

Entertainment, Media & Communications Industry

Perspectives*

Filmed entertainment: cost capitalization, amortization,
and impairment

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Financial executives who are adept at navigating the intricate accounting and reporting rules will be able to drive the presentation of the key performance indicators for their companies.

The heart of the matter

Many challenging issues are involved in accounting for film assets. Have financial executives contemplated all of the key reporting considerations?

The motion picture industry has a long history of seeking to maximize the returns on investments made in feature films and episodic television series.

Escalating production and marketing costs continue to increase the financial risks associated with the production and distribution of motion pictures. Production studios continue to seek ways of minimizing production costs and overall investment in films by leveraging tax incentives, film financing structures, and new revenue opportunities.

Because the production of motion pictures and episodic television series requires significant upfront investment, cost mitigation activities are as important as revenue enhancement strategies to achieve desired returns on investments. Factors that directly affect the overall economics of the project include decisions to produce the content in a tax jurisdiction that provides real economic incentives. Further, many management judgments and estimates influence overall project economics and return-on-investment analyses, such as allocation of overhead costs and overall deals.

To help address uncertainties in this area, PricewaterhouseCoopers offers perspectives on significant accounting and reporting matters that face companies in the filmed entertainment production and distribution industries. This paper focuses on matters related to the production, amortization, and impairment of film assets. The information provides a framework which considers the impact of various transactions on your company's financial reporting process.

An in-depth discussion

Many critical considerations are involved in the capitalization, amortization, and impairment of produced film assets. Have you achieved your company's financial reporting objectives?

The capitalization, amortization, and impairment of motion picture productions often requires financial executives to make meaningful estimates and careful judgments that can have significant impact on reported financial results.

Navigating those matters can be challenging, particularly because the primary accounting standard that governs the accounting for motion pictures—Accounting Standards Codification (ASC) 926—*Entertainment—Films* (previously SOP 00-2, *Accounting by Producers and Distributors of Motion Pictures*), offers little interpretive guidance.

The key accounting policies associated with film cost assets are as follows.

Capitalized costs include expenditures for bringing a film or television production to market and consist of direct negative costs, including production overhead costs, and capitalization-of-interest costs.

Cost amortization is based on the use of the individual-film-forecast method. ASC 926 includes guidance specific to film and episodic television series for assessing which revenue streams can be included in ultimate revenues.

Impairment assessment is performed when an event or change in circumstance indicates that the unamortized capitalized costs of a film or an episodic television series may exceed its fair value. Any write-off is calculated as the amount by which the unamortized capitalized costs exceed the fair value.

These policies seem quite simple when put into this basic format. However, in practice, many complex issues arise to challenge financial executives.

This issue of *Perspectives* is presented in four sections to address certain common matters associated with capitalization of film costs, amortization of film costs, impairment of film costs, and purchase accounting matters unique to film costs.

Capitalization of film costs

For development costs, what is meant by the expression set for productions within three years of the first capitalized transaction?

The accounting rules acknowledge that projects to produce content can include significant expenditures in the development stage, including those to acquire intellectual property such as film rights to books or original screenplays. And there can be the additional cost of adaptation to serve as the basis for production of the film. Often, these preproduction expenditures can be considerable.

The film accounting principles indicate that such development costs would be written off if the project has not been green-lit, or set for production, within three years of the date of initial cost capitalization. The set-for-production milestone would typically include establishment of a filming and release schedule, identification of a director and talent, and management's intent and ability to produce and release the film.

When does the three-year development cycle begin?

The film accounting principles indicate that the three-year development cycle begins with capitalization of the first costs related to a project. Some studios question when the three-year window commences—particularly when the first capitalized production costs are de minimis to the production entity and when more significant development spending occurs a year or more after these initial expenditures. Accordingly, we have observed that some studios have established accounting policies that set a dollar threshold for initial capitalization of the costs of a new project in order to prevent premature commencement of the three-year window. If such a policy is selected, any spending prior to the commencement of the three-year clock is, in theory, not a development cost and should likely be expensed.

How does the three-year rule apply to feature animation, which usually has a longer development cycle?

For feature animation, the development activities associated with story acquisition, idea formulation, storyboarding, and initial character rendering and design can often take longer than three years. A literal application of the three-year rule would often lead to the write-off of the animated development project while the animated development cycle remains ongoing.

There has been a significant increase in the number of studios producing high-quality feature animations. We believe that the film accounting principles did not contemplate the operational realities related to the development of feature animation. Accordingly, if management has created and committed to a plan to continue development of the animated project and is actively working and funding the project, we believe the presumption that the fair value of the animated project is zero may be refuted. That determination is often based on the specific facts and circumstances of the feature animation project.

What type of evidence is necessary to rebut the presumption that a project will be abandoned after three years and, accordingly, that its fair value is greater than zero?

In instances when development activities will continue, strong positive evidence such as the following would generally be necessary to rebut the presumption that the project's fair value is greater than zero.

- Senior management's review and approval of project
- Identification of key positions such as director and lead actors
- Financing for project is in place
- Direct relationship of the project to another existing finished or in-process project
- Project timeline is in place and film development is meeting key deadlines

Capitalization of film costs (continued)

What methods are acceptable for recording write-offs of development costs?

Throughout the preproduction process, management must continually assess capitalized projects to determine whether an impairment may exist. There are several methods of recording write-offs of development costs, including specific identification and the recognition of reserves based on historical write-off history.

Under the specific-identification model, a company records a write-down of development costs when it determines that it is probable that a capitalized project has become impaired. This normally occurs near the end of the three-year window, but it can occur earlier if the studio determines that the project will not be set for production.

The reserve method acknowledges that most production entities have histories of development spending and are able to track the population of projects that ultimately are set for production. Accordingly, some studios record an estimate of the percentage of production costs that would be written off based on historical results. A reserve is recorded ratably against production spending to reflect the estimated write-offs in each fiscal quarter.

We generally believe that both approaches are acceptable and that the selection of an approach is an accounting policy election that should be followed consistently, with appropriate disclosure in the financial statements if such disclosure is material.

The following example illustrates the two methods for reserving film costs. In this example, Studio XYZ has planned development spending as follows.

Year ending December 31, 2009		Year ending December 31, 2010		Year ending December 31, 2011	
Project A	\$ 50	Project C	\$ 70	Project E	\$ 80
Project B	\$ 50	Project D	\$ 50		-
Total	\$100	Total	\$120	Total	\$ 80

Normally, Studio XYZ makes a final decision—in the quarter prior to the three-year period ending—on whether a development project will be set for production. Also, Studio XYZ has historical experience indicating that only 67% of its development costs will be set for production. In this example, Project A is set for production in 2011 and Project C is set for production in 2013. Last, no additional development spending is expected to occur in subsequent years other than the aforementioned. The balance sheet movements for Studio XYZ are as follows.

Capitalization of film costs (continued)

Specific identification method

	2009	2010	2011	2012	2013
Beginning development asset	-	100	220	250	200
Additions to development costs	100	120	80	-	-
Expensed in income statement	-	-	-	(50)	(50)
Set for production (transfer to film costs)	-	-	(50)	-	(70)
Ending development asset	100	220	250	200	80

Reserve method

	2009	2010	2011	2012	2013
Beginning development asset	-	67	147	150	150
Additions to development costs	100	120	80	-	-
Expensed in income statement ¹	(33)	(40)	(27)	-	-
Set for production (transfer to film costs)	-	-	(50)	-	(70)
Ending development asset	67	147	150	150	80

¹ Expensed in the income statement based on 33% of current-year additions to development. Such percent is consistent with Studio XYZ's historical experience that only 67% of its development costs will be set for production.

What costs should be included in the production overhead allocation?

While it is clear that production overhead is a component of film costs, the identification of costs which qualify for capitalization requires careful judgment. There is diversity in practice on what is considered overhead depending on the studio's size, organizational structure, and operating practices. Film accounting principles define production overhead as the "costs of individuals or departments with exclusive or significant responsibility for the production of films." In other words, labor and overhead elements closely aligned with and related to production activities should be capitalized.

Based on our experiences, the following activities and costs are generally not considered capitalizable as components of an overhead pool.

- Costs associated with corporate management, such as the compensations of the chief financial officer and other non-production-related senior management members, because such costs are considered general and administrative
- Marketing expenses, selling expenditures, and distribution costs
- Costs associated with overall deals
- Costs associated with impairments recorded in connection with current or prior film projects
- Other costs not directly or indirectly attributable to such production activities as accounting and human resources functions

Additionally, stock-based compensation associated with employees included in the production overhead should be considered in the pool of capitalized costs similar to the cash compensations paid to employees.

Capitalization of film costs (continued)

How should interest be capitalized to a particular film?

Accounting principles require studios to account for interest costs related to the production of a film in accordance with ASC 835-20, *Capitalization of Interest Costs*. Capitalization of interest costs should generally commence when a film is set for production and end when a film is substantially complete and ready for distribution.

Generally, the interest eligible for capitalization includes stated interest, imputed interest, and interest related to capital leases as well as amortization of discounts and other debt issue costs. Unless there is a specific new borrowing that can be attributed to the financing of the film, a weighted average capitalization rate should generally be applied. Also, the principles of interest cost capitalization require a consideration of general corporate debt for capitalization in instances when specific financing was not secured for the production of a particular film.

We are aware that some studios capitalize interest only for projects that are in the production phase for periods exceeding an operating cycle. Such policies are usually in place for overall accounting ease due to the de minimis amount of interest that would be capitalized to a particular film. While we understand that such a policy may be acceptable for those reasons, interest should typically be capitalized to film costs in accordance with the principles of interest cost capitalization as presented in ASC 835-20.

How should overall deals be allocated to specific projects?

An “overall deal” is a common arrangement in the motion picture industry and one in which the studio compensates a producer or other creative talent for the exclusive use of that party’s creative services. An overall deal likely covers several projects and can entail a significant time commitment. A studio would expense the costs of overall deals that cannot be identified with specific projects as incurred over the life of the deal; a reasonable proportion of costs that are specific and directly related to a project would be capitalized.

In determining whether activities and costs are specific and directly related to a project, a studio should generally consider the following factors relative to the producer’s or creative talent’s role on a particular project.

- Participation in the review and approval of scripts and screenplays and the identification of other creative talent
- Direct supervision of production activities and participation in production-related decisions
- Direct supervision of postproduction activities such as review and approval of film editing
- Performance that is measured based on certain identified projects

To the extent a producer’s or creative talent’s activities are determined to be specific and directly related to a project, a reasonable allocation of costs based on a consistently applied methodology would generally be appropriate. An entity should not allocate to specific project film costs any amounts it expensed in previous years.

Capitalization of film costs (continued)

How should production tax credits be accounted for?

Tax incentives state and local governments offer that are directly measured based on production activities may be recorded as reductions in film costs consistent with the accounting prescribed by ASC 740-10-25-46 because the business substance of these transactions is to reduce the overall cost of production for film and television products.

Although deferral of the incentive by reducing capitalized costs is acceptable, another acceptable alternative may be to recognize the incentive in the income statement in the period earned. In this approach, a determination needs to be made regarding whether the tax incentive should be recorded as a component of income tax expense. For an item to be included in income tax expense as a benefit, the incentive would need to be within the scope of the income tax accounting principles as presented in ASC 740, *Income Taxes*. For other incentives (e.g., based on production spending), classification as a reduction of operating expenses or other income would generally be appropriate.

To the extent these activities have a material effect on the financial statements, appropriate disclosure of the accounting policy and of the amounts recognized immediately in income or included in capitalizable costs should be made.

The following examples illustrate the two methods for accounting for tax credits. In these examples, Studio XYZ has a production tax credit of \$10, with total production costs of \$100. Five-year ultimate revenue is estimated to be \$300 for all years, and a 40% effective statutory tax rate is assumed. Last, for the purpose of simplicity, assume that the tax credit of \$10 is not subject to any incremental tax effects and that the entire amount is earned in year 1. Financial results for the title and related expenses are as follows.

Recognition as a reduction of film cost

	Year 1	Year 2	Year 3	Year 4	Year 5	Total
Revenue	150.0	50.0	50.0	25.0	25.0	300.0
Distribution fee (10%)	(15.0)	(5.0)	(5.0)	(2.5)	(2.5)	(30.0)
Prints and ads	(50.0)	(25.0)	(10.0)	(10.0)	(10.0)	(105.0)
Amortization of film costs ¹	(45.0)	(15.0)	(15.0)	(7.5)	(7.5)	(90.0)
Operating (loss)/income	40.0	5.0	20.0	5.0	5.0	75.0
Income taxes ²	(14.0)	(1.3)	(7.3)	(1.7)	(1.7)	(26.0)
Net (loss)/income	26.0	3.7	12.7	3.3	3.3	49.0

Recognition as an income tax

	Year 1	Year 2	Year 3	Year 4	Year 5	Total
Revenue	150.0	50.0	50.0	25.0	25.0	300.0
Distribution fee (10%)	(15.0)	(5.0)	(5.0)	(2.5)	(2.5)	(30.0)
Prints and ads	(50.0)	(25.0)	(10.0)	(10.0)	(10.0)	(105.0)
Amortization of film costs ³	(50.0)	(16.7)	(16.7)	(8.3)	(8.3)	(100.0)
Operating (loss)/income	35.0	3.3	18.3	4.2	4.2	65.0
Income taxes	(14.0)	(1.3)	(7.3)	(1.7)	(1.7)	(26.0)
Recovery of tax credit	10.0	-	-	-	-	10.0
Net (loss)/income	31.0	2.0	11.0	2.5	2.5	49.0

¹ Amortization of film costs calculated using the individual film forecast method, assuming ultimate production cost of \$90 (\$100 production cost minus \$10 tax credit) and ultimate revenue of \$300 for all years.

² The tax provision excludes impact of the \$10 tax credit included within amortization.

³ Amortization of film costs calculated using the individual film forecast method, assuming ultimate production cost of \$100 and ultimate revenue of \$300 for all years.

Amortization of film costs

What revenues should be included in film ultimates?

Generally, film ultimate revenues should include estimates of revenues from all markets and territories where persuasive evidence exists that such revenue will occur. These revenues typically include revenues associated with theatrical release of the film, revenues associated with home video sales (net of reserves for anticipated sales returns in accordance with ASC 605-15-25), licensing sales to broadcast or cable networks, and other merchandising revenues from the sale of consumer products. In some instances, revenues from other sources—such as video games, Internet streaming, and portable player downloads—may be included, if reasonably estimable.

Are ultimates required to cover a 10-year period?

Film ultimate revenues should include estimates over a period not to exceed 10 years following the date of the film's initial release. In practice, many studios utilize ultimate revenue projections of six to eight years because a significant majority of films' revenues are earned over that period. The determination is usually based on the studios' historical practices related to generation of revenues after initial release. This policy should be disclosed as part of the significant accounting policies.

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

The inclusion of licensing revenue in a motion picture's ultimate revenues can be a challenging issue. Following are some practical examples and discussions of each of these arrangements and our perspectives on whether they should be included in ultimate revenues.

Quick-service restaurant: A producer enters into a licensing arrangement with a quick-service restaurant to license characters from a soon-to-be-released motion picture on its children's-meal box. 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.

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

Preexisting contracts involving “library” characters: A producer creates a motion picture involving existing characters from its intellectual property library. The producer has existing license arrangements for those characters and the license arrangement was entered into without specific consideration of creation of the motion picture.

Response: We generally believe it would be inappropriate to include in ultimate revenue an allocation of revenues earned from contracts that significantly predated the motion picture. Additionally, we believe that significant judgment is required in determining what revenues to include in ultimate revenues when licensing contracts are entered into contemporaneously with the production and release of a motion picture. As an example, a recently released large blockbuster-type film with preexisting library characters may include an overall marketing campaign that includes the production and sale of toys specific to the film. In such an instance, it may be reasonable to include revenues from these contracts or specific products in ultimate revenues. Facts and circumstances need to be considered, but generally, we believe a choice of an approach is an accounting policy election.

New intellectual property generated from a feature film: 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 representing the characters contemporaneously with the motion picture. The motion picture is a box office success, and the initial one-year licensing contract is extended to five years.

Response: Consistent with the quick-service restaurant example, we generally believe that licensing revenues expected to be earned from contracts entered into as part of the overall exploitation strategy for the motion picture should be included in ultimate revenues. Subsequent renewals of license contracts involving these characters are less straightforward, however. Management’s judgment is required to determine when the characters move from being created by the film to being part of the producer’s library of intellectual property.

Our experience is that there is diversity in practice. Some producers continue to include in ultimate revenue the licensing revenue from these contract renewals. Other producers exclude these revenues because the producer believes the linkage to the feature film is not evident after the theatrical and home video windows. We believe that either approach may be appropriate depending on the facts and circumstances and as long as it is applied on a consistent basis.

Amortization of film costs (continued)

Should revenues from new technologies be included in film ultimates?

Ultimate revenues generally cannot include estimates of revenue from unproved or undeveloped technologies unless persuasive evidence exists that such revenue will occur. We believe this is a fairly high hurdle. Persuasive evidence usually exists when there is historical experience of exploiting a film in the particular medium. To have sufficient historical experience, a studio would need to generate revenues with a number of similar productions over multiple-year periods. We observe that studios have begun to include iTunes and other similar sources in their ultimates.

How should participations and residuals be recognized in the income statement?

Participation and residual expenses are typically recognized evenly as the ultimate revenues are earned. However, a studio should accrue a liability for participation costs only if it is probable that there will be a participation or residual payment under the contractual terms of such agreement. Further, accrued participation costs at each balance sheet date should not be less than the amounts an entity is obligated to pay as of that date. Any incremental amount accrued is generally expensed. A common scenario would be box office bonuses that are contractually due early in the film's life cycle. Similar to film cost amortization, recognition of participation expenses should generally commence when a film is released, and revenue recognition from the film begins.

For episodic series, what is a secondary market?

Episodic television series are generally “deficit financed.” A producer spends more to produce an individual episode than the producer will earn from licensing the television series into its primary market, which is usually the domestic television market. Prior to the establishment of a secondary market, a producer would normally write off production costs in excess of the contractual license fee on an episode-by-episode basis.

The production costs of the episodic series may be combined as a pool of costs once a secondary market has been established—that is, only if an entity can demonstrate through its own experience or based on industry norms that the number of episodes already produced, plus those for which a firm commitment exists and that the entity expects to deliver, can be licensed successfully in the secondary market. When this milestone occurs, the producer usually begins to estimate incremental future revenues from other markets and territories, which results in the amortization of production costs over a longer period. At a minimum, the establishment of a secondary market usually eliminates the need to record current-period expenses for the cost of each production in excess of current license fees.

The accounting standards define an initial or primary market as the first market of exploitation on a territory-by-territory basis. For example, if a US television producer produces a television show that is licensed for free television in the US and subsequently sold into the free television market in the UK, the US and UK would both be sales in a primary market. In order to pool all episodic television costs, the producer would need to sell the episodic television product into a secondary market in either the US or UK, such as through a syndication arrangement with a cable channel.

Amortization of film costs (continued)

The foregoing example illustrates accounting for episodic-television costs during primary and secondary markets.

A producer has a firm commitment to produce 20 episodes of a new television series. Each episode costs \$1,800 to produce. The producer is paid a license fee of \$1,000 per episode by a domestic television network. In years 1 and 2, once the capitalized costs for each specific episode exceed \$1,000, the remainder of \$800 must be expensed as incurred.

Upon the domestic television network's agreeing to pick up season 3, the producer believes sufficient episodes will be produced such that the series will be licensed successfully into a secondary market. All production costs related to seasons 1 and 2 have already been expensed. Total production costs for the 20 episodes in season 3 are estimated to be \$40,000. The domestic license fee for season 3 is \$30,000, which will be earned in calendar year 3. Further, syndication revenues on cable television of \$15,000 are expected to be earned in each of calendar years 4 and 5.

The following illustration highlights the impact on the income statement following the establishment of a secondary market.

Income statements (if secondary market is not established)

	Year 3	Year 4	Year 5
Excess production write-off ¹	\$10,000	\$ -	\$ -
Amortization of film costs	30,000	-	-
Total expenses	\$40,000	\$ -	\$ -

¹ Calculated based on the difference between the license fee for season 3 \$30,000 and the total production costs incurred \$40,000.

Income statements (if secondary market is established)

	Year 3	Year 4	Year 5
Excess production write-off	\$ -	\$ -	\$ -
Amortization of film costs ²	20,000	10,000	10,000
Total expenses	\$20,000	\$10,000	\$10,000

² Amortization of film costs in accordance with ASC 926 is determined as follows for year 3:
 (Earned revenue for the current season \$30,000 / Remaining ultimate revenue at the beginning of the season \$60,000) x
 Remaining unamortized film costs at the beginning of season \$40,000 for 20 episodes

For episodic series, is the release of a DVD considered a secondary market source?

Since the initial release of the film accounting principles in 2000, the home video market has undergone significant changes. It is currently common for studios to release DVDs of full seasons of episodic television series. The release of a season on a DVD has become fairly common even for shows that were only marginally successful. An issue arises regarding whether the issuance of a DVD should be considered a secondary market. This is an important concept under the film accounting principles because it allows all future episodic television series costs to be pooled into one film asset.

We believe that this determination requires careful judgment. If the DVD release is expected to generate a significant level of revenue, then we believe that a DVD release could potentially represent a secondary market. We are aware of instances when the DVD release is not anticipated to result in significant revenues based on the number of DVDs produced and the history of the show's ratings. In those instances, we do not believe that a secondary market has been achieved, and therefore the pooling of episodic television costs is not appropriate. This is an area that requires management to make judgments specific to the facts and circumstances of each episodic television series.

Impairment of film costs

What cash flows should be included in performing a fair value calculation?

The traditional, discounted-cash-flow approach and the expected-cash-flow approach are two acceptable methods to determine the film's fair value. Under the traditional, discounted-cash-flow approach, future cash flows should represent the studio's best estimate of the most likely cash flows. Alternatively, under the expected-cash-flow approach, all possible future cash flow scenarios are probability weighted by period, with the estimated mean or average by period used in the analysis.

Under either approach, cash inflows should generally include all sources of revenues. Such sources may include theatrical releases in one market or multiple markets, revenues associated with home video sales (net of reserves for anticipated sales returns in accordance with ASC 605-15-25), licensing sales to broadcast, or cable networks and other merchandising revenues from the sale of consumer products. In addition, cash flows more than 10 years from release, such as those associated with multiple projected theatrical releases and a residual value, are included.

Cash outflows generally include all additional future distribution, advertising, marketing, and other exploitation costs as well as cash flows associated with participations and residuals.

The following also should be considered in an evaluation of the nature and extent of such cash flows.

- Cash inflow or outflows associated with the film to date
- Historical experiences associated with similar films
- Film reviews and observable public perceptions

Can a producer restore all or a portion of the film costs that were written off in previous quarters due to changes in a film's estimated net cash flows?

A producer can restore all or a portion of the film costs expensed within the same fiscal year. The film accounting principles require that ultimate revenue estimates be reviewed as of each reporting date. The revised estimates are applied to the unamortized film costs as of the beginning of the year, and the difference between amortization determined using the new estimates and any amounts previously expensed during that fiscal year are charged or credited to the income statement in the period (e.g., the quarter) during which the estimates are revised.

Impairment of film costs (continued)

Following is an example of an impairment recorded in the first-quarter (Q1) year to date (YTD), while estimates were subsequently revised in the second quarter (Q2).

Assumptions and income statement impact

	Q1 YTD	Q2 YTD
Remaining revenue ultimate as of <i>beginning</i> of year	100	300
Unamortized film cost as of <i>beginning</i> of year	100	100
Current period revenue	25	75
Amortization expense ¹	25	25
Write-off ²	25	-
Remaining inventory as of end of period	50	75

¹ Amortization expense calculated using the individual film forecast method.

² Write-off assumes that fair value of the film at the end of Q1 was \$50 based on a model prepared based on Q1 estimates, and \$75 at the end of Q2 based on Q2 estimates.

How should costs related to a studio's distribution system be included in a discounted-cash-flow model to determine a film's fair value?

A key consideration in determining the net outflows related to a motion picture involves the remaining distribution costs, particularly for major studios that have mature distribution networks. Accordingly, the incremental distribution costs of adding a single film to a studio's distribution network are generally insignificant given the economies of scale. However, from an independent producer's perspective, the cash outflows from distribution may be significant because the independent producer generally will be required to hire a distributor and pay a distribution fee (ranging from 8% to 15% or more of revenues). This raises conceptual questions regarding whether a film can have multiple fair values depending on who is acquiring or distributing the film.

We note that the accounting principles associated with fair value measurements as presented in ASC 820, *Fair Value Measurements and Disclosures*, require a determination of fair value based on exploitation of the film in its most advantageous market by market participants. Accordingly, management must exercise judgment in determining the most advantageous market and the market participants. Those determinations can impact the estimate of outflows related to distribution efforts.

Additionally, the chosen valuation model should be applied consistently to the valuation of films in similar situations (e.g., preparation of an impairment test or the valuation of an acquisition of a film library). We would generally expect that similar assumptions would be used for cash outflows related to distributing a library as cash outflow estimates related to the distribution costs associated with a potentially impaired feature film.

Impairment of film costs (continued)

Is the discount rate used in determining a film's fair value different based on whether the film has been released?

The appropriate discount rate to use in a film valuation can be significantly impacted by whether the film has been released into the theatrical market. Prior to a film's release, there is significant risk related to whether the film will perform to expectations and be accepted by the film-going public. After a film's theatrical release, the timing and amount of cash flows are generally known with a high degree of certainty based on a producer's prior history. Accordingly, we believe that the discount rate used for valuing an unreleased film (e.g., in a prerelease write-down valuation) would generally be significantly higher than the discount rate used for valuing a released film.

What are the considerations relative to a "prerelease" write-down?

Prerelease write-downs generally occur when there is an adverse change in the expected performance of a film prior to release. Such adverse changes typically are associated with:

- Production costs that have significantly exceeded budgeted amounts
- Market conditions for the film that have changed significantly due to timing or other economic conditions
- Screening, marketing, or other similar activities that suggest the performance of the film will be significantly different from previous expectations
- A significant change to the film's release plan and strategy
- Other observable market conditions, such as those associated with recent performance of similar films.

In such situations, an impairment write-down will be necessary for the amount by which the carrying value of the film cost exceeds its estimated fair value.

Can a film have a negative gross margin and not be impaired?

The accounting model for determining film impairments could lead to situations in which a film has a negative gross margin. ASC 926 requires a film's fair value to be compared to its carrying amount if certain factors are present. In determining the fair value using discounted future cash flows, management generally estimates a terminal or library value that results from cash flows after the end of its ultimate period. In some instances, it is possible that revenues remaining during the ultimate period may be less than remaining capitalized film costs, but the specific film has undiscounted cash flows in excess of remaining capitalized film costs due to the expected cash flows outside the ultimate period. Accordingly, in this instance, a film will have a negative gross margin over its remaining ultimate life. We believe that this is generally acceptable as long as amortization expense continues to be calculated in accordance with the film accounting principles as presented in ASC 926 and as long as the company continues to perform its fair value analysis at the end of each reporting period.

Are there any post-balance sheet events which would be considered Type II subsequent events?

The film accounting rules presume that events occurring subsequent to the balance sheet date but prior to the filing of the financial statements should generally be treated as Type I subsequent events. Accordingly, prior to the filing of financial statements, impairments arising from a subsequent event would generally need to be recorded in the previous accounting period. A common example is a film that performs significantly below estimates which is released after the balance sheet date, but prior to the filing of the financial statement.

There are situations where we believe an event which gives rise to an impairment could be a Type II subsequent event and, therefore, the impairment could be recorded in the period when the event occurred. An example could include the significant incapacitation of a major actor or the director where a decision is made to abandon the title. However, we note that these types of situations are rare and are usually heavily dependent on the facts and circumstances related to the specific situation.

Purchase accounting matters unique to film costs

What cash flows should be included in the valuation of a film?

As discussed earlier, in the preparation of valuations of films, cash inflows should generally include all sources of revenues. Such sources may include theatrical releases in one market or multiple markets, revenues associated with home video sales, license sales to broadcast or cable networks, and other merchandising revenues from the sale of consumer products. In addition, all future cash flows, including those more than 10 years from release (i.e., those associated with multiple projected theatrical releases and a residual value) should also generally be included.

Additionally, we believe that cash outflows should generally include, among other elements, future expected print and ad expenditures, cash outflows for participations and residuals, and distribution expenses.

What approaches are commonly used to value films in development?

When a studio is acquired, the purchaser usually also acquires film projects in various stages of completion—from initial development to completion. For a film that is complete or in the postproduction process, valuation of the film is usually performed by using the discounted-cash-flow model.

For a project that is either in development or still in the production phase, a replacement cost valuation approach is often used. Many times, this results in an in-process film being valued at its historical carrying value. While films that have been green-lit usually have an initial ultimate attached to the title, our experience indicates that these estimates are usually not dependable for performing a discounted-cash-flow valuation. Development projects generally are still in script stage and there is generally limited information on fair value other than costs incurred to date.

How are participation and residual obligations recorded in purchase accounting?

Library, recently released, and soon-to-be-released titles are generally valued using the discounted-cash-flow model. Under this model, participations and residuals are included as a cash outflow for valuation purposes. Accordingly, the contractual obligation for participations and residuals is effectively netted into the film asset.

An alternative view would be that the participation and residual obligation should be recorded on a gross basis and that the film asset valuation should exclude the participation and residual cash outflows. The contractual obligation to the participants would be a separate unit of account, and a liability would be reported in purchase accounting for this obligation.

We believe that in practice, most acquirers have determined that the film, including the related participation and residual obligations, is the unit of account. Accordingly, the valuation of the film asset should generally include a cash outflow related to the expected participation and residual obligations.

Last, the acquired studio usually has an obligation for participations and residuals on its balance sheet. That liability is recorded ratably over ultimate film revenue. We believe that the acquirer studio generally should reflect on the opening balance sheet—as participation and residual liability—only those amounts that are legally due to the participant or others (e.g., guild organizations) under their respective contracts.

As an example, assume Title A was released on 1/1/X1 and the title was acquired 12/31/X1. The participation and residual liability of the acquiree as of 12/31/X1 is \$25 based on participation cost accruals in accordance with film accounting principles. However, the amount contractually due to third-party participants is \$10 per the contract by the acquiree. The amount the acquirer studio will record on its opening balance sheet will be \$10.

What this means for your business

Financial executives who are adept at navigating the intricate accounting and reporting rules will be able to drive the presentation of the key performance indicators for their companies.

As producers continue to explore opportunities for maximizing their returns on investments in filmed entertainment, companies face the complicated challenges of complying with the limited financial reporting guidance for film and television.

Studios will continue exploring various financial incentives to reduce cost outlays and explore new revenue opportunities to enhance the returns on filmed entertainment. Accordingly, financial executives must also be adept at navigating the accounting and reporting requirements in order to successfully determine the impact of these initiatives on a company's reported results.

PricewaterhouseCoopers professionals have significant experience in dealing with those and many other issues unique to the entertainment, media, and communications industry. Our perspectives on the issues, including practical insights, have been gained from years of direct personal experience in assisting clients to navigate the often difficult challenges they face. We offer those perspectives as a framework to help businesses manage successfully in today's complex world.

Future documents in this series will cover (1) matters unique to acquired programming rights and (2) revenue recognition matters related to cable affiliation contracts.

This document describes PricewaterhouseCoopers' perspectives with respect to the application of accounting and/or auditing literature to actual or hypothetical situations. 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 drawn. This document should not be relied on as the sole source of information leading to a decision on significant accounting, auditing, and/or US Securities and Exchange Commission matters. Rather, the information in this document should be considered only in conjunction with a review of current authoritative literature together with direct consultation with an independent accounting firm.

This edition of *Perspectives* is the third in a series.
Upcoming topics will cover the following:

Acquired programming rights

Cable affiliation contracts

Prior issues of *Perspectives* covered:

Film financing and passive investor arrangements

Revenue recognition matters unique to the motion picture industry

You can view previously released *Perspectives* and all updates at www.pwc.com/EMCPerspectives.

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Filmed entertainment: cost capitalization, amortization,
and impairment
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