Overview

1. At its May 8, 2019 meeting, the Board added this Issue to the EITF’s agenda to address revenue recognition for contract modifications of licenses of intellectual property (IP), which will primarily affect licenses to functional IP. At that meeting the Board decided that the scope of the Issue should include the following:
   
   (a) Accounting for contract modifications under which the contract term for existing rights is extended, while also adding rights
   
   (b) Accounting for the revocation of licensing rights (including conversion of term software licenses to software as a service (SaaS) arrangements).

2. The first Task Force meeting on this Issue was held on June 13, 2019. The purpose of that meeting was to educate the Task Force on the issues. Following the June EITF meeting, the staff formed a working group composed of preparers, practitioners, and users who have expertise in revenue recognition, specifically on accounting for licenses of intellectual property. The working group was composed of 19 members including 8 preparers (5 software, 2 pharma, 1 media), 7 accounting firms, 2 financial statement users, a PCC member, and the EITF member liaison for this Issue.

3. The staff organized a working group meeting that was held on July 16, 2019, in a non-public setting. The objective of the working group meeting was to (a) present the working group with background about the issues to be considered, and (b) identify the potential alternatives to resolve those issues and fulfill this Issue’s objective to reduce diversity in revenue recognition for contract modifications of licenses of functional IP, while maintaining or increasing operability and the decision usefulness of information provided. This appendix provides a summary of that working group meeting.

Issue 1: Accounting for Contract Modifications under Which the Contract Term for Existing Rights Is Extended, While Also Adding Rights

4. Issue 1 relates to the accounting for contract modifications involving licenses of IP that extend the original license term and grant additional rights. There is diversity in determining whether to apply the contract modification guidance (paragraphs 606-10-25-12 through 25-13) or the licensing guidance (paragraph 606-10-55-58C) in cases in which a modification to a license arrangement involves extensions of the original license term and granting additional rights to the licensee (that is, the renewal is not at the same terms and conditions as the original licenses). The diversity primarily results from
different views about whether revenue resulting from the modification should be recognized at the date of the modification (because the modification is accounted for as the termination of the existing contract and the creation of a new contract) or at the start of the renewal period (because the guidance on license renewals applies).

5. The staff proposed the following three potential alternatives for the working group to discuss:

(a) Alternative 1: The additional rights granted are a separate contract and the renewal guidance would apply to existing rights

(b) Alternative 2: Modification Implementation Guidance for Licenses—When a Contract is Considered Terminated

(c) Alternative 3: Modifications Implementation Guidance for Licenses—A License Modification is Always a Termination of the Existing Contract.

Working Group Discussion

6. The working group discussed how current practice is dealing with the issue of accounting for contract modifications when additional rights are being added and the term for existing rights is extended. The working group also discussed the three proposed alternatives and whether they would be operable.

Overall Considerations

7. Working group members generally stated that this issue is relevant in today’s accounting practice. Most working group members agreed that while they currently use Alternative 1 in practice, additional guidance to simplify the current accounting would be helpful. The group had diverse views about the proposed alternatives and did not reach a consensus on any of them. However, there was general agreement that an alternative that requires an analysis of standalone selling price (SSP) would be operationally challenging.

Preparer Considerations

8. Working group members who are preparers provided background on their contracting process, current accounting approach, and feedback under the proposed alternatives with a focus on operability. Preparers from the larger companies noted that they have standard contracts and a contracting process, which enables them to distinguish between renewals and “renegotiations” that include a renewal as well as additional rights. Furthermore, they also highlighted that, operationally, a “renegotiated” contract replaces the data from the original contract in their accounting systems, which makes Alternative 1 operationally challenging.
9. Comparatively, working group members who are preparers from smaller companies noted that given their size and market share, they do not have standard contracts like larger companies, and that they generally negotiate each contract, including renewals, differently. They stated that negotiation regarding the price is typically based on the relative size and negotiating power of the customers, that some customers may negotiate better discounts than others, and that even the original contract may not be at SSP. They also stated that, generally, customers do not exist in a static environment where they would enter into amendments for only time extension of original rights. Rather, a renegotiation typically involves additional usage rights of original products (licenses), additional products, swaps of products, reductions in price or rights, term extensions, conversions to or from SaaS, or any combination thereof.

10. One preparer noted that they would disagree with a presumption that a software license is never at SSP (which is part of the basis for Alternative 3) and that they always sell their product at SSP. In general, all the preparers highlighted that determination of SSP in software arrangements is very challenging.

11. One preparer noted that they would have issues applying Alternative 1 because they do not have SSP information for their licenses. They explained that when a product is sold to a customer for the first time, they recognize the consideration received from that contract as revenue per the five-step model, without needing to determine whether the consideration reflects SSP of the product (for example, because no allocation is needed). Thereafter, when the contract is amended, they are required to perform an SSP analysis even though the SSP of the product was never established in the first place.

12. Preparers for whom this issue is prevalent stated that they are following Alternative 1 for most of their contract modifications, and that most companies are allocating the consideration received between the new rights added to the contract and the extension of existing rights. One preparer stated that in some cases, they are using Alternative 2, but only when the contract modification is based on SSP. Another preparer noted that they generally would follow Alternative 1 when the contract modification was clearly an early renewal and material. Otherwise, they follow Alternative 3 because they generally consider additional term licensing rights in combination with an extension of term licensing periods to be a new contractual obligation (and the termination of the original contract) both legally and economically. Preparers generally agreed that while they are currently following Alternative 1, it is often time intensive and operationally challenging. This is primarily due to the complexities associated with allocating the contract price between the new rights and the existing rights.

13. One preparer discussed that customers may have trade-up rights for a better version of the product (or upgrades) and noted that while Alternative 1 is easier to apply for straightforward cases (for example, where there is a clear delineation between new scope and renewals), it is operationally difficult to apply when there are changes to features or functionality of the original product. Therefore,
they stated that Alternative 2 would be their preferred approach for more complex situations. This member also stated that they always try to price contract modifications at SSP.

14. In general, preparers viewed the principles of Alternative 2 that require an analysis of SSP as overly complex and operationally challenging. Preparers also raised a concern that trying to apply Alternative 1 or Alternative 2 could create diversity in practice because each company analyzes SSP differently and each company could structure their deals differently.

15. A few preparers highlighted that Alternatives 1 and 2 would be difficult to operationalize because the information required to apply either of these alternatives can be highly judgmental and could differ from one company to the next. For example, one entity stated that for revenue recognition, they focus on the effective date of the contract, after that effective date has passed and they have recognized the revenue, they no longer retain the information related to the original contract, which makes Alternative 1 difficult to apply. They said that they very rarely have a pure renewal (that is, only the addition of time for existing rights) and that customers are usually adding new rights along with extending the term of their license.

16. Preparers noted that Alternative 3 bypasses certain principles laid down in the contract modification guidance; however, they generally stated a preference for Alternative 3 because it is the most operational alternative. In response to the potential for abuse and structuring with Alternative 3, a preparer highlighted that companies have to get their customers to agree to any contract changes before they are finalized and so that should inherently minimize the potential for abuse.

17. A working group member who is a preparer from the pharmaceutical industry stated that while they do have licenses of IP, they do not believe that potential amendments to the guidance in this project will have major implications for their industry. They stated that contract modifications are generally not made in their industry to add time but, rather, to add new molecules or geographies. A preparer from the media industry stated that similar to the pharmaceuticals industry, in many contract renewals time is not the only element that is changed. This preparer noted that while software could be seen as an “infinite” good in the sense that once it is developed it can be distributed an unlimited number of times to an unlimited number of customers, media content, such as movies, may have a “limited life” because the value is generally higher in the early stages of distribution and may be considerably lower several years after initial release. Additionally, for media content each title is unique thus making the concept of SSP somewhat elusive when applied to the various rights to an individual title, such as a renewal of streaming rights accompanied by temporary download rights. Noting the complexities regarding the nature (or functionality) of the media rights as well as related SSP, this preparer also stated that Alternative 3 would be much easier from an operability standpoint.

18. While the working group members from the pharma and media industries did not see the issues in this project as critical for their companies, they did express concerns about the potential for
unintended consequences for their industries if the Board amends the licensing guidance to deal with what they view as primarily a software licensing issue.

**Auditor Considerations**

19. In general, the working group members representing accounting firms noted that Alternative 1 is the predominant view being taken by their national offices. Some of the firms highlighted that the unit of account (PO or the contract) is not clear in the proposed alternatives, and that whichever alternative is elected, it should clearly articulate the unit of account.

20. One firm noted that Alternative 2 is most consistent with the existing contract modification guidance but acknowledged the related challenges because it relies on an evaluation of SSP to determine the appropriate accounting. This firm emphasized that unlike the other two alternatives, Alternative 2 is based on the contract modifications guidance, and that the staff should stick to those principles in developing a license implementation guidance. The firms generally agreed that, absent a strict pricing model, assessing SSP in licensing arrangements can be difficult and, therefore, considered Alternative 2 to be difficult to operationalize. One firm also highlighted that Alternative 2 may increase diversity.

21. Another firm highlighted that contract amendments are often driven by companies that are trying to upsell incremental functionality or upgrades to the original software granted. This firm noted that existing contracts are amended during the original term to add additional functionality or to replace the original product with a more sophisticated product, and that customers would get credit for product or functionality that has been taken away. This firm stated that while Alternative 2 is difficult to apply, both Alternatives 1 and 3 are acceptable, and that functionality of the product should be assessed to determine the appropriate accounting. They proposed that when looking at the totality of the rights, consideration should be given as to whether the original functionality is still distinct. If you simply add a module and the new functionality is not distinct from the original functionality, then Alternative 1 is appropriate. Otherwise, the amendments have led to a termination of the old contract and the creation of a new contract, and Alternative 3 is appropriate. They noted, however, that a policy election for Alternative 1 or Alternative 3 is not appropriate.

22. Multiple other working group members also noted merit in both Alternative 1 and Alternative 3 and stated that determining which alternative to use is often based on the facts and circumstances of the contract. One firm stated their preference for Alternative 1 because it considers the renewals guidance regardless of additional rights; they recommended that this alternative should go through the contract modification guidance and also noted that Example 59, Right to Use Intellectual Property (paragraph 606-10-55-389), does not illustrate the application of contract modification guidance in case of renewals.
23. Another working group member saw merit in all three alternatives and agreed that there are certain situations in which the modifications to the contract are so substantive that there is clearly a termination of the old contract and a creation of a new contract. One working group member noted that instead of adding more judgment as to whether a change is substantive, it is better to go all the way to Alternative 3, which is easier to apply; however, they noted that Alternative 3 has theoretical issues.

24. Multiple working group members noted that Alternative 1, which is the predominant view in practice, is consistent with the licensing guidance but operationally complex, and Alternative 3, while most operable, overrides the renewals guidance. One firm had concerns with Alternative 3 because they want the ability to ensure that the changes made to the contract are substantive before the entity can account for the modification as a contract termination, which would accelerate the revenue recognition.

25. Some firms stated that Alternative 3, while not consistent with the contract modification guidance, could be an acceptable solution given the unique challenges in applying that guidance to software arrangements; however, they noted that this alternative could be better articulated by providing some basis, instead of simply bypassing the contract modification principles. One firm recommended that Alternative 3 could be improved by distinguishing between a simple contract renewal and a contract modification under which rights are added to the contract; they noted that this may address structuring concerns. One firm noted that considerations should be given to whether Alternative 3 has any potential impact on symbolic IP licenses, which may breach the intended scope of the Issue.

26. Two firms also had concerns about the examples that were provided by the staff because those examples did not clearly articulate the unit of account and the application of contract modification guidance. They noted that in most instances a contract would not be complete because there would likely be remaining services and that the changes should be assessed as a modification rather than as a separate contract. One firm also cautioned that amending the guidance could potentially lead to a lot more work for both the preparers and the auditors.

**User Considerations**

27. One user in the working group stated that current accounting practice is not very transparent to users, noting that point-in-time revenue recognition itself is not understood by users, and that modification or termination makes it more complex. This user saw the lack of transparency as an issue in drawing the line between what is considered a renewal and what is considered a modification, and raised concerns about Alternative 3 and whether it could pull forward revenue and not be transparent to users.

28. Another user had hesitations about alternatives that refer to SSP because of the diversity in how companies assess SSP or determine pricing for their various licensed products. This user noted that
users assess revenue in terms of pricing, volume, and mix, and that now timing of executing an amendment also affects the revenue. This member thought that Alternative 3 was the best alternative because it is simpler for preparers and when coupled with additional disclosures, users will be able to obtain the information they need to do their analysis.

**Working Group Recommendation on Issue 1**

29. There were differing working group members’ views on which of the proposed alternatives would be the best option in moving forward. Most of the preparers preferred Alternative 3, while many of the firms preferred Alternative 1. Preparers stated that Alternative 1 is time intensive and often challenging. Preparers preferred Alternative 3 because it is more operable and reduces the impact of management judgment on revenue recognition, whereas auditors were concerned that that view could result in significantly different accounting when only immaterial changes are made to a license (whether through intentional structuring or not). While the users were split on proposed alternatives, they agreed that there needs to be transparent disclosures regardless of the alternative chosen.

30. Most of the working group members agreed that (a) when a contract modification only involves increasing the term of the license, revenue is deferred under the licensing guidance for renewals until the renewal period begins and (b) when a contract is completely renegotiated (such that in substance there is no renewal), revenue is recognized on the effective date of the contract and it is treated as a termination of the old contract and the creation of a new contract (Alternative 3). Working group members noted that while (a) and (b) are clear, it is not clear which approach to apply to scenarios that fall in between (a) and (b). Most working group members agreed that following Alternative 1 or Alternative 3 is largely based on the facts and circumstances of the contract modification that involve significant changes in functionality and rights such that in substance there is no renewal. The working group members did not reach a consensus for any of the proposed alternatives. They did, however, provide feedback on the operability of each and, for any alternative pursued, requested that consideration be given to the related disclosure requirements.

**Issue 2: Accounting for the Revocation of Licensing Rights (Including Conversion of Term Software Licenses to Software as a Service (SaaS) Arrangements)**

31. An emerging issue in the software industry is the existence of contracts that include, whether from inception or by subsequent modification, a feature that allows a customer to convert from an on-premise software license to a hosted software solution (such as SaaS). Revenue from a license to functional IP is recognized at a point in time when the entity provides a copy of the IP to the customer and the period in which the customer is able to use and benefit from the license has begun (paragraph 606-10-55-58C). Revenue from SaaS is typically recognized over time because the performance obligation likely would meet the criteria for over time recognition. Therefore, questions have arisen about how to account for the conversion of a point-in-time license to a service provided over time.
This issue also relates to when functional license rights are revoked, even in cases in which there is not a conversion to SaaS.

32. The staff proposed the following two potential alternatives for the working group to discuss:

(a) Alternative A: A portion of the software license revenue is deferred and recognized over the SaaS period

(b) Alternative B: The SaaS conversion is accounted for prospectively.

Working Group Discussion

33. The working group members discussed their experience with various types of arrangements within the purview of this issue and how practice is currently dealing with it. The working group also discussed the proposed alternatives.

Overall Consideration

34. Most working group members agreed that there are numerous ways a software agreement could be structured to convert term license to SaaS. In discussing the proposed alternatives, the group noted that it will be challenging to develop a single model that would address all possible scenarios. Rather, they noted that appropriate accounting could be determined by referring to the existing principles in Topic 606 and that, potentially, additional implementation guidance is not necessary.

Preparer Considerations

35. The working group members who are preparers discussed their current accounting approach wherein most reserve a portion of the revenue from term licenses for expected conversions. A preparer highlighted that recognizing SaaS revenue is important because SaaS, being a recurring revenue model, is viewed favorably by financial statement users. In order to increase returns to investors, companies are increasingly investing in cloud-based services and recommending cloud migration to existing customers. Therefore, if a software company has decided to move towards cloud migration, the preparer would want that over time revenue stream to be reflected in the go forward revenue (and not affected by the prior functional license revenue recognized). Preparers raised significant concerns with Alternative B because it would significantly reduce cloud-conversion revenue and growth in their financial statements, and that deterioration in cloud margin will diminish their “cloud story” and affect their valuation. Therefore, they emphasized their preference for an alternative that would appropriately reflect revenue from SaaS conversion.

36. Multiple working group members brought up complexities associated with Alternative A. They were primarily concerned about the judgment required in making estimates to determine the amount of revenue to defer until the SaaS conversion. One working group member stated that as data models
are evolving and becoming more dynamic, these estimations will only get more complex. They noted that sometimes contracts are structured in such a way that the customers could have the ability to switch between on-premise and cloud-based services daily and the decision to switch back and forth could be driven entirely by artificial intelligence. A preparer commented that customers will want the option to use whichever model is best for them at that time and the estimates required under Alternative A could prove to be difficult and could have a significant effect on a company’s overall revenue number.

37. Another preparer noted that oftentimes customers have the option to convert to SaaS but may not convert or delay conversion for various reasons that are entirely outside of the company’s control. For example, delays could be due to regulatory delays because customers want to wait and see how the new cloud platform works for other companies, or customers could simply want the option to switch to the cloud platform as a backup plan in case they have an issue with their on-premise systems. This preparer talked about the negative impact of revenue fluctuation brought on by licensing guidance in Topic 606 (that is, recognition for functional licenses of IP at a point in time) and stated that investors place a heavy value on the predictability of revenue streams. This preparer noted that current accounting rules make it difficult for investors to predict revenue streams and that their company has moved towards SaaS arrangements for predictable revenue streams. This member voiced their preference for an approach under which entities could recognize revenue associated with the contract over time, such as on a quarterly basis, and stated that by recognizing revenue one quarter at a time, they will avoid having to make expensive estimates and large revenue reversals if the estimates are incorrect.

38. Some members asserted that Alternative A was difficult because of its required assumptions, its auditability, and its potential for revenue reversals. Some preparers noted that applicability of both of the proposed alternatives is further complicated by contracts that allow customers to switch back and forth between products.

39. Several working group members agreed that they did not understand the need for additional guidance in this area, and that each individual fact pattern could be different. While judgment is required to determine appropriate accounting, they asserted they are able to address this issue without the need for additional guidance. One working group member noted that developing additional guidance that applies to all licenses but is only focused on the software industry could be detrimental to industries such as pharmaceuticals or media.

40. Another working group member noted that a principles-based standard might be the best approach and agreed that Topic 606 includes those principles and entities would always have to apply judgment. This working group member noted that disclosure requirements may be improved to increase comparability.
Auditor Considerations

41. Multiple working group members representing the firms noted that coming up with a single solution for this issue would be difficult. Every arrangement could have different facts and circumstances and developing a model that could be applied to all potential scenarios would be complex. Some working group members had concerns with both of the proposed alternatives. A working group member noted their concern with Alternative A regarding the estimation of returns reserve, and that the possibility for revenue reversals (or catch ups) would always exist. Working Group members were also hesitant about a requirement to have companies look forward and make those difficult estimations, especially in cases in which there is no option in the original contract. Regarding Alternative B, they highlighted that it ignores accounting for a significant event (the SaaS conversion) and that too little revenue would get allocated to the SaaS arrangement, especially if the option to convert was included in the original contract. They noted that while the functionality of the product might not change when a customer converts to SaaS, the economics of the transaction and the transformation from the customers perspective is significant.

42. In discussing Alternative A, some firms noted that if the approach is based on sale with a right of return guidance, it would not be inappropriate for an entity to record a subsequent revenue reversal. Another member proposed a new alternative under which the entity identifies all of the rights granted to the customer up front—if the customer has a term-based license and as part of that arrangement they get a discount on SaaS conversion, that would be accounted for up front as a material right, rather than as a right of return.

43. Considering that the conversion right may not always be considered a material right (and hence a performance obligation), one firm noted that maybe the uniqueness of software arrangements warrants specific standard setting and proposed an alternative under which the on-premise license and conversion right would always be treated as two separate performance obligations, regardless of whether the conversion option is a material right.

44. Several of the firms generally agreed with a preparer who highlighted that additional standard setting for this issue is not required because Topic 606 provides sufficient principles to adequately account for all conversion scenarios. Those firms noted that given the numerous fact patterns that may exist, application of judgment will always be needed, and that standard setting to develop a single model to address all those scenarios will be a challenging task and may not be the best solution after all. Those firms agreed that Topic 606 provides sufficient principles and additional standard setting for this issue. Some members noted that while additional guidance might not be necessary, the staff should still consider disclosure requirements for this issue. Many members agreed that Issue 2 is a less significant issue than Issue 1.
User Considerations

45. One working group member who is a user stated that they are not concerned about revenue reversals and that they would rather see a large revenue reversal than have a company make a large estimate upfront and reassess it every quarter (and record adjustments). This working group member preferred Alternative B. Another user stated that financial statement users are focused on understanding the actual return amount and the actual estimate. That is, in case of revenue reversal, they would want to be able to separately analyze the impact of estimate from the impact of returns. This member stated that while they preferred Alternative B, after hearing the views of preparers and auditors, if the Task Force decides to pursue Alternative A, a solution might be to increase disclosures about the reserve balance and adjustments.

Working Group Recommendation on Issue 2

46. The working group members did not generally concur on or support any of the proposed alternatives. After discussing the numerous fact patterns that may exist and potential solutions to address those scenarios, the members generally agreed that developing a single model to apply to all facts and circumstances would be challenging. Many, but not all, working group members agreed that Topic 606 includes necessary principles and that additional standard setting might not be needed for this issue. At the end of the discussion, some working group members proposed removing this issue from the scope of EITF Issue 19-B; notwithstanding their agreement to such proposal, some members encouraged the staff to consider disclosure requirements for this issue.