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Ms. Susan Cospers
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20 March 2019

Agenda request – Accounting for contract modifications involving licenses of IP that include extensions of the original license term

Dear Ms. Cospers,

EY appreciates the opportunity to submit an agenda request to the Emerging Issues Task Force (EITF). We request that the EITF address the application of Accounting Standards Codification (ASC) 606-10-55-58C(b) to contract modifications involving licenses of intellectual property (IP).

We are making this request because we are seeing diversity in practice in the accounting for contract modifications for software license arrangements that involve extensions of the original license term. We believe there is an opportunity to increase consistency in this area. While a clarification of the guidance would broadly affect all licenses of IP, it would affect licenses of functional IP most significantly.

The licensing guidance in ASC 606-10-55-58C(b) states that "... an entity would not recognize revenue before the beginning of the license period even if the entity provides (or otherwise makes available) a copy of the intellectual property before the start of the license period or the customer has a copy of the intellectual property from another transaction. *For example, an entity would recognize revenue from a license renewal no earlier than the beginning of the renewal period.*" (emphasis added)

Example 59 (ASC 606-10-55-389 to 55-392D) shows that an entity would first apply the modification guidance and then apply the example in ASC 606-10-55-58C(b) to account for a renewal of a license of IP under the same terms and conditions as the original license. However, it is unclear when an entity would be required to defer revenue recognition until the end of the term of the original license if a modification is not solely a renewal of the same terms and conditions of the original license.

An entity and its customer may agree on contract modifications that include, either explicitly or implicitly, an extension to the term of the original software license among other changes (e.g., adding or removing other goods or services from the contract, changing the pricing of the original license of IP granted to the customer).

When considering the contract modification guidance in ASC 606-10-25-12 and 25-13, the entity will likely conclude that the license of IP granted in the modified contract is distinct from the license of IP granted in the original contract based on the discussion in the Background Information and Basis for Conclusions of Accounting Standards Update 2016-10 in paragraph BC50.



Therefore, the accounting for the modification will depend on whether the consideration in the modification reflects the standalone selling price, and the modified contract will either be accounted for as a separate contract under ASC 606-10-25-12 or as a termination of an existing contract and a creation of a new contract under ASC 606-10-25-13(a).

The guidance in ASC 606-10-55-58C is then evaluated to determine when any revenue related to the modified license is recognized. We have observed the following interpretations of this guidance:

View A: The entity has, in substance, renewed the original license and, therefore, it must defer revenue recognition of amounts allocated to the modified license until the beginning of the license renewal period in accordance with ASC 606-10-55-58C(b) regardless of whether the modification results in a renewal license with the same terms and conditions of the original license granted. This view would require an entity to defer revenue recognition of the modified license regardless of whether the application of the modification guidance results in a separate license in accordance with ASC 606-10-25-12 or a termination of an existing contract and a creation of a new contract in accordance with ASC 606-10-25-13(a).

This view results in the broad application of the license renewal example in ASC 606-10-55-58C(b) since the customer would not be able to use and benefit from the modified license until the end of the term of the original license. The view also requires an entity to conclude that a license renewal has occurred even when the terms of the original license have significantly changed because of the modification.

View B: Since the modified contract includes changes to the scope that are beyond renewing the terms and conditions of the original contract, the modification is not a renewal of the original license, and the entity is able to use and benefit from the modified license immediately. The customer is not renewing a license with the same terms and conditions as the original contract (therefore, the entity is accounting for the modification as a separate contract or as a termination of an existing contract and a creation of a new contract). This is inconsistent with the notion that a renewal has occurred.

As a result, any transaction price allocated to the license will be recognized as revenue at the contract modification effective date, which is the beginning of the period in which the customer is able to use and benefit from the license granted in the new contract in accordance with ASC 606-10-55-58C(b) since the customer already has a copy of the license.

This view significantly limits the instances in which an entity concludes it cannot use and benefit from a modified license until the original license term has expired (i.e., only when the customer renews a license with the same terms and conditions as the original license). Because there frequently are changes to the terms and conditions of a license upon renewal, many entities will conclude that the customer can use and benefit from a modified license at the modification date.

View C: The entity considers the example referring to a license renewal in the licensing guidance in ASC 606-10-55-58C(b) when a modification results in a separate contract in accordance with ASC



606-10-25-12, but it does not consider a license to be renewed when the application of the modification guidance results in a modification in accordance with ASC 606-10-25-13(a).

A modification accounted for under ASC 606-10-25-12 would suggest that the original terms of the license have not changed and, therefore, any additional rights granted should be accounted for as a separate contract. Thus, any additional consideration allocated to the license should be recognized after the restrictions of the original license lapse, even if other goods or services were added to the contract. That is, the customer can only use and benefit from the modified license after the restrictions of the original license lapse.

However, modifications accounted for under ASC 606-10-25-13(a) would result in a termination of the original license before the restrictions of the license lapse, which would suggest that there is not a renewal of the original license granted and that the customer is able to use and benefit from the modified license at the modification date.

Since licenses of IP are generally found to be distinct, this view focuses on the determination of standalone selling price (SSP), which can be challenging with certain types of licenses (e.g., software licenses where SSP is determined by the residual method or a value relationship between the software license and other performance obligations).

These interpretations could result in revenue recognition related to the license at different points in time (i.e., the modification date or the beginning of the implied renewal period). In some circumstances, the timing difference could have a material impact across reporting periods.

We have provided several examples in the Appendix to illustrate the scenarios in which we think entities could benefit from the clarification of the applicability of the license renewal example in ASC 606-10-55-58C(b).

In summary, it is unclear when an entity is required to defer revenue recognition from a modified license of IP until the end of the original license term when a contract modification includes an extension of the original license term, but is not solely a renewal of the same terms and conditions of the original license. We believe that the FASB should add this issue to the EITF's agenda to reduce diversity in practice in this area.

If you have any questions, please contact Paul Beswick or Alison Spivey.

Sincerely

A handwritten signature in black ink that reads 'Ernst & Young LLP'.

Ernst & Young LLP



Appendix - Illustrations

Illustration 1:

Entity A enters into a contract on 1 January 2018 with Customer B to transfer a software license to 100 seats of Product A for a two-year term for \$200,000, which reflects the standalone selling price (SSP) of Product A. On 31 December 2018, Entity A and Customer B modify the contract because the customer made an acquisition and needs more seats. As part of the modification, the old license is terminated, and the customer is granted a new license to 150 seats for a two-year term for an additional \$200,000, which reflects the same per-seat pricing of the original contract.

In evaluating the contract modification guidance, Entity A determines that the additional seats are distinct from the original seats, and the additional seats are priced at SSP. Therefore, the modification is accounted for as a separate contract in accordance with ASC 606-10-25-12.

View A: Entity A considers the contract modification to be the addition of 50 new seats for a two-year term (from 1 January 2019 through 31 December 2020) and a one-year renewal of the original 100 seats (from 1 January 2020 through 31 December 2020).

The license has been renewed, in substance (assume the entity has concluded that the license in the modified contract is the same as in the original contract), and the \$200,000 of additional consideration is allocated between the new seats and the renewal.

The \$100,000 consideration allocated to the new seats is recognized on 1 January 2019, while the \$100,000 consideration allocated to the renewal is deferred and will be recognized on 1 January 2020, which is the beginning of the license renewal period and the date at when Customer B is able to use and benefit from the modified license.

View B: Entity A determines that a new license has been transferred that provides Customer B with 150 seats for two years. Entity A considers the guidance in ASC 606-10-55-58C and concludes that Customer B is able to use and benefit from the modified license immediately (as the customer is not renewing a license with the same terms and conditions as the original contract due to the 50 new seats), and the entire \$200,000 is recognized on 1 January 2019.

View C: For this illustration, View C results in the same accounting treatment as View A.

Entity A determines that because the modification is accounted for in accordance with ASC 606-10-25-12, the license has been renewed, in substance, and Customer B is not able to use and benefit from the additional rights granted until the license renewal date. Therefore, consideration allocated to the additional rights related to the original 100 seats should be recognized as revenue after the restrictions of the original license lapse. That is, the modification is treated as a renewal of the original license that expires on 31 December 2019, and the \$100,000 consideration allocated to the renewal is recognized on 1 January 2020.



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The \$100,000 consideration allocated to the 50 new seats is recognized on 1 January 2019 in accordance with ASC 606-10-55-58C.

In all of these scenarios, the analysis would need to consider any ongoing services, such as post-contract customer support (PCS), which could change the allocation of consideration to the performance obligations and the timing of revenue recognition.

Illustration 2:

Entity C enters into a contract on 1 January 2018 with Customer D to transfer a software license to 100 seats of Product B for a two-year term for \$200,000, which reflects the SSP for Product B. On 31 December 2018, Entity C and Customer D modify the contract because the customer made an acquisition and needs more seats to the license. As part of the modification, the old license is terminated, and the customer is granted a new license to 150 seats for a two-year term for an additional \$176,000, which represents an 8% discount per seat from the pricing of the original license due to the additional volume purchased and is not at SSP.

In evaluating the contract modification guidance, Entity C determines that the additional seats are distinct from the original seats, and the additional seats are not priced at SSP. In addition, the pricing for the license granted in the original contract has changed (decreased by 8%). Therefore, the modification is accounted for as a termination of an existing contract and a creation of a new contract in accordance with ASC 606-10-25-13(a).

View A: Entity C considers the contract modification to be the addition of 50 new seats for a two-year term (from 1 January 2019 through 31 December 2020), a one-year renewal of the original 100 seats (from 1 January 2020 through 31 December 2020) and a reduction of the price of the second year (from 1 January 2019 through 31 December 2019) of the original license by 8%.

The license has been renewed, in substance (assume the entity has concluded that the license in the modified contract is the same as in the original contract), and the \$176,000 of additional consideration is allocated between the new seats and the renewal. The consideration allocated to the new seats is recognized on 1 January 2019, while the consideration allocated to the renewal is deferred and will be recognized on 1 January 2020, which is the beginning of the license renewal period and the date at when Customer D is able to use and benefit from the modified license.

View B: Entity C determines that a new license for 150 seats for a two-year term has been transferred. Entity C considers the guidance in ASC 606-10-55-58C and concludes that Customer D is able to use and benefit from the modified license immediately since the customer is not renewing a license with the same terms and conditions as the original contract due to the addition of 50 new seats and change in pricing. As a result, the entire \$176,000 is recognized on 1 January 2019.

View C: For this illustration, View C results in the same accounting treatment as View B.

Because the existing contract has been terminated before the restrictions of the original license lapsed, Entity C determines that a new license for 150 seats for a two-year term has been transferred. Therefore, the entire



\$176,000 is recognized on 1 January 2019 when Customer D can use and benefit from the modified license in accordance with ASC 606-10-55-58C.

In all of these scenarios, the analysis would need to consider any ongoing services, such as PCS, which could change the allocation of consideration to the performance obligations and the timing of revenue recognition.

Illustration 3:

Entity E enters into a contract on 1 January 2018 with Customer F to transfer a software license to 100 seats of Product C with coterminous PCS for a four-year term for \$400,000, which reflects the SSP for Product C. Based on the SSPs of the performance obligations, Entity E allocates \$220,000 of the consideration to the license, which is recognized on 1 January 2018, and \$180,000 to the PCS, which will be recognized over the four-year term.

On 31 December 2018, Entity E and Customer F modify the contract. As part of the modification, the old license is terminated, and the customer is granted a new license to 100 seats for a four-year term with coterminous PCS for no additional consideration, since Customer F is an important customer of Entity E.

In evaluating the contract modification guidance, Entity E determines that the new license is distinct from the original license. However, since there is no additional consideration, the modification is not at SSP. Therefore, the modification is accounted for as a termination of an existing contract and a creation of a new contract in accordance with ASC 606-10-25-13(a). The remaining consideration of \$135,000 must be allocated to the performance obligations in the new contract.

View A: Entity E considers the contract modification to be a one-year renewal of the original 100 seats of Product C and related PCS (from 1 January 2022 through 31 December 2022).

The license has been renewed, in substance (assume the entity has concluded that the license in the modified contract is the same as in the original contract), and the consideration allocated to the one-year license renewal is deferred and will be recognized on 1 January 2022, which is the beginning of the license renewal period and the date when Customer F is able to use and benefit from the modified license. The consideration allocated to the PCS related to the one-year license renewal is deferred and will be recognized over the one-year term of the renewal (1 January 2022 to 31 December 2022). The consideration allocated to the remaining PCS from the original contract is deferred and will be recognized over the three-year remaining term (1 January 2019 to 31 December 2021).

View B: Entity E determines a new license to 100 seats for a term of four years with coterminous PCS has been transferred. Entity E considers the guidance in ASC 606-10-55-58C and concludes that Customer F can use and benefit from the modified license immediately (as the customer is not renewing a license with the same terms and conditions as the original contract due to the change in pricing) and the \$135,000 of remaining consideration from the existing contract is allocated between the license and PCS. The amount allocated to the license is recognized on the modification date of 1 January 2019, and the amount allocated to PCS is deferred and will be recognized over the four-year term of the new contract (1 January 2019 to 31 December 2022).



View C: For this illustration, View C results in the same accounting treatment as View B.

Because the existing contract has been terminated before the restrictions of the original license lapsed, Entity E determines that a new license for 100 seats for a term of four years with coterminous PCS has been transferred. Therefore, the \$135,000 of remaining consideration from the existing contract is allocated between the license and PCS. The amount allocated to the license is recognized on the modification date of 1 January 2019 when Customer F can use and benefit from the modified license, and the amount allocated to PCS is deferred and will be recognized over the four-year term of the new contract (1 January 2019 to 31 December 2022).

Illustration 4:

Entity G enters into a contract on 1 January 2018 with Customer H to transfer a software license to 100 seats of Product D for a three-year term and 100 seats of Product E for a three-year term. The total price for the contract is \$600,000, which reflects the SSPs for Product D and Product E. On 31 December 2018, Entity G and Customer H modify the contract because the Customer H's needs have changed. As part of the modification, the old licenses are terminated, and the customer is granted a new license for 50 seats of Product D for two years and 150 seats of Product E for three years for an additional \$150,000, which reflects the same per seat pricing as the original contract.

In evaluating the contract modification guidance, Entity G determines that the modification is not just related to an increase in scope (since the number of seats for Product E has decreased) so the modification is not accounted for in accordance with ASC 606-10-25-12. Because the additional seats are distinct from the original seats, the modification is accounted for as a termination of an existing contract and a creation of a new contract in accordance with ASC 606-10-25-13(a).

View A: Entity G considers the contract modification to be a decrease of 50 seats of Product D for the second and third years of the original term (from 1 January 2019 through 31 December 2020), the addition of 50 new seats of Product E for a three-year term (from 1 January 2019 through 31 December 2021) and a one-year renewal of the original 100 seats of Product E (from 1 January 2020 through 31 December 2021).

The license has been renewed, in substance (assume the entity has concluded that the license in the modified contract is the same as in the original contract), and the \$150,000 of additional consideration is allocated between the new seats and the renewal. The consideration allocated to the new seats is recognized on 1 January 2019, while the consideration allocated to the renewal is deferred and will be recognized on 1 January 2021, which is the beginning of the license renewal period and the date when Customer H is able to use and benefit from the modified license.

View B: Entity G determines that a new license for 50 seats of Product D for two years and 150 seats of Product E for three years has been transferred. Entity G considers the guidance in ASC 606-10-55-58C and concludes that Customer H is able to use and benefit from the modified license immediately (since the customer is not renewing a license with the same terms and conditions as the original contract due to the change in number of seats for each product), and the entire \$150,000 is recognized on 1 January 2019.



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View C: For this illustration, View C results in the same accounting treatment as View B.

Because the existing contract has been terminated before the restrictions of the original license for Product D and Product E lapsed, Entity G determines that a new license for 50 seats of Product D for two years and 150 seats of Product E for three years has been transferred. Therefore, the entire \$150,000 is recognized on 1 January 2019 when Customer H can use and benefit from the modified license in accordance with ASC 606-10-55-58C.

As part of any of these scenarios, Entity G should also consider whether any revenue related to the revoked rights to Product E must be reversed at the modification date. Entity G also needs to consider any ongoing services, such as PCS, which could change the allocation of consideration to the performance obligations and the timing of revenue recognition.