Grant Thornton

Technical Accounting Alert

Income from licensing intangibles

Overview

Licensors enter into various types of licensing agreements with third parties. These licensing agreements may be:

- exclusive (where the licensee solely exploits the rights granted); or
- non-exclusive (where more than one licence will be granted).

Complications can arise where a combination of rights are granted or a number of different geographical territories are involved. Additionally, contracts may contain advance payment and ongoing fee arrangements for the licensee, leading to a number of options for the recognition of revenue.

The varied terms and conditions of these licensing arrangements result in some diversity in revenue recognition policies in practice. This alert outlines some of the factors to consider in developing an accounting policy that will recognise revenue at the appropriate time.

The alert highlights the general principles applicable to identifying when revenue from licensing agreements over intangible assets can be recognised. It uses motion picture films, TV programmes and software as examples of intangible assets over which rights are commonly licensed to customers.

Scope of the Alert

The aspects of this alert dealing with motion picture films and TV programmes focuses on the issue as described above, ie the licensing of completed films. It is not aimed at accounting for revenue earned by entities that function as producers, broadcasters, retail outlets or movie theatres. Specifically, it does not deal with revenue recognition during the production phase where the film has been commissioned by a customer and is being produced to order. In such situations, the AASB 118 *Revenue* requirements relating to rendering of services and the percentage of completion method referred to in AASB 118.21 and set out in more detail in AASB 111 *Construction Contracts* should be applied in respect to the film-making service being provided.

Relevant accounting standards

- AASB 118 Revenue

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Guidance

Revenue arising from intangible asset licensing agreements shall be recognised on an accrual basis in accordance with the substance of the relevant licence agreement when it is probable that the economic benefits associated with the transaction will flow to the entity and the amount of revenue can be measured reliably (AASB 118.29-30). The substance of the agreement might involve:

- a right of use over a specified period of time; or
- a sale of the underlying rights.

When an agreement confers rights over a period of time it will often be appropriate to recognise revenue over that time period. This will be the case if the licensor retains significant risks and control over the licensed rights or has obligations to perform over the licence period. In this situation the licensee is in substance paying for a right of use or for a service that is provided over time.

However, where an assignment of rights for a fixed fee or non-refundable guaranteed fee under a non-cancellable contract permits the licensee to exploit those rights freely and the licensor has no remaining obligations to perform, this is, in substance, a sale (AASB 118.Appendix.example 20). Consequently revenue should be recognised for the entire fee when the conditions for recognising the sale of goods in AASB 118.14 are met. This may be the case both for fixed duration ("time-based") licences and perpetual licences.

In many cases, the transaction involves multiple deliverables (licence; service; customer-support; upgrades; etc) over a period of time and so it may be necessary to apply the revenue recognition criteria of AASB 118 to each separately identifiable component in order to reflect the substance of the transaction (AASB 118.13).

AASB 117 vs AASB 118

Licensing agreements for such items as motion picture films, video recordings, plays, manuscripts, patents and copyrights are excluded from the scope of AASB 117 *Leases* (AASB 117.2(b)). Consequently, although many licensing agreements over intangible assets have the characteristics of a lease, the scope exclusion in AASB 117 requires that such agreements be accounted for by the licensor in accordance with AASB 118 *Revenue*, as discussed in this Alert.

Detailed analysis

An entity may license rights over its intangible assets to customers such as manufacturers, distributors, or other licensees on either an exclusive or non-exclusive basis in a particular market or territory. The licensing agreement involves the transfer of a single right or group of rights for a single intangible asset or multiple assets. The licence fee may be fixed (flat fee) or may be based on usage or on a percentage of a revenue (variable fee). A variable fee arrangement may include a non-refundable guaranteed minimum (fixed) amount paid in advance or over the licence period. The terms and conditions of these licences vary significantly and may allow the licensor to continue to exercise direct control over the distribution or use of the licensed asset or may transfer control to the licensee. Similarly, the terms and conditions may

impose obligations on the licensor to provide future deliverables (products or services) or to refrain from exploiting the intangible asset rights so as not to interfere with the benefits obtainable by the licensee.

The diversity of types of arrangement gives rise to questions over the timing of revenue recognition by licensors of intangible asset rights such as film and software licensors. The main policies seen are recognition on delivery of the licensed asset to the licensee (in substance a sale of goods) or recognition over the whole licence period, most often on a straight-line basis (in substance a right of use or service agreement). The acceptable treatment depends on the substance of the agreement. It is also important to ensure that disclosures are sufficiently clear to enable readers of the financial statements to fully understand the accounting policy adopted and the nature of the arrangements.

When is it a sale under AASB 118?

Intangible asset licences generally assign specific rights over the underlying asset but do not transfer ownership. Consequently they are generally regarded as arrangements to generate revenue from the use by others of an entity's asset(s) and so are accounted for in accordance with AASB 118.30(b) and 33. These paragraphs require that revenue shall be recognised on an accrual basis in accordance with the terms of the relevant agreement unless, having regard to the substance of the agreement, it is more appropriate to recognise revenue on some other systematic and rational basis. This may include recognising revenue on commencement of the licensing arrangement if the substance of the arrangement is the sale of rights over the asset, as noted in AASB 118.Appendix.example 20:

> “Fees and royalties paid for the use of an entity's assets (such as trademarks, patents, software, music copyright, record masters and motion picture films) are normally recognised in accordance with the substance of the agreement. As a practical matter, this may be on a straight-line basis over the life of the agreement, for example, when a licensee has the right to use certain technology for a specified period of time.
>
> An assignment of rights for a fixed fee or non-refundable guarantee under a non-cancellable contract which permits the licensee to exploit those rights freely and the licensor has no remaining obligations to perform is, in substance, a sale. An example is a licensing agreement for the use of software when the licensor has no obligations subsequent to delivery. Another example is the granting of rights to exhibit a motion picture film in markets where the licensor has no control over the distributor and expects to receive no further revenues from the box office receipts. In such cases, revenue is recognised at the time of sale."

Difficulties arise in practice because many licences specify a fixed time period. Consequently, the pattern of revenue recognition frequently used for such licences is, based on the first paragraph of this example, deferral and recognition over the term of the licence, frequently on a straight-line basis.

However, the second paragraph within this same AASB 118 example goes on to use a software licensing agreement as an example of a sale of rights. This does not indicate whether the licence is time-based or perpetual but focuses on the fact that the licensee can "exploit those rights freely" and "the licensor has no obligations subsequent to delivery". In this case, the most

appropriate accounting treatment would be to recognise the revenue when the technology or user licence is granted, regardless of whether the licence is time-based or perpetual.

These two approaches, when applied to the specific case of time-based licences, highlight the need to apply judgement in determining the most appropriate treatment for these types of arrangements. It is clear from this example that any time-based element in the contract is not critical to the determination of the revenue recognition method. Other factors, in particular the licensee's exploitation rights and the licensor's risks, obligations and involvement subsequent to delivery need to be carefully analysed to determine the most appropriate timing of revenue recognition.

Where the licensing agreement is, in substance, a sale, revenue should be recognised using the criteria for recognition of revenue from sale of goods in AASB 118.14:

"Revenue from the sale of goods shall be recognised when all the following conditions have been satisfied:

a the entity has transferred to the buyer the significant risks and rewards of ownership of the goods;

b the entity retains neither continuing managerial involvement to the degree usually associated with ownership nor effective control over the goods sold

c the amount of revenue can be measured reliably;

d it is probable that the economic benefits associated with the transaction will flow to the entity; and

e the costs incurred or to be incurred in respect of the transaction can be measured reliably." (AASB 118.14)

Determining the substance of the licence

The contractual terms of the licensing agreement and also the economic substance of the arrangement should be considered in order to determine whether the relevant revenue relates to the use by the licensee of the entity's intangible asset or it is, in substance, a sale of rights over the asset. In some cases, the analysis will be clear. However, in many cases judgement will be required.

Key considerations might include:

- To what extent the licensor is exposed to the risks and rewards of the rights assigned under the agreement, e.g. is the revenue a fixed fee or is it variable depending on the revenue generated by the licensee?

- What level of managerial involvement, if any, does the licensor retain in the licensee's use of the asset, e.g. motion picture films - is the licensee's use of the film rights variable subject to licensor approval?

- Does the licensor have any ongoing obligations to provide future products or services to the licensee, e.g. product upgrades, marketing orf technical support?

- Is the licensor restricted from using or exploiting the underlying asset through the terms of the licensing contract for substantially the whole life of the asset or is the licensor still exposed to residual value risk?

If the indicators suggest the licence is, in substance, a sale of rights, then the following factors should be considered to determine whether revenue from the sale can be recognised on delivery or should be delayed:

- Are there restrictions on when the licensee can initiate its exploitation of the licensed rights?
- Is the intangible asset covered by the licensing agreement complete and available for delivery to the licensee?
- Does the licensor need to make any significant changes to the asset before the licensee can initiate its exploitation of the licensed rights?

The following sections consider some of these issues.

Fee structure

In licensing arrangements that have a variable fee structure, the licensor may be exposed to significant risks and rewards of the rights assigned under the agreement. For example, the licensor may receive royalties from the licensee's exploitation of the intangible asset. This may be based on a fixed amount per unit of usage, e.g. a fixed fee for each time a film is exhibited. It may be a percentage of the revenue generated by exploitation of the rights by the licensee, eg a percentage of box office takings for a film. In such cases, royalties should be accrued in accordance with the terms of the agreement.

However, if the licensee guarantees to pay the licensor a non-refundable minimum amount that is to be applied against variable fees then the overall commercial effect of the arrangement needs to be carefully reviewed. If the minimum guarantee represents a value close to the maximum revenue expected under the variable fee arrangement, it could be argued that the licensor has transferred the significant risk associated with the rights assigned and, with no further obligation and with no real expectation of further revenues, the agreement is, in substance, a sale.

Alternatively, if the non-refundable minimum amount represents an advance payment that still leaves the licensor exposed to significant risk of variability of the overall revenue receivable, it could be argued that this is merely a cash flow arrangement to accelerate some of the revenue due to the licensor. The substance of the arrangement is the granting of rights for use of the licensor's asset and so the recognition of the advance payment would be deferred and accrued in accordance with the terms of the agreement.

Example 1 - variable fee

Entity X is a record company and owns a collection of music video recordings. It has entered into a non-exclusive licensing agreement with entity Y, a television broadcaster. The licence grants entity Y the right to broadcast any of the videos from the collection an unlimited number of times over the 2-year licence period. Entity Y will pay $20 to entity X each time a video from the collection is shown.

Analysis

This is an example of a royalty agreement in which the licensor will receive royalties from the licensee's exploitation of the intangible asset (the video collection) based on a fixed amount per unit of usage, i.e. a fixed fee for each time a video is exhibited. Entity X still has control of the underlying collection and can exploit it in other ways, as the arrangement with entity Y is non-exclusive. In this case, entity X should accrue royalties as videos are broadcast, as notified by entity Y in accordance with the terms of the agreement.

Example 2 - fixed fee

Entity A owns a single film asset. The film is complete and available for immediate distribution. Entity A enters into a 15-year, non-exclusive licensing arrangement with an Australian film distributor, Entity B. Entity A receives a fixed fee of $5 million. In exchange for this fee, Entity A grants Entity B the right to exploit freely the film during the licence period but only in Australia. Exploitation includes distribution of the film for showing in cinemas, granting rights for TV broadcasts, distributing DVDs for sale and rental, and sale of film-related merchandise.

Entity B is free to decide when and how it exploits the film within the geographical restriction during the period and at what price. On delivery of the film to Entity B, Entity A has no remaining obligations to perform. Entity A retains all other rights to the film, including the right to grant other licences in different geographical locations over distribution and exhibition rights, merchandising rights, TV and DVD rights. Entity B expects to generate substantially all its revenue from exploiting its rights in the first few years of the licence period, as the film is not expected to have long-term appeal.

Analysis

Based on the information provided, this appears in substance to be a sale of rights. Entity A should recognise the $5 million on delivery of the film at the inception of the agreement, assuming all other revenue recognition criteria are met.

This is because Entity A has no continuing involvement or control over the way that Entity B exhibits the film in the geographical location nor does entity A have any remaining obligations under the agreement. The fee received is fixed and so is not dependent on the successful exploitation of the film by entity B or the risks associated with the way that entity B exercises its rights under the licensing agreement. The life of the film is expected to be shorter than the licence period and so entity A retains little residual value risk. Therefore, the criteria in AASB 118.14 are met.

Example 3- non-refundable guaranteed minimum fee

Entity A enters into another 15-year, non-exclusive licensing agreement for the same film with Entity C, another distributor based in the USA. The rights granted under the agreement are the same as in example 2, but cover only the geographical region of the USA. However, instead of a fixed fee, Entity C agrees to pay a variable fee equal to 5% of the revenue generated by Entity C under the terms of the agreement. However, Entity C pays Entity A $10 million on inception of the licensing agreement as a non-refundable guaranteed minimum fee. This fee was calculated as 5% of the estimated revenue Entity C is expected to generate from exploitation of the film rights, discounted to reflect the up-front timing of payment. Although there may be a small possibility that Entity C will earn more income than anticipated, Entity A considers it is very unlikely and so does not expect to receive any further amounts under the agreement. As in Australia (example 2 above), the useful life of the film is expected to be shorter than 15-years.

Analysis

Based on the information provided, there does not seem to be a substantive difference between this agreement and that in example 2. However, although the terms of the agreement state that the fee is variable, the risk associated with this is minimal. The guaranteed minimum amount paid of $10 million is expected to be the maximum amount payable, as it is very unlikely that the exploitation of the film will generate any revenue above this amount. Again this appears in substance to be a sale as substantially all the risks and rewards of ownership have transferred to Entity C on delivery. Entity C can exploit its rights freely for the whole of the expected useful life of the film, leaving Entity A with little residual value risk. Entity A would recognise the $10 million on delivery of the film at the inception of the agreement, as all the other revenue recognition criteria in AASB 118.14 are met.

If expectations change in the future and entity A later considers that more income will become receivable, a policy will need to be developed regarding the recognition of this additional income.

Example 4 - non-refundable up-front fee and reduced ongoing payments

Entity A enters in two agreements for the same film considered in examples 2 and 3 with Entity D and Entity E, who each operate a chain of cinemas in two separate European countries. These agreements provide entities D and E with exclusive rights to exhibit the film an unlimited number of times in their own and other cinemas within their respective countries for a 2-year period. They have no other exploitation rights under the agreements. During the licence period, Entity A is not able to exploit the film in these countries but expects to exploit it later through future TV broadcasting, DVD distribution and merchandising licences.

The general terms of the two agreements are the same except for the payment terms. Entity D agrees to pay 5% of box office takings each time it exhibits the film. Entity E agrees to pay an up-front non-refundable fee of $3m and then pay 1.5% of box office takings each time it exhibits the film.

Analysis

The agreement with Entity D is a royalty agreement similar to that between X and Y in example 1 above. Entity A is restricted from exploiting the film for less than a major part of its useful life and retains significant residual value risk. Entity A is also exposed to the risk of variable income during the licence period, as the level of revenue depends on the number of times Entity D exhibits the film. Entity A should accrue royalties as the film is exhibited, as notified by

Entity D.

The terms and conditions of the agreement with Entity E are the same except for the cash flow pattern. Although entity A has secured an amount of its expected royalties up-front, this is in exchange for a lower level of royalty going forward. Entity A is still exposed to the risk of variable income during the licence period. In this situation, it would be appropriate to reflect the agreement's substance rather than its form and spread the up-front receipt over the expected number of sales to be made in the future because, in substance, the receipt is an advance royalty.

Example 5 - restricted rights

Entity R owns the rights to a popular TV drama mini-series that is expected to have a long-term appeal to a wide audience. Entity R grants a licence to a TV broadcaster, Entity S, to show the series up to five times under an exclusive 3-year licence agreement. Entity S agrees a fixed fee of $2m for the arrangement, payable to Entity R on delivery of the mini-series. Entity S's rights are restricted to broadcasting the series and using short extracts from it to advertise the TV channel. There is no right to reimbursement of any part of the fee if Entity S chooses not to broadcast the series or shows it less than the contractual maximum number of 5 times.

During the period of the licence, Entity R is not able to exploit the programmes, but they anticipate the series will still be popular for a much longer period after the licence expires. At the end of the licence period, Entity R plans to exploit the mini-series further through a combination of future TV broadcasting licences, DVD distribution and retail arrangements, as well as merchandising of various products using characters, images and catch-phrases from the series.

Analysis

The agreement with Entity S is, in substance the right to use Entity R's asset for the 3-year fixed period of the licence, which is less than a major part of the expected useful life of the series. Entity S has limited rights under the agreement and is not able to exploit freely the underlying asset. Entity R expects to receive further revenues from the asset and so is exposed to significant residual value risk.

Consequently, Entity R has not transferred the significant risks and rewards of ownership of the mini-series to Entity S. Entity R should recognise the $2m fee over the licence period on an accrual basis in accordance with AASB 118.30. As a practical matter, this is likely to be on a straight-line basis over the period of the arrangement, as Entity R has no control over when and how often Entity S will broadcast the series (subject to the maximum limit of 5 times), but another more systematic basis can be used if applicable.

Licensor's continuing managerial involvement / control

Some arrangements may restrict a licensee from freely exploiting the rights assigned to it by, for example, imposing a condition that approval is obtained from the licensor before exploitation can commence. Such restrictions may be imposed to protect the licensor's reputation or ability to exploit the underlying intangible asset. In these circumstances, the revenues generated under the licensing agreement are influenced by the licensor's continuing managerial involvement. This continuing involvement allows the licensor to retain control over exploitation of the underlying asset. Consequently, this is not, in substance, a sale but is an agreement for right of use of the asset. The licensor should, therefore, recognise revenue from the agreement over the

licence period on an accrual basis in accordance with AASB 118.30. As a practical matter, this is likely to be on a straight-line basis over the period of the licence unless a more systematic and rational basis applies.

Example 6 - continuing involvement

Entity A enters into another licensing agreement with Entity F for the same film considered in examples 2-4. In this case, Entity A does not grant Entity F the right to exhibit the film but instead grants rights to exploit film-related merchandise such as board games, computer games and other merchandising, eg posters, stickers, t-shirts, lunch-boxes, etc. for a 3-year licence term. This allows exploitation worldwide except in Australia and USA, where these rights have already been granted to Entities B and C (see examples 2 and 3). Entity F has responsibility to design, produce and distribute the products but must obtain Entity A's approval prior to production and marketing. Entity A retains the right to refuse approval if the product is considered unsuitable, eg if the quality is not acceptable or if the product is in direct competition with Entity A's own exploitation of similar film-related products.

Entity A will receive 15% of the profit generated by Entity F's exploitation of its rights under the agreement but Entity F agrees to pay $5 million on inception of the licensing agreement as a non-refundable guaranteed minimum fee. Entity A is obliged to use its best efforts to grant approval to F's plans and to provide clear reasons for any refusal. The entities agree that the potential market for the relevant film-related products is so favourable that Entity A expects to receive significantly more than $5 million over the term of the agreement but is unable to make a reliable estimate of the amount.

Analysis

Based on the information provided, entity F is unable to exploit freely its rights under the licence because entity A has continuing managerial involvement and control over the way that entity F exploits those rights. Entity A has an obligation to provide management time and services to ensure appropriate approval of plans as they are submitted by entity F. Also, the ultimate fee receivable by entity A is dependent on the successful exploitation of the film rights by entity F and so entity A retains significant risks associated with the way that entity F exercises its rights under the licensing agreement.

In substance this is not a sale of rights but is an agreement for right of use with significant continuing managerial involvement and control. Entity A should defer recognition of the initial fee and recognise it, together with any addition revenue from the licence on a systematic and rational basis over the 3-year licence term. This may be to recognise the $5m straight-line over the 3-year licence term with any additional revenue recognised as it arises. An alternative pattern may be supported by any plans or forecasts that might be available.

Licensor's obligations regarding future deliverables

Some agreements involve granting rights of use (a licence) along with other deliverables. For example, a software licence agreement may include the primary software, installation service, customer-user support (technical helpline), upgrades, etc. over the licence period. In some cases, the separate deliverables are clearly identified and priced separately and so the revenue recognition criteria can be readily applied to each component. However, in many circumstances, the package is negotiated as a whole. In this situation, judgement is needed to analyse each separately identifiable component of the arrangement and allocate the total revenue appropriately to each component (AASB 118.13)

Extra care needs to be taken in analysing licences where the components are not explicitly identified but the substance of the arrangement requires the licensor to fulfil ongoing implicit obligations throughout the period of the licence.

Example 7 - ongoing access obligations

Entity P grants a licence to a customer to use its proprietary databases using a direct, on-line link. The licence allows the customer unlimited use of the databases for a two-year period. The customer pays an up-front, non-refundable licence fee of $40,000.

Analysis

Although there may be no explicit obligation for entity P to provide ongoing services to the customer, the nature of the licence requires entity P to keep access to the databases available for the two-year period. The substance of the agreement is therefore that the customer is paying for entity P to 'stand-ready' to enable them to access the databases, which is a service that is delivered over time. Entity P may also have a constructive obligation to incur costs to maintain the databases and keep them up-to-date. The revenue from the licence fees should be accrued over the period of the agreement that reflects the provision of the service. This is likely to be on a straight-line basis unless it is anticipated that the services will be provided on a different basis.

Example 8 - time-based (fixed-period) licences

Entity Q supplies games software and grants two different types of licence to electronic games manufacturers to use the software for a certain game. The annual licence is sold for a fee of $240,000. It allows the software to be used for one year and can be renewed annually. Entity Q has no ongoing obligations under this licence.

The perpetual licence is sold for a fee of $500,000. It allows the software to be used indefinitely with the licensee entitled to any upgrades issued free of charge. The contractual terms of the licence do not oblige entity Q to upgrade the software.

The game's expected life is three years. Entity Q expects to make minor modifications/upgrades during this time but does not expect to incur significant costs in performing any upgrades.

Analysis

Under the perpetual licence, there may be a constructive obligation to upgrade the software, particularly if entity Q has communicated its intentions to customers or has provided upgrades to other products under similar licences in the past. There is some cost in satisfying this obligation. In this situation, there is a strong argument for spreading the licence fee over the game's expected life in order to match it with the costs of providing the upgrades. This is likely to be on a straight-line basis.

The annual licence fee, on the other hand, does not carry any further obligations on the part of entity Q and so is, in substance, a sale. Entity Q will recognise the $240,000 on inception of the licence agreement, assuming all other revenue recognition criteria are met.

Delays to commencement of exploitation of rights

Some arrangements may restrict a licensee from initiating its exploitation of the intangible asset until some future point in time. For example, rights granted to exhibit a motion picture film on television often include a clause delaying the first showing for several months in order to protect the potential revenue stream associated with the rights to exhibit the film in cinemas and movie theatres. Revenue should not be recognised until such restrictions lapse or expire.

In some cases, the exploitation may not be possible or permitted until the licensor has satisfied further obligations under the agreement, such as customising the licensed asset specifically for the licensee, eg writing additional software to ensure the licensed software asset is compatible with the licensee's operating system. In such cases, the licensor should consider AASB 118.13 and defer recognition of all or part of the revenue until it satisfies its obligations. Identifying what changes are considered significant requires judgement. For example, in the context of motion picture films, significant changes may be considered to be those that involve additions of new or additional content to the film, such as re-shooting a scene or adding special effects.

In some cases, the licensee can begin to exploit the film rights but may still require the licensor to make some insignificant changes to the film in order to exploit their rights fully. Insignificant changes may include minor re-editing, addition of subtitles to existing footage, reformatting of the film, and adjustments to allow for the insertions of commercials. If the substance of the licensing agreement is that of a sale, the revenue can still be recognised immediately with the cost of insignificant changes being accrued (AASB 118.19). However, the terms and conditions of the agreement need careful consideration if the technical acceptance of the product, eg film or TV programme is dependent on such changes being completed. In such circumstances, recognition of revenue may need to be deferred until the economic benefits associated with the transaction become probable, which may not happen until technical acceptance becomes probable (AASB 118.14(d)).

If the substance of the agreement is the granting of rights of use, the most appropriate treatment will require judgement depending on facts and circumstances. The delay in making the changes can be argued to be a restriction of rights and so delay the recognition of some revenue under the licence.

Further information

For further information on any of the information included in this TA alert, please contact your local Grant Thornton Australia contact or a member of the National Audit Support team at NAS@grantthornton.com.au