

# MFRS Hot Topics

Contracts requiring payments linked to future sales

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## Issue

This Hot Topic considers the appropriate accounting for contracts that require an entity to make payments based on future entity revenues or product sales. In particular, when will such a contract require a liability to be recognised?

### Relevant MFRS

MFRS 132 Financial Instruments: Presentation  
MFRS 137 Provisions, Contingent Liabilities and Contingent Assets  
MFRS 138 Intangible Assets  
MFRS 139 Financial Instruments: Recognition and Measurement  
MFRS 117 Leases  
MFRS 118 Revenue  
MFRS 119 Employee Benefits

## Guidance

The most common type of contract in this category is a license to use another entity's intellectual property in exchange for sales-based royalties. In many situations it is appropriate to account for such an arrangement by recording a liability and an associated expense on an accrual basis as sales are made. This is because the licensor does not acquire the underlying intellectual property but rather 'uses' it each time a sale is made.

Other contracts requiring payments linked to future revenues or product sales can give rise to more complex accounting issues. The terms and conditions of such arrangements differ extensively. This Hot Topic provides general guidance on some of the key matters to consider. However, careful evaluation of all relevant facts and circumstances will be required to determine an appropriate MFRS treatment in each case.

## Contracts for non-financial items

### Pre-delivery

If the contract requires payments linked to future revenues in exchange for goods, services or use of the counter-party's intellectual property it is 'executory' until the non-financial item (goods, services or intellectual property) has been delivered. In most circumstances no liability or asset is recorded in relation to an executory contract. However:

- if the executory contract is onerous a liability is recorded in accordance with MFRS 137 (MFRS 137.3)
- the contract is within the scope of MFRS 139 if (in summary) it is cash-settled and it is not an 'own-use' contract

### Post-delivery

Once the non-financial item has been (wholly or partly) delivered the contract may no longer be executory. In the case of the simple, sales-based royalty agreement described above, the uncompleted part of the contract (i.e. the obligation to pay future royalties as the underlying intellectual property is used in future sales) remains executory. Accordingly, a liability is recognised only to the extent of royalties due on past sales.

However, in other situations 'delivery' may have occurred in the past but the contract payments are linked to sales in the future. In such cases the obligation to make payments linked to future sales may give rise to a liability in accordance either with MFRS 132/139 or MFRS 137. Our preferred view is that this situation gives rise to a financial liability in accordance with MFRS 132/139 to the extent that the future payments relate to goods or services that have been delivered in the past. We also believe that this 'MFRS 132/139 view' is the only credible interpretation when:

- the obligation is linked to entity-wide revenues (MFRS 132.25) or
- if the arrangement includes a contractual obligation to make (or attempt to make) the sales that will trigger payments.



An alternative view can also be supported if the arrangement is linked to specific sales (e.g. sales of a specific product) and does not include a contractual obligation to make those sales. In this case it can be argued that there is no contractual obligation to pay cash (and hence no financial liability in MFRS 132/139 terms). Under this alternative view we consider that the arrangement should be analysed to determine if a liability should be recognised in accordance with MFRS 137.

If a liability is recognised, the corresponding debit will be recorded either as an expense or as the appropriate type of asset. The 'cost' of the asset corresponds to the amount of the liability assumed (plus any other payments paid and costs that are included in accordance with applicable MFRSs). For licensing arrangements involving intellectual property, judgement will often be required to determine whether, in substance, the arrangement is a purchase of an intangible asset or an executory contract.

### Financial instruments

As noted above, a contract that was for receipt or delivery of a non-financial item at inception may become a financial liability once receipt or delivery has occurred. A contract that requires the reporting entity to make payments linked to future sales in exchange for cash (or another financial asset) is a financial instrument from inception.

The guidance in MFRS Hot Topics Jan 2017 Financial Instruments with Payments Based on Profits of the Issuer should be applied to these contracts.

### Implications of applying MFRS 132-139 or MFRS 137

If the obligation is a financial liability within the scope of MFRS 132/139, it is measured at fair value on initial recognition (adjusted for transaction costs in some circumstances) - MFRS 139.43. Fair value should take into account the expected level of future sales and consequent payments. Subsequently the liability is measured in accordance with the appropriate MFRS 139 measurement category. An assessment should also be made as to whether the contract contains an embedded derivative and, if so, if it requires separation from the host contract.

If MFRS 137 is applied, a provision should be recognised if an outflow of benefits is considered probable and a reliable estimate can be made of the amount (MFRS 137.14). In our view the entity's present obligation arises as a result of entering into the contract, not as a result of making the sales that trigger payments. If an outflow of benefits is not probable, the obligation is a contingent liability and no provision is recorded (MFRS 137.10 and 27). When a provision is recorded, the amount provided is the best estimate of the expenditure required to settle the obligation (MFRS 137.36). This amount may be similar to fair value. Accordingly, the most important difference between applying MFRS 137 rather than MFRS 139 is that the former contains a 'probability recognition threshold' while the latter does not.

Some might argue that 'present obligation' for the purpose of MFRS 137 exists only when a sale is made that will trigger payment under the contract. We do not support this view for the reasons explained in the Discussion section.



## Discussion

### General

Many types of contract require an entity to make payments based on future entity revenues or product sales. Types of contract that may operate in this way include:

- licences to use another entity's intellectual property in exchange for royalty payments
- some franchising arrangements
- some 'in-licensing' (or revenue sharing) arrangements in the pharmaceutical and other sectors
- agreements to pay sales commissions to employees or intermediaries
- sales-based leases.

As noted in the guidance section, this Hot Topics does not address agreements within the scope of MFRS 117 or MFRS 119.

It is sometimes assumed that there is no liability in relation to sales-based payment obligations until a sale is made. This is not always the correct approach. Careful evaluation of all relevant facts and circumstances will be required to determine the appropriate MFRS treatment in each case. The key matters to consider include:

- whether the contract is 'executory'
- if not, whether MFRS 139 or MFRS 137 applies
- when MFRS 137 applies, the point at which a present obligation arises.

### Executory contracts

Executory contracts are defined as:

'contracts under which neither party has performed any of its obligations or both parties have partially performed their obligations to an equal extent' (MFRS 137.3)

Generally no liability is recorded for such contracts. This is because they are outside the scope of MFRS 137 unless they are onerous (MFRS 137.3) and are also outside the scope of MFRS 132 and 139 if they are contracts for receipt or delivery of a non-financial item (MFRS 132.AG20).

An example of an executory contract is a purchase order for goods that have neither been delivered nor paid for. We also consider that licensing arrangements in which the licensee does not (in substance) acquire the underlying intellectual property can be viewed as executory. Support for this view can be drawn from MFRS 132's discussion on operating leases:

'an operating lease ... is regarded as primarily an uncompleted contract committing the lessor to provide the use of an asset in future periods in exchange for consideration similar to a fee for a service' (MFRS 132.AG9)

Accordingly, many sales-based licenses, royalty agreements and similar arrangements are considered executory and no liability is recorded until sales are made. Franchise agreements are often also treated as executory contracts because the franchisor has ongoing obligations to provide services (marketing, training and product development for example). As an aside, this approach may have the effect that the associated expense is recognised by the licensee or franchisee in a manner that is consistent with revenue recognition by the licensor or franchisor (see MFRS 118 Appendix 18(c) and 20).

### Non-executory contracts

Once delivery has occurred, contracts that were executory become non-executory. In the case, say, of a royalty-based technology licensing agreement, 'delivery' occurs as the technology is used by the licensee in selling its products or services. A liability and an associated expense therefore arise as sales are made. The future right to use the same technology in exchange for additional royalties remains executory. The question of whether MFRS 137 or MFRS 139 applies has limited practical importance because the recognised liability is typically short-term.

Complications arise in cases where delivery has occurred in the past but payments are linked to sales in the future (especially as those sales are usually uncertain in timing and amount). An example of this situation is an 'in-licensing' arrangement in the pharmaceutical sector. Such arrangements typically involve an early-stage drug development company transferring its rights to an unproven drug compound to a commercial pharmaceutical company. The latter company undertakes all further development, testing and commercialisation and pays the early stage developer a fee based on any future product sales. The majority of such arrangements never reach the commercial sale stage, as a result of the risks and uncertainty inherent in developing and commercialising new drug products. In this type of situation, the effect of applying MFRS 137 may differ from the effect of applying MFRS 132/139.

### Applying MFRS 132/139

Most contracts for non-financial items become financial instruments once delivery has occurred. At that point the contract establishes a right for one party to receive cash and an obligation of the other to pay cash. If those cash payments are uncertain (or contingent), this has an effect on measurement. It does not negate the existence of a financial asset of one party and a liability of the other (MFRS 132.AG-8 for more discussion on this point).

Accordingly, we believe that arrangements such as the in-licensing agreement outlined above give rise to a financial liability for the pharmaceutical company. Under this analysis, the liability is measured at fair value on initial recognition. An intangible asset is recognised if MFRS 138's criteria are met.

We believe that an alternative analysis is also supportable if the obligor is contractually able to 'control' the future sales that would trigger payment (ie to prevent those sales from taking place). The obligor does not have this ability if:

- the payment obligation is linked to total entity revenues - the entity is not realistically able to stop generating revenues whilst remaining a going concern. MFRS 132 is clear that a contingent settlement based on revenue is not within the control of the entity (MFRS 132.25) or
- the entity is contractually obliged to sell the products that will trigger payment (or use its best efforts to do so).

In such cases we believe MFRS 132/139 must be applied to the recognition and measurement of the liability.

If on the other hand the entity is able to decide not to sell the products that would trigger the payments, a case can be made that there is no contractual obligation to pay cash. If that argument is applied, an analysis should then be carried out based on MFRS 137.

## Applying MFRS 137

The first question to ask in applying MFRS 137 is when an arrangement such as the pharmaceutical revenue-sharing gives rise to a 'present obligation as a result of a past event' (see definition of liability in MFRS 137.10). In our view the entity's present obligation arises as a result of signing the contract. This view is consistent with MFRS 137's approach to warranties and guarantees (MFRS 137 Appendix C Examples 1 and 9).

Some may argue that a present obligation exists only when a sale is made that will trigger payment. The argument for this view is that the entity can avoid the expenditure by its future actions (MFRS 137.17-19). However, we believe the former view is better supported by the Standard and a better reflection of the economic substance of these arrangements.

If a present obligation exists, the second question is whether an outflow of economic benefits is 'probable', which MFRS 137 defines as more likely than not (MFRS 137.23). If the outflow is probable, a provision is recorded if a reliable estimate can be made of the obligation (MFRS 137.14). If not, the obligation is a contingent liability and no provision is recorded (MFRS 137.10 and 27). Disclosure is required unless the probability of any outflow in settlement is remote (MFRS 137.86). 'Remote' is not defined.

The requirement for a 'reliable estimate' to be possible in order to record a provision merits consideration. MFRS 137.26 indicates that cases when no reliable estimate is possible should be 'extremely rare'. Nonetheless, in situations such as the early stages of drug development, the range of possible outcomes and the uncertainties may well be so great as to call into question the ability to make a reliable estimate. This will require careful analysis of facts and circumstances, and will often involve professional judgement. Disclosure will be required if no liability is recognised for this reason (MFRS 137.26 and 86).



## Examples

### Example 1 - technology license

Entity A signs an agreement with Entity B to use patented technology in a specified product for a period of 10 years. The license is non-exclusive. Entity A is not permitted to sell or sub-license the technology, or to use it for any purpose other than the specified product. Entity A is obliged to make payments to Entity B in the form of a royalty of 5% of product revenues.

### Analysis

In this arrangement Entity B is providing ongoing access to its technology to Entity A in exchange for royalties. Entity B appears to have retained control over this technology - evidenced by the facts that: (i) the license is non-exclusive; and (ii) the uses to which Entity B may put the technology are highly restricted. Accordingly, the arrangement is most appropriately viewed as an executory contract. Royalties are accounted for as payable when units of product are sold by the distributor and calculated in accordance with the terms of the arrangement.

It should be noted that rights under licensing agreements for items such as motion picture films, video recordings, plays, manuscripts, patents and copyrights are within the scope of MFRS 138 and are excluded from the scope of MFRS 117 Leases (MFRS 117.2(b) and MFRS 138.6). It could be argued that this licensing agreement gives rise to an asset that should be recognised in accordance with MFRS 138. However, given that there is no upfront payment and our view that MFRS does not require a liability to be recognised, such an analysis would result in the recognition of an intangible asset at zero cost.



### Example 2- pharmaceutical revenue sharing arrangement

Entity C is a biotechnology company that has developed and patented a new compound. Early stage laboratory tests indicate some potential for the compound to form the basis for a commercial drug but significant further development, trials and regulatory approvals would be required.

Entity C enters into an agreement with pharmaceutical company D in which it transfers all rights under the patent to D in exchange for an entitlement to 20% of all sales revenue from any drug that Entity D brings to market that incorporates this compound. Entity D is also entitled to sell the technology to a third party, in which case the contract stipulates a formula to determine the compensation to be paid to C. Entity D intends to continue to assess and develop the compound (but is under no obligation to do so) but estimates that the probability of bringing a commercial drug to market is less than 25%.

### Analysis

In this example, Entity C has 'delivered' all of its obligations under the contract and has transferred rights equivalent to ownership to Entity D. Accordingly, and in contrast to Example 1, the contract is not an executory contract. Therefore, it is necessary to consider whether a liability should be recognised.

Under an 'MFRS 1139 view', a contractual obligation exists that may result in payments based on future drug sales. This gives rise to a financial liability. This liability is recognised at its fair value, which will reflect the probability of future sales being made. An intangible asset is also recognised in accordance with MFRS 138. Because Entity D's rights exist through separate acquisition, the condition that an intangible asset exists only if the entity expects an inflow of economic benefits is always considered to be met (MFRS 138.25).

In this example, Entity D has a realistic discretion to avoid making payments - in other words settlement is conditional and Entity D is able to control the outcome of the contingency. We therefore believe it is acceptable to analyse the obligation under 'MFRS 137 view'. Under this alternative view, an obligating event has occurred (the signing of the contract), and as noted above the contract is not an executory contract. However, the outflow of economic benefits is not 'probable' because there is only a 25% chance that a commercial drug will be developed. MFRS 137 therefore treats this obligation as a contingent liability and no liability is recorded (MFRS 137.13(b)(ii) and 27). If the assessment of future commercialisation improves to become 'more likely than not', a liability is then recognised for the amount Entity D would rationally pay to settle (MFRS 137.23 and 37).

### **Example 3- e-commerce development agreement**

Website development company E agrees to develop and provide content for company F's website, which represents F's only sales channel. Company F agrees to pay a fixed fee plus 5% of revenues generated from the website in the first two years of operation. Company E will also provide ongoing support services but these are covered by a separate agreement and paid for at a fair market rate.

#### **Analysis**

In this example, company E has delivered all of its obligations under the development contract in exchange for a fee which is part fixed and part revenue-based. In our view company F has a financial liability that includes both the fixed and variable components. The revenue-based component is linked to total revenue (i.e. to all the revenue generated by Company F via its website, which represents the only sales channel). Company F does not therefore have a realistic discretion to avoid payment, although the amounts involved are uncertain. It should therefore record this liability at fair value, taking account of the expected level of sales.

Company E should apply the requirements of MFRS 138 and IC Interpretation 132 Web Site Costs to determine whether these costs should be recorded as one or more intangible assets.



# How Grant Thornton can help

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