

# Technical Line

## Accounting for income from the sale of patents

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### What you need to know

- ▶ Selling a patent may raise questions about when and how to recognize the proceeds in the income statement.
- ▶ Entities must assess all applicable facts and circumstances to determine whether the patent arrangement includes multiple deliverables, such as the rights to future patents and when-and-if-available enhancements.
- ▶ Significant judgment may be required to determine whether proceeds from a patent sale should be classified as revenue or a gain.

### Overview

In recent months, we have seen an increase in transactions in which entities seek to monetize their intangible intellectual property assets by selling a patent or a portfolio of patents. Many of the companies involved in these transactions are technology companies.

Because these arrangements can be complex, determining when and how to account for the proceeds can require significant judgment. This publication highlights various factors that should be considered when accounting for the sale of patents.

### Background

The intellectual property held by technology companies often consists of the proprietary technologies and processes on which companies rely to develop new products. A patent is a form of intellectual property that is used to protect products and technologies from illegal copying and distribution. If a patent is infringed upon, entities can take legal action to enforce the patent.

Recently, many entities have been selling patents and patent portfolios in an effort to unlock value from these intangible assets. Parties acquiring the rights to this intellectual property include companies that intend to incorporate the underlying technologies and ideas into their existing businesses and companies that otherwise invest in the patents.

The facts and circumstances of these arrangements vary greatly. For example, arrangements may be as simple as the sale of a single patent, or may be as complex as the sale of entire patent portfolio, including the rights to future patents and when-and-if-available enhancements.

## Key considerations

### Income statement presentation

Questions arise about whether the proceeds from the sale of intellectual property should be presented as revenue or a gain on the income statement. While the net effect on the seller's financial statements will be the same in both cases, the presentation may affect how users of a company's financial statements perceive the results of the company's operations.

Because the terms "revenue" and "gain" are not defined in the Codification, we believe the definitions in the concept statements should be considered in making this determination. FASB Concepts Statement No. 6 (CON 6) defines revenues as "inflows or other enhancements of assets of an entity or settlements of its liabilities (or a combination of both) from delivering or producing goods, rendering services, or other activities that constitute the entity's ongoing major or central operations." CON 6 defines gains as the result of activities that are ancillary to an entity's ongoing central operations.

Companies entering into these transactions will have to assess their facts and circumstances to determine whether a transaction is more akin to a revenue transaction (ongoing major or central operations) or to a one-off transaction to monetize certain assets of the company and therefore should be presented as a gain rather than revenue. In many cases, the sale of a patent will be subject to gain accounting.

### Timing of income statement recognition

A common question in accounting for the sale of a patent is when to recognize the gain or, if applicable, revenue in the income statement. In some cases, the answer is straightforward. A company that sells a patent for a fee and has no continuing obligation to the acquirer would likely be able to recognize the transaction when it delivers the patent.

However, recognition of a gain or, if applicable, revenue may be limited or precluded when an arrangement includes continuing obligations. For example, the seller may be obligated to hand over to the buyer any patents it obtains for a specified period of time after the initial sale. In this case, significant judgment may be required to determine the number of deliverables in the arrangement, the timing of recognition of a gain or revenue and the appropriate accounting literature to apply.

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US GAAP provides models for the recognition of only a narrow set of intellectual property arrangements, such as the guidance in ASC 985-605 governing the sale of software licenses. For arrangements involving sales of intellectual property that are not subject to the scope of a specific standard, entities must consider the facts and circumstances of the arrangements and apply the guidance from other standards that is most appropriate.

In general, we believe the guidance in ASC 605-25, *Revenue Recognition – Multiple-Element Arrangements*, and ASC 985-605, *Software – Revenue Recognition*, provide good starting points for accounting for intellectual property arrangements with continuing performance obligations.

#### **Guidance on multiple-element arrangements**

ASC 605-25 governs all arrangements that obligate a vendor to provide more than one product or service, known as a deliverable, that is not subject to the scope of other specific accounting literature. For some arrangements, it may be difficult to identify the deliverables, particularly when continuing obligations are implied by an entity's business practices rather than explicitly stated.

A common example of a continuing obligation for the sale of intellectual property is when-and-if-available new patents that are required to be delivered, either explicitly or implicitly, by the seller over a specified future period. If explicitly required within an arrangement, these when-and-if-available clauses represent an obligation that is fulfilled over the period the clause is in effect, and should be evaluated using the guidance of ASC 605-25, even if the selling entity does not intend to make any improvements to the intellectual property or develop new information about it. Alternatively, depending on the frequency with which the selling entity obtains and delivers new patents, this obligation may more closely resemble a subscription right, and the entity should consider by analogy the guidance of ASC 985-605-25-58 and 25-59.

Arrangements may also include rights to specified future patents (e.g., intellectual property already under development). When an entity promises to provide a buyer with a specified future deliverable, another element likely exists that must also be evaluated under the multiple-element arrangement guidance. This type of deliverable would not be fulfilled until the specified right is provided.

Under ASC 605-25-25-5, a delivered item is accounted for as a separate unit if (1) it has standalone value, (2) the customer has a general right to return the delivered item, and (3) delivery or performance of the undelivered item is probable and is substantially within the vendor's control. In some arrangements, it may be difficult to separate the continuing obligation from the deliverable already provided. If an entity has a continuing obligation that cannot be separated from the delivered intellectual property, its ability to recognize a gain or, if applicable, revenue on the initial transfer of the intellectual property may be limited.

ASC 605-25-25-5(a) states that a delivered item has standalone value to the customer when either (1) any vendor sells that item separately or (2) the customer could resell that item on a standalone basis. In many cases, it is likely that the delivered intellectual property will have standalone value without the when-and-if-available deliverables. For example, a buyer that acquires a portfolio of patents would likely be able to use

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those patents for their intended purpose without any future enhancements or information. However, in some circumstances this may not be the case, and the facts and circumstances of each transaction should be carefully analyzed.

Once the deliverables have been identified, the arrangement consideration needs to be allocated to those deliverables. In many cases, it will be difficult for an entity to estimate the selling price of the when-and-if-available deliverables because they are rarely, if ever, sold on a standalone basis. However, ASC 605-25 requires that such an estimate be made.

## How we see it

Depending on the facts and circumstances, determining the appropriate timing for recognizing a gain or, if applicable, revenue and the appropriate classification for proceeds from sales of intellectual property may require significant judgment. Companies need to clearly understand the terms of the arrangement, and whether the proceeds relate to their ongoing major or central operations.

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