimate expected royalties and apply a measure of progress subject to a cumulative royalty exception

	Y1	Y2	Y3	Y4	Y5	Total
Billings	750	1,500	2,000	1,000	3,000	8,250
Annual revenue[4]	1,650	1,650	1,650	300	3,000	8,250
Cumulative revenue	1,650	3,300	4,950	5,250	8,250	

Approach C – Recognize the minimum amount using a measure of progress and recognize variable amounts when the minimum is exceeded

	Y1	Y2	Y3	Y4	Y5	Total
Billings	750	1,500	2,000	1,000	3,000	8,250
Annual revenue[5]	1,000	1,000	1,000	1,250	4,000	8,250
Cumulative revenue	1,000	2,000	3,000	4,250	8,250	

[4] The estimated royalties of $8,250 ÷ 5 years. However, the cumulative revenue earned cannot be more than the $5,000 minimum guarantee unless the amount the entity is entitled to receive is greater than $5,000.

[5] Years 1-3: $5,000 ÷ 5 years; Year 4: ($5,000 ÷ 5 years) + ($5,250 cumulative royalties – $5,000 minimum guarantee); Year 5: ($5,000 ÷ 5 years) + ($8,250 cumulative royalties – $250 already recognized - $5,000 minimum guarantee).

Incremental Costs of Obtaining a Contract

Incremental costs of obtaining a contract are costs an entity "would not have incurred if the contract had not been obtained."

If the entity would have incurred the costs even if it did not execute the contract, the costs are not incremental.

Incremental costs of obtaining a contract with a customer, e.g., commissions, are recognized as an asset if they are expected to be recovered. The asset should be amortized on a systematic basis that is consistent with the transfer to the customer of the goods or services to which it relates. The asset may relate to goods or services to be transferred under a specific, anticipated (future) contract. The TRG discussed implementation questions about identifying incremental costs and the amortization of the asset.

The TRG agreed that the FASB staff paper provided several helpful examples about evaluating whether a cost is incremental. Some TRG members observed that more costs may be subject to capitalization under the standard than under current practice. The TRG agreed that the timing of cost recognition would be consistent with the recognition of a liability for an eligible expenditure.

The TRG generally agreed on key considerations for determining the amortization period and pattern for costs of obtaining a contract.

- An amortization period longer than the initial contract term would be appropriate if past experience indicates that a contract renewal is likely.
- An amortization period longer than the initial contract would be inappropriate if an entity pays a commission on a contract renewal that is commensurate with the commission paid on an initial contract.
- The average customer life may be a starting point to determine the amortization period. However, an amortization period that reflects specific, anticipated renewals may be shorter than the average customer life if the goods or services provided today are very different from the goods or services that will be provided in the future. For example, if the average customer life is 20 years, the FASB staff believes that it is unlikely that the commission paid today would relate to goods or services that would be provided in 20 years. The TRG suggested that the meeting minutes identify factors an entity might consider when determining the amortization period.
- The asset is amortized in a pattern consistent with the recognition of the related revenue, which will not necessarily be straight line over the amortization period.

The FASB staff also clarified the intent of TRG Paper 23, which was discussed at the January 26, 2015 meeting. That paper described how to determine when a renewal commission is commensurate with the commission on the initial contract. The FASB staff clarified that the determination does not consider the level of effort to obtain the initial or the renewal contract but whether each commission is commensurate with the expected economic benefits from the respective contract (e.g., the contract margin).

KPMG Observations

If the amortization period is greater than one year, an entity would not be able to apply the practical expedient, which allows costs to be expensed as incurred only if the amortization period is one year or less.[6]

[6] FASB ASC paragraph 340-40-25-4, available at www.fasb.org.

Upfront Payments to Customers

Accounting for nonrefundable upfront payments made to customers is not a policy election.

Payments to customers are accounted for as a reduction to revenue unless the payment is for a distinct good or service.[7] An entity may make nonrefundable upfront payments to customers or potential customers to motivate the customers to enter into a contract (e.g., pay to play, exclusivity, or a reimbursement for transition costs).

The TRG discussed two views to account for upfront payments.

View A – Expected Purchases	View B – Contract Period
Payments to customers are capitalized and amortized as a reduction of revenue over expected purchases, including purchases under potential future contracts.	Payments to customers are recognized as a reduction of revenue over the existing contract. If no contract exists, the payment would be immediately recognized in the income statement.

Example – IT Outsourcing

ABC Co. agrees to pay $1 million to a customer to help offset transition costs for its IT outsourcing contract. The contract term is 5 years but is cancellable each month without penalty. Therefore, the contract term is only 1 month under the revenue standard. ABC expects the customer to purchase services for the full five years with estimated fees of $6 million.

View A – Expected Purchases

The payment would be capitalized as an asset and amortized as a reduction of revenue over five years (i.e., over the period of expected purchases).

View B – Contract Period

The payment would be recognized over the one-month contract period resulting in negative revenue or a loss during the first month.

The TRG agreed that View A would be appropriate if the payment meets the definition of an asset and is recoverable from future cash flows (including cash flows from anticipated renewals). The TRG also agreed that an entity will need to determine the amortization and impairment method of the asset in the same manner that it assesses amortization and impairment of other assets. Most TRG members agreed that this assessment should be based on an evaluation of expected cash flows from the customer.

KPMG Observations

We believe most entities provide nonrefundable upfront payments to customers in anticipation of expected future purchases. We believe that View A generally will be appropriate unless there is sufficient evidence to demonstrate that the asset is not recoverable.

[7] FASB ASC paragraph 606-10-32-25, available at www.fasb.org.

Over Time Revenue Recognition

The revenue standard requires an entity to recognize revenue over time when the entity creates an asset with no alternative future use and it has an enforceable right to payment. The TRG emphasized that the revenue standard may require an entity that currently recognizes revenue when inventory is shipped to change its practice. An entity that produces tangible goods designed to meet a customer's unique specifications will need to carefully evaluate its contracts (including the entity's right to payment) because those goods may not have an alternative use to the entity.

The TRG agreed that the analysis of whether a good is transferred over time or at a point in time should be made on an individual contract basis and for each performance obligation within the contract. The TRG observed that similar goods or services could have different patterns of recognition depending on the rights and obligations in each contract.

The SEC Observer said that the SEC is continuing to evaluate its current guidance on revenue recognition (including guidance on bill-and-hold arrangements and vaccine stockpiles).

The SEC Observer also reiterated the importance of appropriate quantitative and qualitative analysis about the effect of recently issued accounting standards (SAB 74 disclosures).

KPMG Observations

Entities will need to establish internal controls, policies, and procedures to identify contract terms (e.g., a right to payment on termination) that would result in recognizing revenue from goods or services over time versus at a point in time.

Next Steps

The FASB said that no TRG meetings have been scheduled, but it stands ready to discuss additional implementation issues as needed. The FASB is performing research related to pre-production costs and nonrecurring engineering costs and expects to conduct outreach with stakeholders about issues related to applying the current U.S. GAAP guidance in the context of the revenue standard.

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