

Entertainment, Media & Communications Industry

Perspectives*

Revenue recognition matters
unique to the motion picture industry



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Financial executives adept at navigating revenue recognition rules will be key in the development of contractual agreements to ensure that operational and financial objectives are met.

The heart of the matter

Revenue recognition is becoming increasingly complex for the film industry. Are financial executives fully prepared to navigate revenue recognition challenges?

For many industries, revenue recognition is a difficult area of finance and accounting, but the evolving film industry faces particular challenges.

While SOP 00-2, “Accounting by Producers or Distributors of Films,” provides industry-specific guidance for revenue recognition, no interpretive guidance has been released since 2000. However, the film industry has experienced significant change since then, as advancing technology and shifting consumer demands have impacted everything from production to distribution. Although those developments present exciting new opportunities for producers of filmed content to exploit their product, they also pose new challenges in accounting for revenue transactions.

Without guidance to address key practical considerations, financial executives are left to search through other accounting literature for reasonable analogies or to rely on the perspectives of their peers at other studios for input on critical issues in balancing (1) compliance with accounting principles with (2) proper reflection of the economic substance of a transaction in the financial statements.

Standard business practices, such as having “evidence of an arrangement,” as well as inclusion of certain deal terms important to the producer, distributor, or licensee—including run restrictions, variable licensee fee structures, and gross versus net reporting—can significantly affect the pattern of revenue recognition.

To help address uncertainties in those areas, PricewaterhouseCoopers offers the following perspective on revenue recognition issues unique to motion pictures. This is the second in our ongoing series addressing significant accounting and reporting matters facing companies in the filmed entertainment production and distribution industries. The information should be used as a framework within which to consider the impact of various transactions on a company’s financial reporting process.

An in-depth discussion

Accounting for revenue recognition can be subjective and complex. Are you making the right judgment calls for your business?

The primary starting point for addressing revenue recognition matters (unless other specific authoritative guidance exists) is US Securities and Exchange Commission Staff Accounting Bulletin (SAB) No. 104, “Revenue Recognition” (SAB 104). In the filmed entertainment industry, there is specific authoritative guidance in SOP No. 00-2, “Accounting by Producers or Distributors of Films” (SOP 00-2).

SOP 00-2 requires the recognition of revenue from a sale or licensing arrangement when the following conditions are met.

- Persuasive evidence of a sale or licensing arrangement with a customer exists.
- The film is complete and, in accordance with the terms of the arrangement, has been delivered or is available for immediate and unconditional delivery.
- The license period of the arrangement has begun, and the customer can begin its exploitation, exhibition, or sale.
- The arrangement fee is fixed or determinable.
- Collection of the arrangement fee is reasonably assured.

In addition, a common discussion point in assessing revenue recognition is how each party should account for the reporting of revenues and costs—commonly called “gross” versus “net” accounting which has been addressed in Emerging Issues Task Force (EITF) No. 99-19, “Reporting Revenue Gross as a Principal versus Net as an Agent” (EITF 99-19).

The determination of gross versus net reporting is often important due to the timing of recognition of revenues and related cost amortization and the timing of recognition of advertising expense. Additionally, for companies that place value on such metrics as operating margin, the timing of (or the need to recognize) advertising expense is a relevant consideration in the structuring of transactions.

This edition of *Perspectives* addresses commonly asked questions in these areas. There is also an additional section addressing other common issues for matters related to revenue recognition that do not fit squarely into the five criteria of SOP 00-2 or under the guidance in EITF 99-19.

Persuasive evidence of an arrangement

Are transactions between producers and distributors usually evidenced by signed contracts?

In our experience, the use of signed contracts is a customary business practice in any sales arrangement between a producer and a distributor. The terms of the arrangement usually evidence the key agreement between the parties, such as period of allowable exploitation, holdbacks for various windows, form of compensation (including minimum guarantees), delivery mechanism, and settlement terms.

Can a term sheet or other written documentation between the contracting parties ever be considered evidence of an arrangement?

Sometimes. Occasionally, a final signed contract is not generated to evidence an arrangement. Instead, the producer and the distributor rely on a term sheet to document the key understanding between the parties and the terms of the arrangement. For a term sheet to be considered sufficient evidence of an arrangement, all salient provisions—including period of allowable exploitation, delivery mechanism, form of compensation, timing of payments, and products licensed—must be included. In addition, we believe the producer must have evidence that the parties have actually agreed to the terms. In some cases, we understand that the term sheet may evidence the signatures of both parties and be legally binding. In other cases, the producer may have delivered the licensed product, and the licensee may be paying for the product in accordance with the provisions of the term sheet. This may represent sufficient evidence of the arrangement. However, as the level of evidence of an arrangement moves away from signed contracts, it becomes more challenging to support that it is appropriate to recognize revenue.

Film is complete and available for immediate delivery

How do distribution conditions included in the sales or licensing of episodic television series affect revenue recognition?

There are a variety of methods for delivering content in the filmed entertainment industry. For example, in a syndication arrangement involving a long-running episodic television series, the producer may agree to deliver episodes via a satellite uplink to the licensee on a daily or weekly basis, even though all of the episodes are complete and ready for delivery. In many instances, the producer delivers the completed product on a daily or weekly basis in order to insert the advertisements into the filmed product. The delivery mechanism ensures, from the producer's and licensee's perspective, that the producer's ad spots get properly inserted into the programming.

In an assessment of whether revenue recognition is appropriate, the first part of the criterion is met once the filmed content is complete. However, further consideration is required to determine whether the film is available for immediate and unconditional delivery. As discussed above, the primary business reason for the daily/weekly delivery process is that it enables the producer to insert its national advertisements in the appropriate places in the program prior to delivery. If the producer had provided all of the episodes to multiple licensees, each licensee would need to obtain the national advertising spots from the producer and individually insert them in the appropriate places in the episode. From the producer's perspective, this could lead to problems with the ad insertion process.

Film is complete and available for immediate delivery (continued)

SOP 00-2, paragraph 11, includes the presumption that if the licensing arrangement requires physical delivery of a film or is silent about delivery, that physical delivery is required in order to recognize revenue. Further, SOP 00-2, paragraph 72, acknowledges that there are a variety of delivery mechanisms in the film industry and that revenue recognition is still appropriate even though physical delivery often does not occur upon commencement of the license period. We believe two key considerations need evaluation to determine whether the unconditional-delivery criterion has been met: (1) whether the film requires modification (such as the insertion of advertisements) and (2) the ability to unconditionally deliver the product to the licensee.

SOP 00-2, paragraph 13, discusses certain film modifications that would preclude revenue recognition. Paragraph 13 specifically states that “adjustments to allow for the insertion of commercials are examples of changes to a film that are not significant and do not preclude revenue recognition prior to their completion.” Accordingly, a contractual provision allowing the producer to insert its national advertising spots is not considered a provision that would preclude revenue recognition.

In addition, companies should consider whether the delivery process, agreed to by the producer and the licensee, meets the criterion of “available for immediate and unconditional delivery” under the SOP. The licensee in its arrangement with the producer desires (and has been given) exclusive usage rights to the episodic series in its market over the contractual term. The licensee has acquired the full “basket” of episodes and is not paying individually for any given episode based on past individual episode rating or audience preference for an episode. Although physical delivery may not have occurred, as the agreed-to delivery mechanism benefits both parties, we generally believe the licensor has met the substance of these SOP requirements.

Based on the facts and circumstances presented, we generally believe that revenue recognition is appropriate upon commencement of the license period. However, the terms, conditions, and obligations of each arrangement need to be reviewed carefully. In some instances, the terms of the arrangement—which may include the provision of additional content, requirements to make other significant modifications to the film, or other significant obligations—may preclude immediate recognition upon commencement of the license period.

Does the sale of multiple films or episodic television series impact revenue recognition if some number of the films or episodic television programs are not yet available?

SOP 00-2 defines a cross-collateralized arrangement as one “that grants a licensee distribution rights to multiple films or territories and/or markets to a licensee; and the exploitation results for all applicable films, territories, and/or markets are aggregated by this licensee for purposes of determining amounts payable to the licensor under the arrangement.”

We believe a producer who sells multiple films or television programs should base the allocation of the total consideration to be received for each of the various titles on the relative fair value of each title. Such allocation can be made at contract inception, and we do not believe it is necessary to reevaluate the allocation as subsequent titles become produced and are made available to the licensee. The allocation of revenue on a title-by-title basis is important not only for revenue recognition purposes but also for inclusion of amounts into film ultimates for the determination of film cost amortization.

How is it determined whether changes that need to be made to a film are significant or insignificant?

SOP 00-2, paragraph 13, defines significant changes to a film as those that require a producer to create new or additional content after the film is initially available to a customer. The SOP defines insignificant changes to a film as dubbing, subtitling, removing offensive language, reformatting, and adjustments to allow the insertion of advertisements. Such changes would not preclude revenue recognition prior to their conclusion.

In practice, a product may be acquired by a party with the intent of selling the product into international markets. The costs of dubbing or subtitling may be significant to the overall cost of the product (for example, costing more than 25 percent of the total cost of the product). Accordingly, a question arises regarding whether it would be appropriate for a producer to consider these costs as significant. We believe that a literal reading of SOP 00-2 should be followed and that revenue recognition would not be precluded. In addition, we generally believe that dubbing costs should be expensed as incurred.

License period has begun, and the customer can begin exploitation

How is revenue recognition impacted by contractual provisions that prevent the licensee from exploiting a film for a period of time during the license period in a given market and territory?

We believe the impact on revenue recognition depends on whether the producer licensor has the right to exploit the film in the same market and territory during the blackout period. For example, say that a domestic television network acquires the right to air a film four times in a three-year period, but none of the airings may be during the second year and at least one airing must take place during the third year. If the producer does not have the ability to license the film in the same market and territory during the blackout or refresh period, we believe use restrictions after the initial exploitation period begins do not preclude immediate revenue recognition—per SOP 00-2, paragraph 76.

However, if the producer has the right to license the product in the same market and territory to another licensee in that market and territory during the blackout period (the so-called broken window), we believe there are effectively two license terms, and that revenue should be allocated between the two license periods based on the relative fair value of the rights of each license. From a practical perspective, we understand that in certain cases, the licensee would likely pay less to air the film when the producer retains the right to exploit the title in the same or a similar market during the licensee's exploitation period.

Some episodic television series are licensed to secondary markets with the provision that the contractual term will be extended by one year if subsequent seasons of the show are produced. Such contracts usually include a preestablished license fee if the next season is produced. When is revenue recognition appropriate for these types of contracts?

It depends on the situation. For example, say an episodic television series has produced four seasons by July 2009. Secondary-market syndication arrangements state that the producer will be paid an annual license fee (paid monthly) of \$1.5 million if a fifth season is produced and \$1.8 million if a sixth season is produced. Production of the fifth and sixth seasons will be completed in July 2010 and July 2011, respectively, and will be available to the secondary market licensee in May 2013 and May 2014, respectively. The contract runs on an annual basis from May to April. As the series is available in this situation, we believe the entire license fee for the successive season should be recognized once all of the episodes for that season are produced and the licensee can exploit the product. Accordingly, in May 2013 and May 2014, the producer should recognize revenues of \$1.5 million and \$1.8 million, respectively.

Arrangement fee is fixed and determinable

How should revenue be recognized for the licensing of a film to a counterparty covering multiple markets which includes a minimum guarantee?

It is common in certain international territories for a producer to license a film to a counterparty in several markets, such as theatrical, home video, and television. Such contracts usually have predefined dates when the title can be exploited in each of the markets. Each contract also typically specifies an overall minimum guarantee that may be paid up front or that allocates the guarantee into various components by market, which generally are paid as each market becomes available.

We believe the minimum guarantee should be allocated to each market based on the market's relative fair value. Revenue would be recognized equal to the allocated minimum guarantee for each market when the market is contractually available for exploitation. We understand that many producers perform an assessment of the relative fair value based on their history of prior films in the market and territory and that many producers do not allocate advertising expenditures to any specific window, as that would normally result in the theatrical market having very little fair value. We believe these are acceptable as long as the producer performs a regular evaluation of its estimate to determine whether it remains appropriate.

We also believe that any changes in estimates of the relative fair value percentages should be applied prospectively to new contractual arrangements.

Arrangement fee is fixed and determinable (continued)

How should variable royalties in excess of a fixed minimum guarantee be recognized as revenue? Does recognition of excess variable royalties impact recognition of the amount of revenue to be recognized when the next market becomes available?

In a licensing arrangement, a licensee may commit to pay a minimum nonrefundable license fee up front. The licensor may also include a provision stipulating that the licensor is entitled to a percentage of the licensee's revenues once the variable rate exceeds the amount of the fixed minimum guarantee.

With respect to the nonrefundable fixed minimum guarantee, the associated revenue would be allocated to each market being licensed and would generally be recognized once that market is available for the licensee—presuming all other revenue recognition conditions have been met. With respect to the amounts to be paid by a licensee in excess of any fixed nonrefundable minimum guarantee payments, such revenue would typically be recognized by the producer once the variable fee exceeds the total minimum guarantee.

The following example illustrates revenue recognition in this scenario:

Situation

On January 1, 2010, Studio XYZ (with a fiscal year ending December 31) licenses the theatrical, home video, and television rights of Film A to a customer for a five-year period in return for minimum guarantee of \$10 million. The guarantee is to be paid as follows: \$4 million on theatrical availability (July 1, 2010); \$4 million on home video availability (November 15, 2010); and \$2 million on television availability (September 1, 2011). In addition, the licensee agrees to pay the producer a variable license fee of 10 percent of the licensee's revenues in excess of \$100 million. The licensee agrees to report its revenues to the producer on a quarterly basis. The producer determines that the contractual allocations (via cash payment terms) to each market represent the relative fair value of each market.

Scenario A: The licensee's exploitation of the film does not generate more than \$10 million in variable royalty fees for the producer.

Accounting response: The producer recognizes the relative fair value of the theatrical, home video, and television windows on the date that the licensee can exploit the product. In this example, revenue totalling \$4 million (theatrical), \$4 million (home video), and \$2 million (television) is recognized on July 1, 2010; November 15, 2010; and September 1, 2011, respectively.

Scenario B: The licensee's revenues generate variable royalty fees of \$5 million from the theatrical release; \$6 million from the home video release; and \$2 million from the television release. The following chart reflects the timing of when these fees are reported to the producer:

Timing of variable fees reported by licensee

Period	Theatrical	Home video	Television	Total
Q3 FY 2010	\$ 3	\$ -	\$ -	\$ 3
Q4 FY 2010	2	3	-	5
Q1 FY 2011	-	3	-	3
Q2 FY 2011	-	-	-	-
Q3 FY 2011	-	-	2	2
Total	\$ 5	\$ 6	\$ 2	\$ 13

Arrangement fee is fixed and determinable (continued)

How should revenue be recognized by the producer?

The recognition model for this scenario is as follows:

Period	Fixed license revenue	Variable revenue	Total revenue
Q3 FY 2010 ^(a)	\$ 4	\$ -	\$ 4
Q4 FY 2010 ^(b)	4	-	4
Q1 FY 2011 ^(c)	-	1	1
Q2 FY 2011	-	-	-
Q3 FY 2011 ^(d)	2	2	4
Total	\$ 10	\$ 3	\$ 13

^(a) Fixed license revenues relate to the \$4 million earned by the producer for the theatrical window.

^(b) Fixed license revenues relate to the \$4 million earned by the producer for the home video window.

^(c) Variable revenues relate to the recognition of minimum guarantees by the producer. Because the licensee does not have a legal obligation to pay the producer until total variable royalties exceed the \$10 million minimum guarantee, we believe the licensor may recognize incremental revenue of \$1 million in the first quarter of 2011, when total earned revenues are \$11 million.

^(d) Fixed and variable revenues relate to the television window. Such revenues cannot be recognized until that window is available for exploitation.

Gross versus net revenue reporting

Producers and distributors of motion pictures are often focused on the income statement impact of distribution arrangements. When they negotiate distribution arrangements, certain attributes such as distribution fee, length of the arrangement, prints and advertising risk, and shared investment in a motion picture are important negotiating points. Some of these critical decision factors are also important levers in determining the proper revenue and cost presentation of the results of the film for both the producer and the distributor.

It is our observation that various producers and distributors have different objectives relative to the financial statement presentation of the results of a distribution arrangement. We are aware that some of the major distributors prefer to structure arrangements that yield net accounting, whereas others prefer arrangements that yield gross accounting. The same holds true with independent producers that need a distribution outlet: some desire a net presentation, and others prefer a gross presentation. Accordingly, we are frequently involved in discussions related to gross versus net accounting for distribution arrangements.

As a starting point, we generally believe that the distributor often meets many of the criteria for gross revenue recognition. As an example:

- The distributor usually negotiates and establishes pricing with the exhibitors, home video outlets, and free and pay television networks.
- The distributor is usually considered the primary obligor by each of its customers.
- The distributor usually provides a service through its expertise in distributing motion pictures—including determining the most beneficial marketing campaign, timing the film release, and leveraging its network of customer contacts.

Gross versus net revenue reporting (continued)

On the other side of the equation, we note that credit risk is often shared between the producer and the distributor in proportion to the waterfall of film profits. Additionally, we note that the waterfall of funds collected by the distributor is often allocated to the producer and the distributor via various mechanisms that adjust for the risks of the arrangement between the producer and the distributor. Each of these mechanisms is important to the consideration of gross versus net accounting.

The determination of gross versus net revenue presentation is a matter of judgment that depends on the relevant facts and circumstances. We believe that net reporting by a distributor is generally appropriate only when the distributor bears little or no financial risk in an arrangement, including no significant prints or advertising risk. In other words, the arrangement should generally be a “fee-for-services” arrangement.

To demonstrate some of the financial statement impacts of gross versus net accounting, we present five common arrangements in the motion picture industry and our views with respect to the proper treatment for each.

Arrangement 1 — Rent-a-system deals

The distributor earns a fee for distributing the film, collects the cash, and is reimbursed first for its distribution fee and then for any prints and ads costs advanced. The producer of the film guarantees that if the gross revenues minus the distribution fee are less than the amount the distributor advanced for prints and ads, then the producer will reimburse the distributor for the shortfall.

Accounting by the distributor: We believe that the distributor should account for this film on a *net* basis. By *net* basis, the distributor only records their distribution fee as revenue. Additionally, any amounts advanced for prints and ads should be recorded as a receivable from the producer and not expensed as incurred. An assessment of collectability of a receivable would need to be made at each reporting period. We believe that *net* reporting is appropriate because the distributor bears limited financial risk in this arrangement. The distributor's financial risk is limited to collectability risk from the producer for any prints and ads costs advanced in a situation where the film performs so poorly that the gross revenues are not sufficient to reimburse the distributor.

Accounting by the producer: We believe that the producer should account for this film on a *gross basis*. By *gross basis*, we mean that the producer records the total gross revenues and then records a distribution fee expense for amounts owed to the distributor. Additionally, any amounts advanced by the distributor for prints and ads should be recorded as an expense of the producer and a payable to the distributor in the period incurred. Negative costs recorded as an asset on the producer's books would be amortized by using the individual film forecast method.

Gross versus net revenue reporting (continued)

Arrangement 1 – Rent-a-system deals

Producer of the film guarantees that if the gross revenues minus the distribution fee are less than the amount advanced for prints and ads by the distributor then the producer will reimburse the distributor for the shortfall. For example, presume the producer creates a film that costs \$150. The distributor earns a 10% distribution fee. The film earns revenues of \$225, \$150, \$90, and \$35 in Year 1, Year 2, Year 3, and Year 4, respectively over the ultimate period. Print and ad costs are \$105, \$30, \$10 and \$5 in Year 1, Year 2, Year 3, and Year 4, respectively.

	Year 1	Year 2	Year 3	Year 4	Total
Accounting by the distributor: Net					
Distribution fee income	\$ 22.5	\$ 15.0	\$ 9.0	\$ 3.5	\$ 50.0
Costs ^(a)	-	-	-	-	-
Operating income	\$ 22.5	\$ 15.0	\$ 9.0	\$ 3.5	\$ 50.0
Accounting by the producer: Gross					
Revenues	\$ 225.0	\$ 150.0	\$ 90.0	\$ 35.0	\$ 500.0
Distribution fee expense	(22.5)	(15.0)	(9.0)	(3.5)	(50.0)
Prints and ads ^(a)	(105.0)	(30.0)	(10.0)	(5.0)	(150.0)
Film cost amortization ^(b)	(67.5)	(45.0)	(27.0)	(10.5)	(150.0)
Total costs	(195.0)	(90.0)	(46.0)	(19.0)	(350.0)
Operating income	\$ 30.0	\$ 60.0	\$ 44.0	\$ 16.0	\$ 150.0

^(a) Costs for prints and ads are not recorded by the distributor as an expense because of the guarantee from the producer. Payments for prints and ads are recorded as a receivable from the producer.

^(b) Calculated as producer's revenues in the current period to total estimated remaining producer's revenues as of the beginning of the year multiplied by unamortized film costs as of the beginning of the year.

Arrangement 2—Distribution deals (without a minimum guarantee to the producer)

The distributor earns a distribution fee for distributing the film, collects the cash, and is reimbursed first for its distribution fee and then for any prints and ads costs incurred. The distributor of the film has risk of loss to the extent that the gross revenues are less than the amount the distributor advanced for prints and ads. The producer earns revenues to the extent that gross revenues exceed the amount the distributor advanced for prints and ads and the distribution fee. The producer is at risk only for the negative costs of the film.

Accounting by the distributor: The distributor should account for its contractual rights and obligations for this film on a gross basis under the provisions of SOP 00-2. Gross revenues from all markets and territories in which the distributor is contractually obligated to distribute the motion picture will be recorded as revenues once all of the criteria of SOP 00-2 have been met. Amounts spent for prints and ads will be expensed as incurred. The payment to the producer (gross revenues minus the distribution fee and minus the costs for prints and ads) will be considered a participation cost payment and will be accounted for under SOP 00-2, paragraph 34. In this manner, the total estimated participation costs during the ultimates period will be expensed based on the ratio of current period actual revenues to estimated total unrecognized revenue during the ultimates period.

Accounting by the producer: The producer should account for this arrangement on a net basis. Gross revenues minus the distribution fee and minus the costs for prints and ads paid for by the distributor would be accounted for as revenues. Note that only the prints and ads costs incurred by the distributor to the reporting date would reduce revenues. Negative costs would be amortized by using the individual film forecast method. The revenues used in the numerator and denominator of the calculation would be based on the actual and expected revenues from the producer's perspective and not on the actual and expected revenues from the distributor's perspective. In other words, the producer would not gross up its revenues and costs for the distributor's distribution fees and costs of prints and ads in applying the individual film forecast method.

Gross versus net revenue reporting (continued)

Arrangement 2—Distribution deals (without minimum guarantee to producer)

Distributor of the film is responsible for payment of prints and ads costs therefore the distributor has risk of loss to the extent that the gross revenues are less than the amount advanced for prints and ads by the distributor. For example, presume the producer creates a film that costs \$150. The distributor earns a 10% distribution fee. The film earns revenues of \$225, \$150, \$90, and \$35 in Year 1, Year 2, Year 3, and Year 4, respectively over the ultimate period. Print and ad costs are \$105, \$30, \$10 and \$5 in Year 1, Year 2, Year 3, and Year 4, respectively.

	Year 1	Year 2	Year 3	Year 4	Total
Accounting by the distributor: Gross					
Revenues	\$ 225.0	\$ 150.0	\$ 90.0	\$ 35.0	\$ 500.0
Prints and ads	(105.0)	(30.0)	(10.0)	(5.0)	(150.0)
Participation to producer ^(a)	(135.0)	(90.0)	(54.0)	(21.0)	(300.0)
Total costs	(240.0)	(120.0)	(64.0)	(26.0)	(450.0)
Operating income	\$ (15.0)	\$ 30.0	\$ 26.0	\$ 9.0	\$ 50.0
Accounting by the producer: Net					
Revenues ^(b)	\$ 97.5	\$ 105.0	\$ 71.0	\$ 26.5	\$ 300.0
Film cost amortization ^(c)	(48.8)	(52.5)	(35.5)	(13.2)	(150.0)
Operating income	\$ 48.7	\$ 52.5	\$ 35.5	\$ 13.3	\$ 150.0

^(a) Total participation to the producer is \$300 (\$500 revenue less \$50 distribution fee and \$150 prints and ads). Amount is calculated as current period distributor revenues divided by total remaining distributor revenues multiplied by remaining participation costs.

^(b) Calculated as distributor's revenues less distribution fee less prints and ads.

^(c) Calculated as producer's revenues in the current period to total estimated remaining producer's revenues as of the beginning of the year multiplied by unamortized film costs as of the beginning of the year.

Arrangement 3—Distribution deals (with a minimum guarantee to the producer)

The distributor earns a distribution fee for distributing the film and advances the producer a substantial fee, which is nonrefundable to the distributor. The distributor of the film has risk of loss to the extent that the gross revenues are less than the sum of the amount the distributor paid for prints and ads and the nonrefundable guarantee. The producer earns the minimum guarantee and earns revenues to the extent that gross revenues exceed the sum of (1) the amount the distributor paid for prints and ads, (2) the amount paid as a guarantee, and (3) the distributor's fee. The producer is at risk only for its negative costs in the film that are not "paid" for by the initial advance made by distributor.

Accounting by the distributor: The distributor should account for its contractual rights and obligations for this film on a gross basis under the provisions of SOP 00-2. Gross revenues from all markets and territories in which the distributor is contractually obligated to distribute the motion picture will be recorded as revenues once all of the criteria of SOP 00-2 have been met. Amounts spent for prints and ads will be expensed as incurred. The nonrefundable advance to the producer for the right to distribute the film will be capitalized by the distributor (similar to negative costs) and amortized by using the individual film forecast method. Additional payments to the producer (gross revenues minus the distribution fee, the nonrefundable advance, and prints and ads costs) will be considered participation cost payments. In this manner, the total estimated participation costs during the ultimates period will be expensed based on the ratio of current-period actual revenues to estimated total unrecognized revenue during the ultimates period.

Accounting by the producer: The producer should account for this arrangement on a net basis. Revenues exceeding the nonrefundable guarantee would be accounted for as revenues when earned. Negative costs would be amortized by using the individual film forecast method. The revenues used in the numerator and the denominator of the calculation would be based on the actual and expected revenues from the producer's perspective and not on the actual and expected revenues from the distributor's perspective. In other words, the producer would not gross up its revenues and costs for the distributor's distribution fees and costs of prints and ads in applying the individual film forecast method.

Gross versus net revenue reporting (continued)

Arrangement 3—Distribution deals (with a minimum guarantee to producer)

Distributor of the film is responsible for payment of prints and ads costs therefore the distributor has risk of loss to the extent that the gross revenues are less than the amount advanced for prints and ads by the distributor and the nonrefundable guarantee. For example, presume the producer creates a film that costs \$150. The distributor earns a 10% distribution fee and pays the producer an upfront nonrefundable minimum guarantee of \$200. The film earns revenues of \$225, \$150, \$90, and \$35 in Year 1, Year 2, Year 3, and Year 4, respectively over the four year ultimate period. Print and ads costs are \$105, \$30, \$10 and \$5 in Year 1, Year 2, Year 3, and Year 4, respectively.

	Year 1	Year 2	Year 3	Year 4	Total
Accounting by the distributor: Gross					
Revenues	\$ 225.0	\$ 150.0	\$ 90.0	\$ 35.0	\$ 500.0
Prints and ads	(105.0)	(30.0)	(10.0)	(5.0)	(150.0)
Film cost amortization (Minimum guarantee) ^(a)	(90.0)	(60.0)	(36.0)	(14.0)	(200.0)
Participation to producer ^(b)	(45.0)	(30.0)	(18.0)	(7.0)	(100.0)
Total costs	(240.0)	(120.0)	(64.0)	(26.0)	(450.0)
Operating income	\$ (15.0)	\$ 30.0	\$ 26.0	\$ 9.0	\$ 50.0
Accounting by the producer: Net					
Revenues ^(c)	\$ -	\$ 2.5	\$ 71.0	\$ 26.5	\$ 100.0
Minimum guarantee ^(d)	200.0	-	-	-	200.0
Total revenues	200.0	2.5	71.0	26.5	300.0
Film cost amortization ^(e)	(100.0)	(1.3)	(35.5)	(13.2)	(150.0)
Operating income	\$ 100.0	\$ 1.2	\$ 35.5	\$ 13.3	\$ 150.0

^(a) Film cost amortization (minimum guarantee) is recorded as current period distributor revenues divided by total remaining distributor revenues multiplied by remaining film cost.

^(b) Total participation to the producer is \$100 (\$500 revenue less \$50 distribution fee, \$150 prints and ads and \$200 minimum guarantee). Amount is recorded as current period distributor revenues divided by total remaining distributor revenues multiplied by remaining participation costs.

^(c) Once cumulative distributor revenue exceeds cumulative distribution fees, cumulative prints and ads and the minimum guarantee, the producer records that net excess as revenue.

^(d) Example assumes the minimum guarantee relates entirely to the theatrical market. If the minimum guarantee covers multiple markets, such amount should be allocated between these markets and recognized when those markets are available.

^(e) Calculated as producer's revenues in the current period to total estimated remaining producer's revenues as of the beginning of the year multiplied by unamortized film costs as of the beginning of the year.

Arrangement 4—Purchase of domestic or selected foreign rights

The distributor/owner earns all gross revenues from the market/territory that it has the right to exploit. The distributor/owner of the film has risk of loss to the extent that the gross revenues are less than the sum of the amount the distributor paid for prints and ads and the amount paid to the producer of the film. There is no net-income-sharing arrangement with the producer. The producer receives payment from the distributor for sale of the selected markets and territories.

Accounting by the distributor: The distributor should account for its contractual rights to exploit this film in a given market or territory on a gross basis in accordance with SOP 00-2. Gross revenues received from all markets and territories acquired from the producer for the film will be recorded as revenues once all of the criteria of SOP 00-2 have been met. Amounts spent for prints and ads will be expensed as incurred. The amount paid to the producer to acquire the rights will be capitalized and amortized by using the individual film forecast method.

The arrangement results in the distributor having an “ownership interest” in the film for selected market or territories. The distributor bears all of the financial risk for the acquired markets or territories. In this arrangement, the distributor is able to establish all of the terms of any transactions it enters into with exhibitors. Additionally, the distributor/owner does not share its results with the producer or any other party.

Accounting by the producer: These arrangements are typically called *presales*. A presale arrangement involves the sale of exploitation rights in certain markets or territories to a distributor. The distributor generally earns its own cash flows based on its distribution efforts in the acquired markets or territories.

Sometimes a question arises as to whether the payment received by the producer should be recorded as (1) a reduction of production costs or (2) deferred revenues. For a presale to be recorded by a producer as a reduction of production costs, the distributor should be investing in the film early in the production process—for example, prior to principal photography. In such instances, the counterparty is effectively involved in the “funding” of the film, and its investment would appropriately be reflected as a reduction in film costs.

If the distributor acquires distribution rights once the film is complete or substantially complete, the transaction is more akin to a revenue transaction because the distributor is acquiring rights in a complete or near-complete film. Accordingly, in these situations, we believe the proceeds received should be recorded as deferred revenue by the producer. Those proceeds will be recognized as revenue once the film becomes available for exploitation by the distributor and once the other criteria for revenue recognition in SOP 00-2 have been met.

Gross versus net revenue reporting (continued)

Arrangement 4—Purchase of international rights

For example, presume the producer creates a film that cost \$150. The producer sells all domestic rights to the film for four years to a distributor for an upfront fee of \$75. The distributor earns revenues of \$75, \$75, \$40, and \$10 in Year 1, Year 2, Year 3, and Year 4, respectively and incurs prints and ads expense of \$55, \$20, \$5, and \$0, respectively. Distributor/owner of the film's international rights has risk of loss to the extent that the gross revenues are less than the sum of the amount paid for prints and ads by the distributor and the amount paid to the producer of the film. The distributor/owner does not share in its results with the producer or any other party.

	Year 1	Year 2	Year 3	Year 4	Total
Accounting by the distributor					
Revenues	\$ 75.0	\$ 75.0	\$ 40.0	\$ 10.0	\$ 200.0
Prints and ads	(55.0)	(20.0)	(5.0)		(80.0)
Film cost amortization ^(a)	(28.1)	(28.1)	(15.0)	(3.8)	(75.0)
Total costs	(83.1)	(48.1)	(20.0)	(3.8)	(155.0)
Operating income	\$ (8.1)	\$ 26.9	\$ 20.0	\$ 6.2	\$ 45.0

^(a) Film cost amortization (upfront fee) is recorded as current period distributor revenue divided by total remaining distributor revenues multiplied by remaining film costs

Scenario A: Accounting by the Producer—Arrangement Entered Prior to Principal Photography. The \$75 received for the domestic rights would be treated as a reduction to film costs. Revenues and expenses associated with other markets (e.g. domestic markets) would be recognized by the producer based on SOP 00-2. The remaining film cost (\$150 total film cost less \$75 for international rights) will be amortized using revenues and ultimates associated with the domestic market only.

Scenario B: Accounting by the Producer—Arrangement Entered When Film is Complete. The \$75 received for the domestic rights would be treated as deferred revenue. Such amount would be allocated based on the relative fair value of the rights among each market (e.g. theatrical, home video, television) and recognized only when the film can be exploited in each market. The film cost will be amortized using the producer's revenues in the current period to total estimated remaining producer's revenues as of the beginning of the year multiplied by unamortized film costs as of the beginning of the year.

Arrangement 5—Split-pot arrangement

Studio A and Studio B agree to jointly participate in the production and distribution of a major motion picture. The economics of the arrangement will be evidenced by a contractual arrangement between the parties and not through ownership of equity interests in legal entities. Studio A will manage the day-to-day production activities and will be responsible for distribution in North America. Studio B will be responsible for the international distribution. Under the arrangement, Studio A and Studio B will equally share in the production costs incurred. Studio A will pay Studio B 50 percent of the net profits from North American distribution, and Studio B will pay Studio A 50 percent of the net profits from international distribution. The studios are each responsible for all distribution costs in their respective locations. On a quarterly basis each Studio will provide to the other party the financial information relating to the production and distribution activities as well as any payments due under the terms of the contractual arrangement.

Evaluation

This arrangement is a collaborative arrangement, as covered by EITF 07-01 “Accounting for Collaborative Arrangements.” Both parties are active participants in the arrangement and are exposed to significant risks and rewards that depend on the ultimate success of the arrangement.

Accounting by Studio A and B: Studios A and B should account for this film on a *gross* basis for the markets and territories in which each studio will distribute the film, in accordance with SOP 00-2. Revenues received from distribution in each market and territory will be recorded as revenue once all of the revenue recognition criteria of SOP 00-2 have been met. For the respective markets and territories, each studio will recognize, on a gross basis, its prints and ads costs as incurred. Each studio’s share of the negative costs will be capitalized and amortized by using the individual film forecast method.

Gross versus net revenue reporting (continued)

A practical consideration is the accounting for the sharing of payments between Studio A and Studio B. We note that SOP 00-2, paragraph 92, specifically states that “the accounting for co-production and co-financing arrangements is based on facts, circumstances and contractual arrangements.”

Accordingly, consistent with EITF 07-1, paragraph 18, Studio A and Studio B should follow a reasonable, rational, and consistently applied accounting policy for the payments made between the studios. We understand that in practice there are at least two common methods of accounting for net profit sharing. One method is to record the estimated net amount due to, or due from, the other studio as a participation cost through a charge or credit to cost of sales—a “participation model.”

Another method is for the net receiver to record the estimated net receipt as revenue and the net payer to record the estimated net payment as a participation cost. If Studio A is the net payer, the estimated net participation payment would be recorded as a participation cost through cost of sales. If Studio B is the net receiver, the estimated net amount to be received would be recorded as revenue when earned in accordance with paragraph 7 of SOP 00-2—a “revenue model.”

The accounting policy for split-pot arrangements should be disclosed if it is material to the financial statements. The following examples highlight these two alternatives.

Split pot arrangements

Studio A and Studio B agree to coproduce a motion picture. Studio A and Studio B agree to equally share the production costs of \$150. Studio A will distribute the motion picture in North America and Studio B will handle international distribution. Studio A and Studio B agree to make quarterly payments to each other for 50% of each studio's net profit. Net profit is defined as revenues less a 10% distribution fee and less the cost of print and ads. The film is released "day and date" on a worldwide basis.

Studio A—North America		Studio B—International	
Projected revenues	\$ 200	Projected revenues	\$ 300
Distribution fee	(20)	Distribution fee	(30)
Prints and ads	(80)	Prints and ads	(70)
Net income	\$ 100	Net income	\$ 200

Based on the above, Studio A expects to receive a net payment of \$50 $((100+200) \cdot .5) - 100$ from Studio B. Each studio makes a profit sharing payment to the other on a quarterly basis.

Gross versus net revenue reporting (continued)

Approach 1 — Studio A and Studio B record sharing payment on a participation model in cost of sales

Studio A

	Year 1	Year 2	Year 3	Year 4	Total
Revenues	\$ 75.0	\$ 75.0	\$ 40.0	\$ 10.0	\$ 200.0
Prints and ads	(55.0)	(20.0)	(5.0)	-	(80.0)
Participation—amount due from Studio B ^(a)	18.8	18.7	10.0	2.5	50.0
Film cost amortization	(28.1)	(28.1)	(15.0)	(3.8)	(75.0)
Total costs	(64.3)	(29.4)	(10.0)	(1.3)	(105.0)
Net income	\$ 10.7	\$ 45.6	\$ 30.0	\$ 8.7	\$ 95.0

Studio B

	Year 1	Year 2	Year 3	Year 4	Total
Revenues	\$ 150.0	\$ 75.0	\$ 50.0	\$ 25.0	\$ 300.0
Prints and ads	(50.0)	(10.0)	(5.0)	(5.0)	(70.0)
Film cost amortization	(37.5)	(18.7)	(12.5)	(6.3)	(75.0)
Participation—amount owed to Studio A ^(a)	(25.0)	(12.5)	(8.3)	(4.2)	(50.0)
Total costs	(112.5)	(41.2)	(25.8)	(15.5)	(195.0)
Net income	\$ 37.5	\$ 33.8	\$ 24.2	\$ 9.5	\$ 105.0

Note: Any differences between payments made or received and amounts recognized in the income statements should be reflected as a receivable or payable from the other studio.

^(a) The sharing payment of \$50 is recorded by each studio ratably over the respective studio's revenues and is reflected in cost of sales.

Approach 2—Studio B accrues amount owed under a participation model and Studio A records amount earned under a revenue model sharing payments

Studio A

	Year 1	Year 2	Year 3	Year 4	Total
Revenues	\$ 75.0	\$ 75.0	\$ 40.0	\$ 10.0	\$ 200.0
Revenues—amount due from Studio B	36.3	5.0	4.5	4.2	50.0
Total revenues	111.3	80.0	44.5	14.2	250.0
Prints and ads	(55.0)	(20.0)	(5.0)		(80.0)
Film cost amortization	(33.3)	(24.0)	(13.5)	(4.2)	(75.0)
Total costs	(88.3)	(44.0)	(18.5)	(4.2)	(155.0)
Operating income	\$ 23.0	\$ 36.0	\$ 26.0	\$ 10.0	\$ 95.0

Calculation of revenues—amounts due from Studio B

Cumulative net income—Studio A

	Year 1	Year 2	Year 3	Year 4
Revenue (excluding Studio B payment)	\$ 75.0	\$ 150.0	\$ 190.0	\$ 200.0
Distribution fee	(7.5)	(15.0)	(19.0)	(20.0)
Prints and ads	(55.0)	(75.0)	(80.0)	(80.0)
Total Studio A cumulative income as defined	\$ 12.5	\$ 60.0	\$ 91.0	\$ 100.0

Cumulative net income—Studio B

	Year 1	Year 2	Year 3	Year 4
Revenue (excluding Studio A payment)	\$ 150.0	\$ 225.0	\$ 275.0	\$ 300.0
Distribution fee	(15.0)	(22.5)	(27.5)	(30.0)
Prints and ads	(50.0)	(60.0)	(65.0)	(70.0)
Total Studio B cumulative income as defined	85.0	142.5	182.5	200.0
Amount owed to Studio B—cumulative ^(a)	36.3	41.3	45.8	50.0
Revenue to Studio A ^(b)	\$ 36.3	\$ 5.0	\$ 4.5	\$ 4.2

^(a) Calculated as cumulative income as defined from Studio A and B divided in half less Studio A cumulative income.

^(b) Calculated as incremental sharing payment.

Other common issues

Are the revenue recognition criteria for merchandise licensing revenue from motion picture–related products covered by SOP 00-2? Or are they covered by SAB 104?

We generally believe SAB 104 covers revenue recognition criteria for merchandise licensing revenues earned from a motion picture. We noted that SAB 104 would generally allow for a variety of revenue recognition patterns (including, among others, immediate recognition or straight line recognition) depending on the terms of the transaction and the accounting policies of the enterprise.

When should revenue from licensing arrangements be included in ultimate revenue?

Inclusion of licensing revenue in a motion picture's ultimate revenue can be a challenging issue. The following examples illustrate various scenarios and address unique revenue recognition considerations as well as address the amount to be included in ultimate revenues.

Scenario A: A producer enters into a licensing arrangement with a quick-service restaurant to license on its children's-meal box the characters from a soon-to-be-released motion picture. Exploitation of the characters by the quick-service restaurant begins two weeks before theatrical release of the motion picture and ends six weeks after theatrical release.

Accounting response: From a revenue recognition perspective, an interesting consideration is whether revenue can be recognized prior to the release date of the motion picture, as the quick-service restaurant has the right to exploit the characters prior to initial theatrical release. Because we believe the producer has an obligation to release the motion picture, we do not believe revenue from the license arrangement should be recognized by the producer prior to the film's release.

Because the arrangement is closely linked to the soon-to-be-released motion picture, we would generally believe that the revenue should be included in ultimate revenues.

Scenario B: A producer has existing license arrangements involving characters in its intellectual property library. The license arrangement was entered into without specific consideration for the creation of a related firm. The producer then creates a motion picture involving characters that reside in its intellectual property library.

Accounting response: We generally believe it would be inappropriate to include an allocation of revenues earned from contracts that predated the motion picture in its estimate of ultimate revenues. In addition, we believe that judgment is required to determine what revenues to include in ultimate revenues when licensing contracts are entered into at the same time as the production and release of a motion picture and when such licensing contracts include the rights to exploit content used in the release. For example, a large, blockbuster-type film may mount an overall marketing campaign that includes the production and sale of toys specific to the film. In such instances, we would consider it reasonable to include revenues from the toy contracts in ultimate revenues. In instances when such revenues are included in the ultimate revenues, judgment would also be required to determine the extent to which license renewals or extensions would also be included in the ultimate revenue estimate.

Scenario C: A producer creates a motion picture with new characters and simultaneously enters into a licensing arrangement with a third party to produce and sell toys of the characters tied to the motion picture. The motion picture is a box office success and the initial one-year licensing contract is extended to five years.

Accounting response: We believe that expected licensing revenues earned from contracts related to the overall exploitation strategy for the motion picture should be included in ultimate revenues. The subsequent renewals of license contracts involving the characters will be subjective, because at some point, the characters will evolve from being film specific to being part of the producer's library of intellectual property. Accordingly, we believe a producer has significant discretion in this area. We also believe the producer should select an accounting policy and follow it on a consistent basis.

What this means for your business

Financial executives adept at navigating revenue recognition rules will be key in the development of contractual agreements to ensure that operational and financial objectives are met.

As the film industry evolves, revenue recognition will continue to pose new accounting challenges for film companies. Financial executives who become adept at navigating the intricate accounting and reporting rules will be able to drive the presentation of key performance indicators for their studios.

The accounting rules for revenue recognition, which often require significant management judgment, are among the most complex in accounting principles to apply. Companies in the film industry frequently find it difficult to navigate the application of these principles while attempting to reflect the economics underlying the deal in the financial reporting process. Understanding the dynamics that affect revenue recognition conclusions will greatly mitigate the risks and provide financial executives with an opportunity to ensure that deal terms are appropriately evaluated prior to execution and that the financial results can be forecast in a more precise manner.

PricewaterhouseCoopers professionals have significant experience in dealing with these, and many other, issues unique to the entertainment and media industry. Our perspectives on these issues, including practical insights, have been gained from years of direct personal experience assisting clients navigate the often difficult challenges they face. We offer these perspectives as a framework to help your business successfully manage in a complex world. However, the authoritative literature in this area continues to emerge as the Financial Accounting Standards Board and the International Accounting Standards Board currently have an ongoing project with the objectives of (1) clarifying the principles for recognizing revenue and (2) creating a joint revenue recognition standard for use both in the United States and internationally. Any new standard may have a significant effect on the perspectives presented in this document.

Future documents in this series will cover other matters unique to motion pictures, including distribution arrangements, cost capitalization, and amortization considerations, as well as matters unique to acquired programming rights.

This document describes PricewaterhouseCoopers' perspectives with respect to the application of accounting and/or auditing literature to an actual or hypothetical situation. The examples and corresponding conclusions reached are based on the specific facts and circumstances of a particular situation and were reached in the context of the professional literature existing at the time. Caution should be exercised in analogizing to any specific situation the conclusions discussed. This document should not be relied on as the sole source of information leading to a decision on a significant accounting, auditing, and/or SEC matter. Rather, the information in this document should be considered only in conjunction with a review of current authoritative literature, together, where appropriate, with direct consultation with an independent accounting firm.

This edition of *Perspectives* is the second in a series.
Upcoming editions in 2009 will cover the following:

Film Cost Capitalization, Amortization, and Impairment

Acquired-Programming Rights

The prior edition of *Perspectives* covered
Film-Financing and Passive Investor Arrangements

You can view this edition as well as previous editions
at www.pwc.com/EMCPerspectives.

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