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Making sense of a complex world

Accounting for royalty arrangements – issues for media companies

This paper explores some of the key challenges under IFRS in accounting for royalty arrangements by both licensors and licensees.

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Introduction to MIAG

PwC's Media Industry Accounting Group (MIAG) brings together our specialist media knowledge from across our worldwide network. Our aim is to help our clients by addressing and resolving emerging accounting issues which affect the entertainment & media sector.

With more than 3,575 industry-dedicated professionals, PwC's global entertainment & media practice has depth and breadth of experience across key industry sectors including: television, film, advertising, publishing, music, internet, video games, radio, sports, business information, amusement parks, casino gaming and more. And just as significantly, we have aligned our media practice around the issues and challenges that are of utmost importance to our clients in these sectors. One such challenge is the increasing complexity of accounting for transactions and financial reporting of results – complexity which is driven not just by rapidly changing business models but also by imminent changes to the world of IFRS accounting.

Through MIAG, PwC[1] aims to work together with the entertainment & media industry to address and resolve emerging accounting issues affecting this dynamic sector, through publications such as this one, as well as conferences and events to facilitate discussions with your peers. I would encourage you to contact us with your thoughts and suggestions about future topics of debate for the MIAG forum, and very much look forward to our ongoing conversations.

Best wishes

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Chairman, PwC Media Industry Accounting Group

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[1] "PwC" refers to the network of member firms of PricewaterhouseCoopers International Limited (PwCIL), or, as the context requires, individual member firms of the PwC network

Accounting for royalty arrangements

In many media sectors intellectual property developed by a company or individual is licensed to another for exploitation. Our fourth MIAG paper explores some of the key challenges under IFRS in accounting for royalty arrangements by both licensors and licensees.

PwC's *15th Annual Global CEO Survey* highlighted that CEOs in the Entertainment & Media (E&M) sector are particularly likely to be planning strategic alliances and to view collaboration as critical to success. The licensing of intellectual property from one party to another is a key component of many media sectors as content is made available to consumers across multiple platforms and territories.

Accounting for these royalty arrangements is challenging due to both the inherent complexity of the commercial contracts and because there is limited accounting guidance available under IFRS for licensors or licensees. Challenges can arise right along the royalties lifecycle, beginning with advance payments from the licensee to licensor prior to content being developed; through the decision as to whether the arrangement constitutes an outright sale of intellectual property by the licensor; and in the final phase when royalties are earned by the licensor through sales by the licensee.

This paper focuses primarily on the treatment of these challenges under current accounting guidance (such as it is) but it does also consider the treatment under the revenue recognition Exposure Draft (ED) re-exposed in November 2011.

We hope that you find this paper useful and welcome your feedback.

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PwC Media Industry Accounting Group

Helen Wise

"Management is often called on to make significant judgements and estimates"

Background

PwC's Media Industry Accounting Group (MIAG) is our premier forum for discussing and resolving emerging accounting issues that affect the entertainment & media sector – visit our dedicated website: www.pwc.com/miag

Royalty agreements are a common feature in the media sector. PwC's *15th Annual Global CEO Survey* highlighted that CEOs in the Entertainment & Media (E&M) sector are particularly likely to be planning strategic alliances and to view collaboration as critical to success. The licensing of intellectual property from one party to another is a key component of many media sectors as content is made available to consumers across multiple platforms and territories. Whether it be royalties for print, music, video games or other forms of content, the accounting implications of these transactions are often complex and may vary depending on the substance of the arrangement.

Royalties are usage-based payments made by one party (the "licensee") to another (the "licensor") for the right to use long-term assets, including intellectual property. In many cases, media companies not only receive royalty revenues for their products but also pay royalty fees to authors, music artists, video game developers and other content producers. Depending on the industry in which the entity operates, royalties can take many different forms. Royalty arrangements typically specify a percentage of gross or net revenues derived from the use of an asset, or a fixed price per unit sold of an item, but there are also other models of compensation.

Where do accounting challenges arise?

Accounting for these royalty arrangements is challenging due to both the inherent complexity of the commercial contracts and because there is limited accounting guidance available under IFRS for licensors or licensees. Licensing agreements are scoped out of the leasing standard and therefore deciding on an appropriate accounting policy can be a challenge.

Coupled with the absence of detailed guidance under IFRS, accounting for royalties is also becoming more complex as the media sector embraces the move to digital content distribution and as ongoing macroeconomic turmoil increases the likelihood of impairment of royalty generating assets. Due to the nature and complexity of the underlying arrangements, management is often called on to make significant judgements and estimates.

This paper first summarises the structure of some common royalty arrangements in various industries within the media sector. It then considers the treatment of common accounting challenges which arise for licensors (i.e. those that receive royalties) and licensees (i.e. those that pay them) during each stage of the royalties lifecycle (refer to Figure 1 below). As we shall see, the accounting at each stage by the licensor and licensee is not always consistent.

How might the accounting for royalties change in the future?

Although the main focus of this paper is current accounting, it also considers the treatment of royalty revenues under the revenue recognition Exposure Draft (ED) re-exposed in November 2011 by the International Accounting Standards Board (IASB) and its US counterpart (FASB). For a more comprehensive description of the proposed standard and its implications, refer to PwC's MIAG Issue 2 *Revenue recognition for media companies* and PwC's *Practical guide — Revenue from contracts with customers* or visit www.ifrs.org or www.fasb.org.

Figure 1: Common accounting challenges in the royalties lifecycle

Royalties lifecycle	**Licensor** (e.g. Author; Video game developer; Music recording artist)	**Licensee** (e.g. Publisher of books, video games or music albums)
Prior to intellectual property rights (IPR)	Advance payment may be received from licensee *Is the obligation a financial / monetary liability?*	Advance payment may be made to licensor *Is the asset a financial/monetary asset?* *Is the value of the asset fully recoverable?*
Development and delivery of IPR	IPR transferred (in some form) to licensee *Does this represent an outright sale by licensor?*	IPR ready for exploitation by licensee *Are asset and liability recognised immediately?* *Is the value of the asset fully recoverable?*
Exploitation of IPR	Licensor earns royalties based on licensee sales *How are stepped / contingent royalties recognised?*	Licensee owes royalties based on its sales *How are stepped / contingent royalties recognised?*

“Who are the key players in each industry? What are the types of royalties?”

Royalties in the media sector

Publishing

(Books, magazines, newspapers)

Royalties are common in the publishing industry. Publishers often do not employ a staff of writers and are instead reliant on third party authors to provide content, for which royalties are payable.

Who are the key players?

The key players involved in publishing royalties are the publisher and the author.

What are the types of royalties in the industry?

Publishers usually pay authors in one of these ways:

- A fee based on the percentage of the price of each book sold, i.e. a normal royalty.
- A fixed fee when the publisher develops the concept for a book and requires an author to complete the work, or when a celebrity wants to write a book but does not have the "know-how", in which case the author (a "ghostwriter") will write on behalf of the celebrity for a fixed fee while the celebrity receives the royalties.
- An advance payment, which is an upfront payment for future royalties. Royalties earned on the book's sales are offset against the advance and only once the book generates more royalties than the value of the advance are additional amounts paid to the author. These advances are generally not refundable provided a manuscript (of suitable quality) is delivered by the author.

Music

The music industry has seen significant change over the last few years with the dramatic acceleration of the transition from physical (e.g. CDs) to digital (e.g. iTunes). This has negatively affected total spending on recorded music because digital prices are generally much lower than physical prices. This has led to considerable experimentation with business models as industry players seek new ways to monetise evolving consumer behaviours.

Who are the key players?

Royalties in the music industry are earned differently by recording artists, songwriters and publishers. This is based on copyright law in most jurisdictions. Recording artists earn royalties from the sale of their musical works, for example through sale of CD or online purchases of music tracks, and not from "public performances" (e.g. broadcasts) of their work. Songwriters and publishers, on the other hand, earn a greater portion of their royalties from performance royalties than from sales of CDs or digital downloads.

What are the types of royalties in the industry?

Music royalties are complex because there are two separate copyrights, the rights to the song and the rights to the sound recording. Royalties therefore vary based on use and distribution of the music or composition. A single composition can have various sound recordings owned by different record labels. When a piece of music is composed, the composer immediately owns the rights associated with the intellectual property i.e. the composition. When the composition begins to be performed and recorded onto physical media, it is necessary to register the work with the correct music rights organisations, which helps protect and administer those rights and collect royalties for the composition. Where the song is recorded onto physical media by a recording artist, the recording artist will own the rights to the music recording.

The term "music royalties" encompasses:

- Print royalties
- Mechanical royalties
- Performance royalties
- Synchronisation (synch) royalties.

Print royalties arise from music which is distributed in print form or "sheet music". Revenues on these types of royalties are insignificant relative to other music royalties.

Mechanical royalties arise primarily from the sale of CDs but encompass any audio composition that is recorded onto a physical medium such as DVD, CD, cassette tape or vinyl. An artist that wants to record a piece of music onto one of these physical formats must obtain permission from the person or organisation that owns or controls the mechanical rights for that piece of music. Composers earn royalties from their work being copied onto DVDs, CDs, cassette tapes and vinyl to be distributed and sold by music retailers. They also earn royalties from their music being copied onto physical media, such as Betacam tapes and hard drives, to be broadcast on TV.

Performance rights arise from a musical composition being performed publicly and/or played on the air, including music performed live by a band in any public space and pre-recorded music being played in public spaces such as restaurants, bars and nightclubs. Performance rights also encompass music aired by television and radio broadcasters. Individuals and entities must get the permission of the composer of a piece of music to play that music in public or on the air and the composer earns royalties each time their composition is performed or broadcast.

Synch royalties arise mainly from the use of music in audiovisual productions, such as in DVDs, movies and advertisements. These royalties are normally payable to the composer and/ or publisher of the music.

Internet radio

Internet radio can take two forms: the rebroadcasting of terrestrial radio content (i.e. a recorded radio show is rebroadcast over the internet) or the broadcasting of content which is exclusively available on the internet. Many internet radio stations allow listeners to select or create personalised stations with favoured artists, composers, songs and genres.

Who are the key players?

Internet radio stations acquire the rights to broadcast intellectual property. Content acquisition costs, which are made up mainly of royalties payable to recording artists, music publishers or song writers are the largest portion of an internet radio company's expenses.

What are the types of royalties in the industry?

Unlike terrestrial (AM/FM) radio stations, internet radio is able to accurately measure the number of listeners that are currently streaming a webcast. For this reason the royalties payable for webcasting are typically calculated per listener hour. However, there are a wide variety of royalty arrangements e.g. royalties may also be a fixed amount per track play or a percentage of revenue generated.

As explained in the previous section on music royalties, two copyrights are usually involved in music recording: a copyright over the sound recording and a copyright over the musical composition. Internet radio broadcasters pay royalties on the streaming of the music and on sound recordings, whilst terrestrial radio stations usually only pay royalties for broadcasting the music as they are mostly exempted from the royalty on sound recordings.

Video games

The video gaming industry continues to generate sleek and portable technology designed to indulge the gamer's imagination. Video games have evolved from basic two dimensional game-play to interactive three dimensional games with real world graphics. The revenue from hardware or console sales is a relatively minor component of the video gaming industry, whereas royalties from game development and publishing is the largest contributor.

Who are the key players?

The development of video games involves:

- Manufacturers, who develop and produce consoles.
- Developers, who create content and the source code on which the video game is built. This development generally encompasses game design, production, programming, sound engineering, art, and final testing.
- Publishers, who receive the finalised product from the developer and are responsible for the selling and marketing of the game, along with funding the development.
- End-user distributors, who sell the game to the consumer.

What are the types of royalties in the industry?

There are two ways royalties are received and paid in the video game industry:

A developer receives a non-refundable upfront advance payment from the publisher to develop a new game. Once the development is complete, the publisher will market, produce and distribute the game to consumers. The developer will generally receive an additional royalty after the game has achieved a certain revenue target. Thereafter the developer will receive a share of the revenue from game sales.

Video game publishers may also be required to make royalty payments to hardware (console) manufacturers for a license to publish games for that console; and/or to owners of intellectual property for its use in a video game (e.g. copyrights, trademarks, personal publicity rights and other intellectual property). The latter has become a lucrative revenue stream for organisations with popular brands such as FIFA Soccer and NFL Football.

Mobile applications

Consumers' desire to have the latest experience on the latest "smart" device has led to an explosion in the use of both free and paid-for mobile applications ("apps"). Competing operating systems such as Android, iOS, Symbian and others have divided the market, forcing app developers to redesign their apps to make them compatible with multiple operating systems.

Who are the key players?

The parties to an apps royalty agreement are usually the mobile handset designer/manufacturer and the software developer that creates, designs, develops and troubleshoots the app.

What are the types of royalties in the industry?

The sales of apps in "app stores" result in fees being paid or received by various parties such as:

- Revenue sharing arrangements: Mobile operators sell apps developed by third-party developers in their virtual stores in exchange for a fixed percentage of the revenue earned from the app
- Exclusivity arrangements: these are less common, but when an app is developed that could be very popular, some entities will purchase the rights to sell a particular app exclusively in their virtual store. These entities pay developers a fixed royalty fee each time the app is downloaded or sold in the store.

"Who are the key players in each industry? What are the types of royalties?"

Figure 2: The app ecosystem

Film rights

Hollywood regularly releases movies that cost hundreds of millions of dollars to produce and an industry rule of thumb is that a movie must generate revenues of three times its production cost to show a net profit. With such large capital outlays, managing royalties is a critical priority for the film rights industry.

Who are the key players?

Movies can incorporate the use of various other rights such as rights to musical compositions, literary works, historical characters and TV shows. The key players can include directors, actors, producers and the writers of scripts and/or literary works on which a movie is based.

What are the types of royalties in the industry?

Royalties in the film industry often cross into the industries discussed above, most notably music and books.

The parties involved often make use of options to "acquire and produce" to manage cash flows and mitigate the risk of paying for unusable assets, while ensuring that studios are able to benefit as and when opportunities arise. Examples include the acquisition of rights to an individual's life story, buying or selling options to scripts and buying or selling options over sequels.

Sports rights

Sports teams and competition organisers receive a large portion of their income from advertising and royalties (including broadcast rights). The royalty arrangements in this industry can be complex.

Who are the key players?

The parties involved in sports royalties include:

- Sports teams
- Sports event organisers and governing bodies
- Broadcasters.

What are the types of royalties in the industry?

Replica shirts and other team branded merchandise is highly sought after but the teams often prefer to focus on their core sporting operations rather than manage the design, manufacture, shipping and sale of team branded merchandise. Teams therefore outsource this function to a third party, typically a sportswear manufacturer. The team will license its logo and image rights to the sportswear manufacturer that will design and sell branded merchandise. The fee for granting these licensed rights may be a fixed amount, an amount linked to sales, an amount linked to the performance of the team, or a combination of all three.

Royalty revenue accounting by a sports team can be complex where it is linked to team performance. Often there are additional incremental amounts receivable by the licensor above a base fee if the team's performance hurdles are met, and it is common for these hurdles to be calculated on a cumulative basis over the term of the royalty agreement. This means that exceeding performance targets in one year is no guarantee of an incremental receipt because such incremental amounts can be lost if the team's performance is lower in later years.

Sports teams and event organisers will also grant other unrelated entities the right to use their brand and image on their advertising. These entities are often referred to as "partners" and pay a fee for the right to use the event's name and logo on their promotional materials. These fees could be fixed, linked to performance, linked to sales made by the partner, or a mixture of all three. Again, these fee structures can be fixed or linked to sales or team performance.

Broadcast rights to sports events can be extremely lucrative and TV companies will pay large sums for rights to show games. Organisers will invite bids from broadcasters to show games for a period, and these broadcast royalties are then shared among the teams.

"Is a licensor's advance a financial and monetary liability?"

Accounting for royalties receivable

Advance payments

In many media industries, particularly publishing, royalties are paid in advance by the licensee (e.g. the book publisher) to an entity or individual responsible for developing the intellectual property (e.g. the author). This advance payment is an upfront payment of future royalties. Publishing royalties are usually paid by the publisher to the author in three instalments, with the first instalment paid on signing of the contract, the second instalment on delivery of an acceptable manuscript and the third instalment on publication.

The first instalment is usually refundable in the event that the author does not deliver a manuscript of sufficient quality (although this is clearly a subjective judgement). In addition, contracts are sometimes structured such that authors are required to repay to the publisher any "excess advance" in the event that the royalties earned are below the advance received. But in most cases the publisher bears the loss when the advance exceeds the royalties the author would have earned.

A key judgement for the licensor is whether the obligation associated with receipt of the advance represents a financial and monetary liability i.e. is there a contractual obligation for the licensor to deliver cash in return. The most notable implications of this judgement are that financial liabilities are subject to the disclosure requirements of IFRS 7 *Financial instruments: disclosures and monetary liabilities in foreign currencies* are retranslated at each period end under IAS 21 *The effects of changes in foreign exchange rates*.

Illustrative example

Publishing House (the licensee) is keen to publish the new Pottery Harry series of books. The author (licensor) Kennedy Charlton receives an advance from Publishing House of €1,000,000. The advance is paid in three instalments: on signing of the contract, on delivery of the manuscript and on publishing. The royalty payable to the author is €10 per book i.e. it represents sales of 100,000 books. In both examples below the advance is refundable by Kennedy Charlton if he fails to deliver a manuscript of sufficient quality.

Example: Kennedy Charlton is not liable to refund any "excess advance" if actual sales fall short of 100,000; for sales above 100,000 he receives royalties at €10 per book.

On receiving the advance, Kennedy Charlton's obligation is to deliver a manuscript, which is clearly not a financial or monetary item. Since he is not liable to refund any excess advance, the only scenario in which he pays out cash is if he fails to deliver a manuscript of sufficient quality. But that is a "breach" clause, to be enforced only in exceptional circumstances; and moreover the quality of the manuscript is within Kennedy Charlton's direct control. The obligation would therefore likely be deemed non-financial and non-monetary.

Depending on the exact terms of the contract, the advance would be recognised as revenue either once the manuscript is delivered or when the book is published, since at that time Kennedy Charlton has fulfilled all his obligations. Additional royalty revenues for book sales above 100,000 units would be recognised as these sales occur.

Example: Kennedy Charlton is liable to refund any "excess advance" if actual sales fall short of 100,000; for sales above 100,000 he receives royalties at €10 per book.

In this example, Kennedy Charlton's primary obligation is still to deliver a manuscript. But since he may be compelled to pay out cash, it becomes a matter of judgement whether the liability is financial and monetary. This judgement relies on forecast sales – if these are above 100,000 then in practice the obligation would probably be deemed non-financial and non-monetary; but if and when it becomes clear sales may fall below this level then the "excess advance" becomes financial and monetary in nature and would hence require additional disclosures, and retranslation if denominated in a foreign currency. (Licensors may also opt to provide the additional IFRS 7 disclosures even when forecast sales exceed 100,000 if they feel the information is useful.)

In this second example, the timing of revenue recognition by Kennedy Charlton is more complex since there remains a potential obligation for as long as sales are below 100,000. Consideration would need to be given to releasing the advance to the income statement as revenue only as the publisher generates actual sales, rather than recognising in full as under the first example.

Accounting for royalties receivable
Outright sale?

When transferring its intellectual property to the licensee, the licensor must make an assessment as to whether this transfer constitutes an outright sale (implying immediate recognition of revenue) or whether the remaining obligations or uncertainties mean revenue must be deferred until some future time or event.

IAS 18 *Revenue* requires that royalties are recognised as they accrue in accordance with the terms of the relevant agreement unless it is more appropriate to recognise revenue on some basis to reflect the substance of the arrangement. The IAS 18 appendix states: *"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."*

Interpreting this guidance can be challenging. It is important to determine whether the substance of the arrangement is a "sale of rights" (i.e. outright sale) or the provision of a "right to use" the asset (i.e. an ongoing royalty arrangement). Figure 3 sets out some indicators of an immediate transfer of risks and rewards from licensor to licensee i.e. indicators of an outright sale and hence immediate recognition of revenue by the licensor.

If the arrangement does not represent an outright sale then revenue recognition may be deferred over time or until a specific point in the future. Consider the following examples:

Example 1 – Licence fee with continuing obligation

Licensor A, a newspaper publisher, grants licensee B the right to exploit its entire archive of previously published editions. The licence allows licensee B to exploit the archive for a two year period (1 January 20X1 to 31 December 20X2). The licence fee of €1 million is payable on 1 January 20X1. The licence agreement also specifies that licensor A will continue to add each day's edition through 20X1 and 20X2 to the archive.

Figure 3: Indicators of an outright sale by licensor

What is the term in the contract?	Why is this an indicator of outright sale by licensor? (i.e. transfer of risks and rewards to licensee)
Fixed fee or non-refundable guarantee	If the license fee is pre-determined, non-refundable and not contingent on the occurrence of a future event, then the licensor no longer has any continuing involvement with the asset.
Contract is non-cancellable	If the contract cannot be cancelled once delivery has taken place (or is cancellable only in the event of breach) this indicates the inflow of economic benefit to the licensor is probable at the time of the "sale".
Licensee is able to exploit rights freely	The licensed rights are a separable component that can meet the sale of goods criteria separately. If the licensor does not have any significant involvement during the contract period, does not have the right to control or influence the way the rights are used (as long as the customer acts within the contract terms) and/or has the ability to sub-sell the rights or even to stop using the licence at any time, this indicates that the licensee is able to exploit the rights freely.
Licensor has no remaining obligations to perform subsequent to delivery	Such obligations might include significant updating of the product by the licensor, marketing efforts or fulfilling specified substantive obligations to maintain the reputation of the licensor's business and promote the brand in question. The absence of these obligations indicates no substantive ongoing involvement or control.

How should licensor A account for the licence fee revenue?

Licensor A has an ongoing obligation to update content and hence ongoing involvement in a service that is delivered over time to licensee B. Accordingly, the €1 million licence fee revenue should be deferred and recognised (probably straight-line) over the two year period.

Without the obligation to provide new content over two years, it is possible that licensor A could recognise revenue immediately. Additional facts to be considered would include whether licensor A has an ongoing obligation to host the historical archive (e.g. on its website) or can instead pass it over directly to licensee B.

Example 2 – Licence fee with a trigger event

Film distributor C grants a licence to cinema operator D. The licence entitles cinema D to show the film once on a certain date for consideration payable to film distributor C of the higher of a non-refundable guarantee or a percentage of D's box office receipts.

How should licensor C account for the licence fee revenue?

Since cinema D is unable to show the film before the specified date and hence cannot exploit the rights freely, film distributor C effectively has ongoing involvement. Film distributor C should defer revenue recognition until the date the film is shown. It is only then that the revenue has been earned by C.

A related example where licence revenue might be recognised immediately as an outright sale is a non-refundable one-off fee received for the foreign exhibition rights to a film, which allow the licensee to use the rights (in specified countries) at any time and without restriction. The licensor can potentially recognise revenue when the fee is received because it has no control over the film's further use or distribution and no further obligations under the contract.

How might accounting for royalties change in the future?

The revenue recognition Exposure Draft (ED) re-exposed in November 2011 by the IASB and the FASB sets out a general principle that revenue should be recognised when control of goods and services pass to the customer. In respect of licensing, paragraph B34 states: "If an entity grants to a customer a licence or other rights to use intellectual property of the entity, those promised rights give rise to a performance obligation that the entity satisfies at the point in time when the customer obtains control of the rights."

Under current IFRS, the most common approach to time-based licences has been for the licensor to recognise revenue over the licence period. The ED proposals may therefore accelerate revenue recognition in some scenarios. Respondents to the ED have questioned whether arrangements to distribute licensed intellectual property should instead continue to be accounted for as a service arrangement satisfied over time, which many respondents argued better reflects the economics of such transactions, rather than a performance obligation satisfied at the point in time when the licence is provided.

Furthermore, many long-term licence arrangements for film and television contain licensor-imposed restrictions such as interruptions on the right to use the licence during the licence term or constraints on the frequency and timing of the broadcast e.g. to specify the sequencing of television episodes and restrict the maximum number of airings. Many respondents to the ED highlighted that these complexities result in significant judgement to determine when control transfers. Additional clarity may be needed to avoid inconsistent application of the ED.

For a more comprehensive description of the proposed standard and its implications, refer to PwC's MIAG Issue *2 Revenue recognition for media companies* and PwC's *Practical guide – Revenue from contracts with customers* or visit www.ifrs.org or www.fasb.org.

"The licensor must assess whether it has made an outright sale"

Accounting for royalties receivable
Stepped royalties

As explained earlier, many royalty arrangements in the media sector are set up such that the payment due to the licensor is a function of units sold or revenue generated by the licensee. In these arrangements it is not uncommon to see stepped royalties whereby the payment per unit sold either steps up or steps down once certain sales thresholds are exceeded.

For example, in the Pottery Harry example discussed in the section on advances, the royalty payable by licensee Publishing House to licensor author Kennedy Charlton could be flexed so it is set at €10 per book for the first 150,000 books but then steps up to €12 per book for sales between 150,000-250,000 and up to €15 per book above 250,000 (or conversely down to €8 and then €5 at those sales levels).

The question then arises at what royalty rate the licensor should recognise revenue – the actual royalty rate being earned at the current sales level or an effective royalty rate estimated across all sales. This accounting policy choice can have a significant effect on revenue recognised:

The decision on whether to apply the actual or effective rate will depend in part on the historical accuracy of forecasting sales and the magnitude of the different rates. In practice the move from actual to effective rate is less likely in the step-up scenario (since this would accelerate revenue) and relatively more likely in the step-down one (since this will defer it).

Figure 4: Impact of stepped royalty arrangements on royalties earned by licensor

Sales level	**Step-up scenario**	**Step-down scenario**
Up to 150,000	€10 per book	€10 per book
150,000-250,000	€12 per book	€8 per book
Above 250,000	€15 per book	€5 per book
Current sales in period	100,000	100,000
Current revenue at actual royalty rate	**€1.0 million**	**€1.0 million**
Estimated total sales	500,000	500,000
Estimated total revenues	€6.5 million	€3.6 million
Current revenue at estimated effective rate	**€1.3 million**	**€0.7 million**

Accounting for royalties receivable
Contingent royalties

Royalty arrangements often contain both contingent and non-contingent amounts payable to the licensor, in order to limit the licensee's potential loss of capital while ensuring the licensee works the intellectual property to its full benefit.

IAS 18 is not explicit as to whether all elements of consideration must meet the revenue recognition criteria simultaneously in order for any portion of the revenue to be recorded by the licensor, or if each element can be assessed separately and meet the revenue recognition criteria at different times. We believe that a policy choice can be made: the contingent and non-contingent elements of royalty income can be considered separately to determine when revenue is recognised or the contract can be assessed as a whole. The policy should be applied consistently and, where material, be disclosed as a key accounting policy.

Option 1: Separate assessment of each element of royalty income

The licensor might determine that it has met the revenue recognition criteria for the non-contingent portion of the royalty income when the license is available for use by the licensee, but has failed one of the revenue recognition criteria (such as the probable inflow of economic benefit or reliable estimation of revenue to be recognised) for the contingent portion. The licensor therefore records revenue for the non-contingent consideration when the license is available for use by the licensee. Revenue is recorded for the contingent portion of royalty income when the revenue recognition criteria are met for that portion. In determining when the revenue recognition criteria are met for the contingent portion, historical trends and any specific features of the contract amongst other factors should be considered.

Figure 5: Estimated fixed and contingent revenues payable to licensor A

Year	B revenues (€k)	A's share (€k)
Start	n/a – fixed fee	1,000
2010	10,000	100
2011	25,000	250
2012	50,000	500
2013	50,000	500
2014	25,000	250
Total	**160,000**	**2,600**

Illustrative example

Licensor A develops cartoon characters. Licensee B develops and sells cartoons and runs theme parks based on the cartoon characters. B contracts with A to purchase the intellectual property rights over certain characters. The intellectual property agreement contains the following key terms:

1. Licensee B obtains full ownership of the cartoon characters and related intellectual property. No further work will be required from licensor A, as B's in-house animation department will complete the development of all stories and required drawings.
2. On signing the agreement and providing all sketches and story ideas, A will be paid €1 million. This amount is non-refundable.
3. A will also be paid 1% of all revenues generated from the use of the characters.

Licensee B shares its revenue projections with licensor A, which are based on B's extensive historical experience:

How much revenue should licensor A recognise when the contract is signed?

Licensor A may be satisfied that all revenue recognition criteria have been met in relation to the contingent revenue on the basis that B's past experience with similar transactions provide sufficient evidence to meet the probability of economic benefit and reliable measurement. In that case, both the up-front payment of €1 million and the fair value of the total expected future payments of €1.6m would be recorded as revenue when the cartoons and related intellectual property are delivered to licensee B. A corresponding receivable for the fair value of €1.6 million is recorded and adjusted each reporting period to the extent that relevant evidence indicates a change in the expected future cash flows.

In our experience this approach is relatively rare under current accounting standards. More commonly, licensor A would satisfy itself that the revenue recognition criteria have been met in relation to the non-contingent fixed fee of €1 million, but defer recognition of the contingent portion until the corresponding sales are actually made by licensee B. This approach would be consistent with the re-exposed revenue recognition ED, which requires that if a licensee promises to pay a royalty that varies on the basis of the licensee's subsequent sales of a good or service, the licensor is not reasonably assured of its entitlement to the contingent royalty until the uncertainty is resolved (i.e. when the licensee's actual sales occur).

Option 2: Contract considered as a whole

Where the contract is considered as a whole, revenue is recognised in the income statement when the IAS 18 criteria are met for the full transaction. The key judgment will be to determine the date on which the total consideration for the contract can be reliably measured.

Again, licensor A's assessment of the contingent portion could theoretically take place prior to the licensee's actual sales, by instead referencing licensee B's historical experience with forecasting sales; but in practice a more common accounting solution is to spread revenue recognition across the life of the contract using an appropriate mechanism such as proportion of total expected revenues.

"The contingent and non-contingent elements can be considered separately or as a whole"

Accounting for royalties payable

Advance payments

In the advances section we considered the accounting from the perspective of a licensor (e.g. an author) receiving advance payments from a licensee (e.g. a publisher) against future royalties. We now consider these same advances from the perspective of the licensee.

Illustrative example

Publishing House (the licensee) is still keen to publish the new Pottery Harry series of books. The author (licensor) Kennedy Charlton receives an advance from Publishing House of €1,000,000. The advance is paid in three instalments: on signing of the contract, on delivery of the manuscript and on publishing. The royalty payable to the author is €10 per book i.e. it represents sales of 100,000 books. In all examples below the advance is refundable by Kennedy Charlton if he fails to deliver a manuscript of sufficient quality.

An immediate accounting consideration is whether the asset represents a prepayment or intangible asset. Since the advance is refundable if Kennedy Charlton fails to deliver a manuscript, and a major part of the intellectual property rights remain with him post publication, the majority of publishers classify these advances as prepayments rather than intangible assets.

Is the royalty advance a financial/ monetary asset? And is it recoverable?

The first key judgement is whether the prepayment is a financial and monetary asset i.e. is there a contractual right to receive cash. Financial assets are subject to the disclosure requirements of IFRS 7 and monetary liabilities in foreign currencies are retranslated at each period end under IAS 21.

Example: Kennedy Charlton is not liable to refund any "excess advance" if actual sales fall short of 100,000; for sales above 100,000 he receives royalties at €10 per book.

As noted earlier, Kennedy Charlton's obligation is to deliver a manuscript and, excluding the "breach" clause, there is no scenario in which the licensee will receive cash back from the author. The licensee Publishing House would therefore treat the royalty advance asset as a prepayment which is non-financial and non-monetary. This prepayment is then recognised as an expense as the books are sold.

Example: 1 (continued): assume the book generates royalties as in the scenarios below (which will then be offset against the royalty advance):

a. €1,000,000 based on sale of 100,000 books

b. €1,200,000 based on sale of 120,000 books

c. €900,000 based on sale of 90,000 books

Figure 6: Impact of sales levels on the recoverability of advance

Scenario–royalties payable to licensor	Accounting implications for licensee
a. €1,000,000 based on sale of 100,000 books	No additional consideration is paid to the author. The prepayment is amortised as the books are sold.
b. €1,200,000 based on sale of 120,000 books	An additional royalty payment is made (or accrued) and expense recognised as 20,000 books are sold above 100,000.
c. €900,000 based on sale of 90,000 books	Sales are less than estimated in the advance. There are two options available once it becomes clear forecast sales will fall short of 100,000: **Option 1:** €100,000 is recorded as an impairment expense once the lower estimate is determined **Option 2:** When forecast sales are lowered from 100,000 to 90,000 the publisher determines the effective royalty rate on the books to be €11 (€1,000,000 / 90,000 books). This is a change in estimate and is reflected in amortisation prospectively.

In our experience Option 2 (in Figure 6) is more commonly applied. Under this option, an actual impairment of the royalty advance is recognised by the publisher only when it is forecast that the book will be genuinely loss-making (i.e. contributing a negative gross margin) rather than merely paying a higher effective royalty rate.

The assessment of the recoverability of an advance is dependent on accurate forecasting of sales. If this is not possible – e.g. because the licensor is a new, unproven author or music recording artist – then it may be appropriate to write the advance off immediately as an expense.

Example 2: Kennedy Charlton is liable to refund any "excess advance" if actual sales fall short of 100,000; for sales above 100,000 he receives royalties at €10 per book.

In this example, the licensee must make a judgement on forecast sales – if these are above 100,000 then in practice the royalty advance asset would probably be deemed non-financial and non-monetary. But, if and when it becomes clear sales may fall below this level then the "excess advance" becomes financial and monetary in nature and would hence require additional disclosures, and retranslation if denominated in a foreign currency.

(Licensees may also opt to provide the additional IFRS 7 disclosures even when forecast sales exceed 100,000 if they feel the information is useful.)

Since any "excess advance" is repayable by Kennedy Charlton, the licensee would deem the asset fully recoverable regardless of forecast sales, unless the author is deemed a credit risk.

Accounting for royalties payable
Recognition and valuation of assets and liabilities

Are asset and liability recognised immediately?

A key issue when accounting for royalties payable is to understand whether the right to use a licence is a purchase of the licence, which would result in the recognition of an intangible asset and the related obligation by the licensee; or an executory contract, in which case the licensee's obligation only arises when the licensor's revenue is earned or the licensee's right has been used. Accordingly, the royalty expense and the corresponding liability are only recognised at that point in time, which is consistent with the principle that until then the licensee had the unconditional right to avoid payment. Under the most common "fee per unit sold" royalty arrangement, which is usually a form of executory contract, the licensee accrues a royalty liability every time it makes a sale to reflect the royalty payment which must be made to the licensor.

Where a royalty has been paid up front, as in the case of an advance and the arrangement is considered to be an executory contract, the royalty is capitalised as a prepayment.

Similar indicators to those listed under "Accounting for royalties received: Outright sale?" are used to determine whether the licensee has purchased the rights (in which case the asset and liability are recognised immediately) or merely has the ability to exploit the rights in return for a fee (i.e. an executory contract).

An example of a licence which might be capitalised as an intangible asset is the money paid by licensees to sports teams or event organisers to become a "partner" of that team or event. Assuming the recognition criteria in IAS 38 *Intangible assets* are met, an intangible asset will arise because the commercial partner (i.e. licensee) has separately purchased the contractual right to use the sports team or event name and logo for a period of time. The intangible asset is amortised over the period of the "partnership". In practice these "partnership agreements" can be highly complex as the "partner" is often required to provide goods and services to the sports team or event name over the life of the partnership as well as making normal cash payments.

Is the value of the asset fully recoverable?

Where an intangible asset is recognised as a result of a licensing arrangement, it is subject to impairment triggers and, where triggers are present, to impairment review. This impairment risk has increased under current economic conditions as consumers and businesses sacrifice discretionary spend in the media sector.

Examples of external triggers would be significant adverse changes in the:

- Technological environment – e.g. introduction of new gaming consoles or e-book readers
- Market – e.g. bad publicity generated for a title or script
- Economic – e.g. downturn affecting the advertising industry
- Legal environment – e.g. change in patent or royalty legislation.

Examples of internal indicators would be evidence of obsolescence, such as the use of outdated technology platforms, or evidence from internal reporting that the economic performance of an asset will be worse than expected.

The recoverable amount is calculated at the individual asset level where possible. The nature of the royalty asset would drive the determination of whether it is tested for impairment individually or as part of a part of a cash generating unit (CGU). Some royalty assets may be sold or licensed out and could therefore be capable of generating cash flows independent of other assets; some royalty assets are only able to generate cash flows in conjunction with other assets so would be tested for impairment as part of a larger CGU. An asset or CGU is impaired when its carrying amount exceeds its recoverable amount (being the higher of value in use or fair value less costs to sell). Any impairment is allocated to the asset or assets of the CGU with the impairment loss recognised in profit or loss.

Royalty arrangements rarely result in onerous contracts because assets are first impaired before a provision is recorded, and in cases where royalties are paid on a "per sale" basis the licensee would simply stop selling items where the associated royalty payments are so high as to generate losses.

"Impairment risk has increased under current economic conditions"

Accounting for royalties receivable
Stepped royalties

Consider again the Pottery Harry example set out under "Accounting for royalties receivable: stepped royalties" above. The question now is at what royalty rate the publisher (licensee) should recognise the royalty expense – the actual royalty rate being paid at the current sales level or an effective royalty rate estimated across all sales.

Again, the decision on whether to apply the actual or effective rate will depend in part on the historical accuracy at forecasting sales and the magnitude of the different rates. For licensees, in contrast to licensors, the move from actual to effective rate is more likely in the step-up scenario (since this accelerate costs) and relatively less likely in the step-down one (since this will defer costs).

Figure 7: Impact of stepped royalty arrangements on royalties earned by licensor

Sales level	**Step-up scenario**	**Step-down scenario**
Up to 150,000	€10 per book	€10 per book
150,000-250,000	€12 per book	€8 per book
Above 250,000	€15 per book	€5 per book
Current unit sales in period	100,000	100,000
Current revenue at actual royalty rate	**€1.0 million**	**€1.0 million**
Estimated total unit sales	500,000	500,000
Estimated total royalty costs	€6.5 million	€3.6 million
Current revenue at estimated effective rate	**€1.3 million**	**€0.7 million**

Accounting for royalties receivable
Contingent royalties

Accounting complications can arise where a licensee purchases a licence for contingent consideration that it capitalised under IAS 38 *Intangible assets*. This is because IAS 39 *Financial Instruments: Recognition and Measurement* (or IFRS 9 *Financial Instruments*) requires that the financial liability (i.e. the contingent consideration) is initially measured at fair value, meaning that the licence asset must also be fair valued.

In the first half of 2011 the IFRS Interpretations Committee (IFRIC) debated how to account for contingent consideration agreed for the separate of intangible assets. The IFRIC noted that the financial instruments standards do not require total payments to be estimated reliably for the financial liability to be recognised; therefore the licensee will generally recognise its obligation to pay contingent royalty payments earlier than the licensor recognises its right to receive payment. IFRIC has not yet formally concluded its deliberations, but the apparent conclusion would be that the licensee initially recognises the licence asset and associated contingent consideration at fair value with subsequent changes in the expected payments recognised in the income statement. However, this is a tentative conclusion and for now there remains considerable diversity in practice in this area.

"The licensee must decide whether to apply the actual or effective royalty rate"

Conclusion

The licensing of intellectual property from one party to another is a key component of many media sectors as content is made available to consumers across multiple platforms and territories. Whether it be royalties for print, music, video games or other forms of content, the accounting implications of these transactions are often complex and may vary depending on the substance of the arrangement.

Accounting for these royalty arrangements is challenging due to both the inherent complexity of the commercial contracts and because there is limited accounting guidance available under IFRS for licensors or licensees. Coupled with the absence of detailed guidance under IFRS, accounting for royalties is also becoming more complex as the media sector embraces the move to digital content distribution and as ongoing macroeconomic turmoil increases the likelihood of impairment of royalty generating assets.

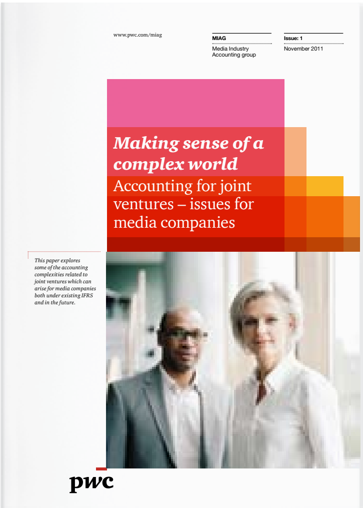
Management is often called on to make significant judgements and estimates for both royalties receivable and payable, which should be disclosed under IAS 1 Presentation of financial statements if they are material. In particular, the accounting for royalties receivable and payable frequently relies on forecasts of future sales volumes to assess the recoverability of advances and licences, the correct stepped royalty rate to apply, and the likely resolution.

This paper has explored some of the key challenges under IFRS in accounting for royalty arrangements by both licensors and licensees; but the answer for complicated real life transactions will depend on the specific facts and circumstances in each case. In addition to this existing commercial and accounting complexity, the recognition of licensing revenue is one of the areas which may be most subject to change under the revenue recognition Exposure Draft (ED) re-exposed in November 2011. As always, planning ahead can prevent painful surprises.

We hope that you find this paper useful and welcome your feedback.

To comment on any of the issues highlighted in this paper please visit our dedicated website www.pwc.com/miag or contact your local PwC entertainment and media specialist.

Further reading



MIAG Issue: 1

Accounting for joint ventures – issues for media companies

This paper explains the treatment of joint ventures and other items and other items under the current standard IAS 31 *Interests in joint ventures* and also considers how the treatment might change under IFRS 11 *Joint arrangements* which is applicable for periods beginning on or after 1 January 2013.

MIAG Issue: 2

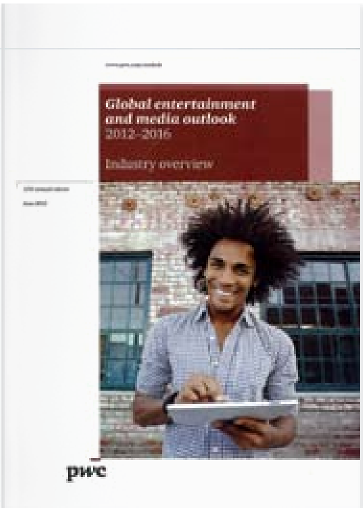
Revenue recognition for media companies

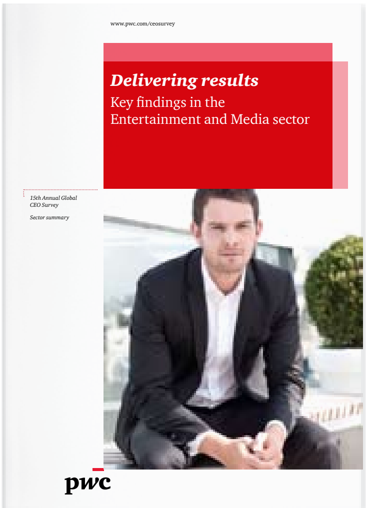
This paper explores some of the main implications for media companies of the revenue recognition ED re-exposed in November 2011.

MIAG Issue: 3

Broadcast television: Acquired programming rights

This paper explores the critical considerations under IFRS relating to the recognition, presentation, amortisation and impairment of acquired programming rights.





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2012—2016

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This year's outlook focuses on the emergence of a golden age for empowered consumers, driven by the profound move to digital, which has created a "new normal" for the entertainment & media industry.

15th Annual Global CEO Survey

Entertainment & Media industry summary

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