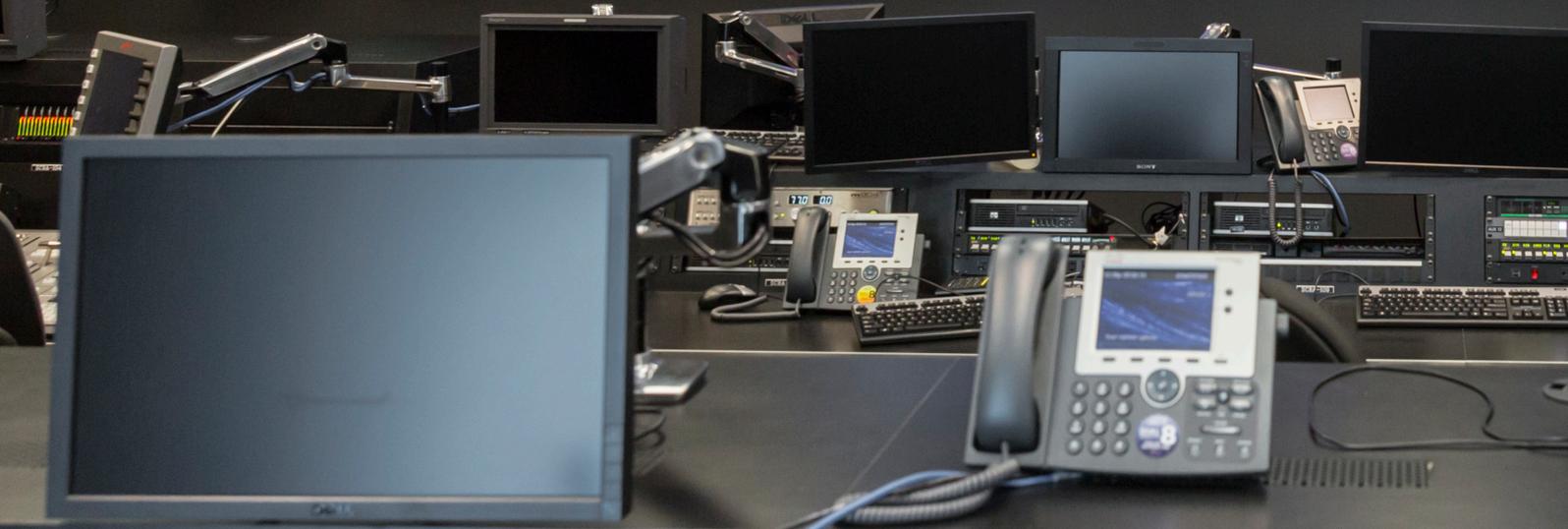


Making sense of a complex world

Film cost capitalisation, amortisation and impairment

This paper explores some of the key considerations under IFRS for film cost capitalisation, amortisation and impairment.





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Introduction to MIAG

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

With more than 4,200 industry-dedicated professionals, PwC's global entertainment and media (E&M) practice has depth and breadth of experience across key industry sectors including: television, film, advertising, publishing, music, internet, video and online games, radio, sports, business information, amusement parks, casino gaming and more. And just as significantly, we have aligned our media practice around the issues and challenges that are of utmost importance to our clients in these sectors. One such challenge is the increasing complexity of accounting for transactions and financial reporting of results – complexity that is driven not just by rapidly changing business models but also by imminent changes to the world of IFRS accounting.

Through MIAG, PwC¹ aims to work together with the E&M industry to address and resolve emerging accounting issues affecting this dynamic sector, through publications such as this one, as well as conferences and events to facilitate discussions with your peers. I would encourage you to contact us with your thoughts and suggestions about

future topics of debate for the MIAG forum, and very much look forward to our ongoing conversations.

Best wishes



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¹ PwC refers to the PwC network and/or one or more of its member firms, each of which is a separate legal entity

Film cost capitalisation, amortisation and impairment

The costs of developing and producing films can be significant and the outcomes unpredictable. Our 10th MIAG paper explores some of the key considerations under IFRS for film cost capitalisation, amortisation and impairment.

PwC's *Global entertainment and media outlook 2015-2019* forecasts global film revenues to grow at 4.1% annually, reaching US\$105 billion in 2019. Strong growth will be seen in China and in Latin America, but even global leader the US, with one-third of market spend in 2014, will see above-average annual growth of 4.6%. But while Hollywood remains at the heart of film, a trend in the forecasts for many markets, from China to Western Europe, is the increased significance of local films in boosting country box office revenue.

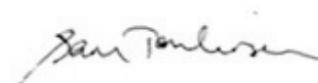
The accounting for spend on film development and production presents challenges such as which IFRS standard to apply; when to start and stop capitalising costs; which costs to capitalise; how to amortise them; and how to conduct impairment reviews of these film assets. The costs of developing and producing films, particularly blockbusters, are significant and the outcome of the film as a hit or miss can be unpredictable. Appropriate, consistent treatment of film development and production costs is therefore key. Companies that are adept at navigating the intricate accounting

and reporting practices can tell their story in a clear and compelling manner, building public trust in their performance with stakeholders such as investors, analysts, employees, suppliers, partners and audiences.

This paper explores the critical considerations relating to the classification, capitalisation, amortisation and impairment of film costs under the applicable IFRS standards IAS 38 *Intangible Assets* and IAS 2 *Inventories*. The examples in our paper are clearly not designed to be exhaustive; but they will hopefully provide food for thought for film companies when considering how to account for their own film development and production costs. In addition, the impact of financing arrangements – i.e. is the film company producing at its own risk or does it have third party backing via an advance or shared outcomes – is considered briefly in this paper and will be covered in more detail in a separate MIAG publication.

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

Best wishes



Sam Tomlinson
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Chairman, PwC Media Industry
Accounting Group



Sam Tomlinson

Background

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

At its heart, the film industry is about great content – that is, developing and producing films to capture an audience that can be monetised through theatrical release or DVD sales and by licensing to distribution channels such as television or digital platforms. It is the timeless appeal of this content – of great films – that continues to drive film industry growth. PwC's Global entertainment and media outlook 2015-2019 forecasts global film revenues to grow at 4.1% annually, reaching US\$105 billion in 2019.

Accounting for the significant film development and production costs, and their unpredictable outcomes, is a significant issue for film producers (and also, increasingly, for producers of high-end scripted television too). Specifically, which costs should be capitalised, and when do you start and end? How should the resulting asset be amortised? And how should impairment reviews be conducted if there are indications a film will not be as successful as anticipated?

What is the relevant IFRS guidance?

IFRS addresses accounting for capitalisation of product development costs, including guidance on the nature of costs, timing of cost capitalisation and method of cost recognition in the income statement as amortisation. However, IFRS does not include specific industry guidance so in practice application of the relevant standards requires careful consideration of the specific facts and circumstances.

Fundamental to the concept of capitalising costs is that they must meet the definition of an asset i.e. a resource (a) controlled by an entity as a result of past events; and (b) from which future economic benefits are expected to flow to the entity.

The two key standards that provide guidance for cost capitalisation are IAS 38 and IAS 2:

IAS 38 Intangible Assets, defined as non-physical resources controlled by an entity for which they will generate future economic benefit. Under IAS 38, costs incurred in the 'research phase' are expensed as incurred, while costs incurred in the 'development phase' are capitalised once the recognition criteria are met. 'Development' is the application of research or other knowledge to a plan or design for the production content before the start of commercial sale.

The threshold for capitalising content development costs is to demonstrate all of:

- The technical feasibility of completing the intangible asset so that it will be available for sale;
- The intention to complete the asset and use or sell it;
- The ability to use or sell the asset;
- The way in which the intangible asset will generate probable future economic benefits i.e. the existence of a market for the asset;
- The availability of adequate technical, financial and other resources to complete the development and to sell the asset; and
- The ability to measure reliably the expenditure attributable to the asset during its development.



Once these criteria are met IFRS requires capitalisation of development costs; there is no option to expense such costs.

IAS 2 Inventories, defined as assets held for sale or in the process of production or to be consumed in that process. Inventory costs are capitalised once the general asset criteria are fulfilled:

- The entity has control of the inventory.
- The inventory will generate probable future economic benefits.
- The ability to measure reliably the expenditure attributable to the asset during its development.

It will be clear that the capitalisation criteria under IAS 38 and IAS 2 are similar but not identical. These similarities and differences are explored in the next section. Judgement is required when determining which standard to apply, whether to capitalise film development and production costs and if so when and which ones. These judgements can have a significant impact on both statutory operating profit and adjusted measures such as earnings before interest, tax, depreciation and amortisation (EBITDA).

This paper first focuses on determining the relevant standard to apply to internal and third party costs associated with film development and production. It then goes on to consider cost capitalisation, amortisation and impairment scenarios in the film industry.

How does film financing affect the accounting?

For the most part, this paper assumes the cost of development and production (i.e. the ‘film financing’) is being funded by the film company itself. Where financing is being part-funded by a third party in exchange for a share of revenues and/or profits, the hurdles for capitalisation change: for example, the ability to complete is more certain; assessments of future profitability must incorporate future payments to the funding party; and, depending on the exact financing terms, there might be an amount to be recognised as a liability or non-controlling interest or reduction in the film costs. Financing arrangements will be considered in more detail in a separate MIAG publication.

Is there any other applicable guidance?

In addition to IAS 38 and IAS 2, film development and production costs can also fall under the scope of IAS 11 *Construction Contracts*, which applies when a film is being made for a single customer under a single contract. Under IAS 11, such costs and revenues are usually recognised in the income statement based on the percentage of completion. The application of IAS 11 is broadly scoped out of this paper since it is being replaced by the new such standard IFRS 15, which will be the subject of a forthcoming MIAG publication.

The examples in this paper also touch on IAS 23 Borrowing costs and IAS 36 Impairment of assets.

Are there any tax implications?

Like all MIAG publications this paper is concerned primarily with accounting, which should be consistent across companies reporting under IFRS, rather than tax, which will vary with each country’s local laws and tax regulations.

However, corporation tax deductions often mirror accounting expenses. So judgements about film cost capitalisation, amortisation and impairment can affect the timing of tax cash payments. And many countries have specific tax legislation relating to film production, such as ‘film tax credits’ to encourage domestic and international film producers to shoot and edit in that country. In such cases, the accounting treatment adopted for cost recognition should in theory be tax neutral, since tax is governed by specific rules. But even here there is an accounting judgement about the presentation of such film tax credits, which we discuss later in this paper.

We would always recommend consulting with a local tax expert to determine possible tax consequences of such judgements.

Classification: IAS 38 or IAS 2 or IAS 11?

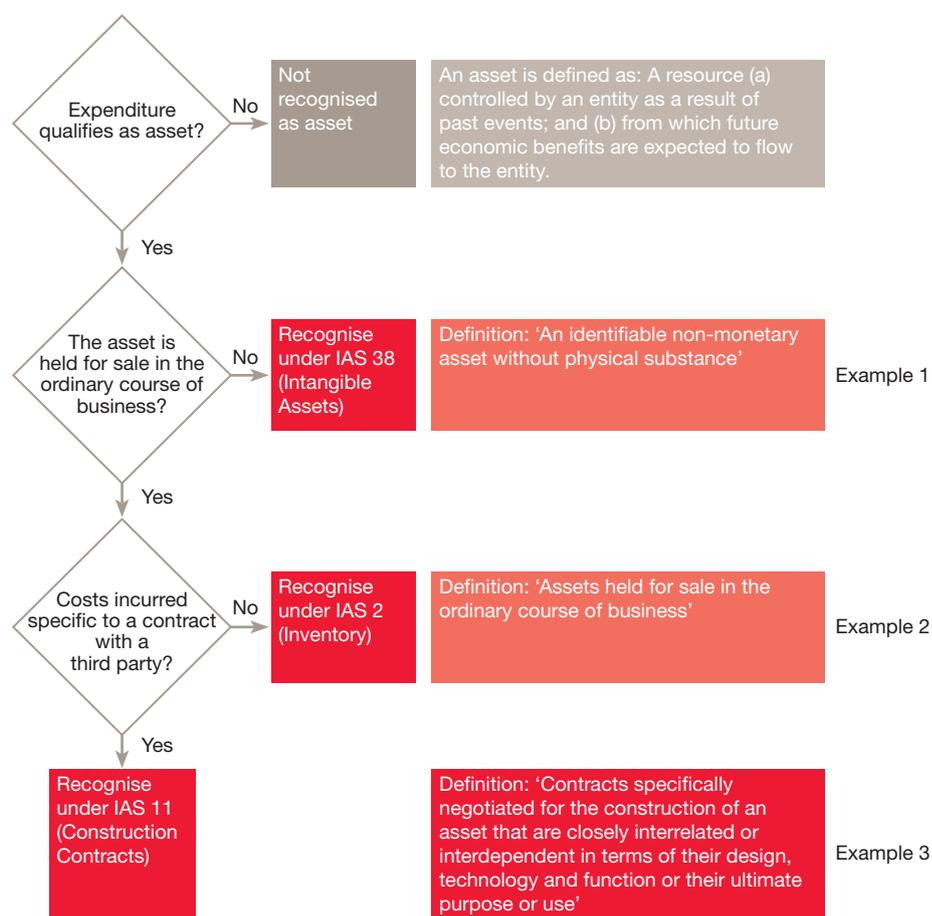
The first question in accounting for film development and production costs is which standard to apply. Do the costs qualify as an intangible asset under IAS 38, inventory under IAS 2, or are they contract costs under IAS 11? A guide to the relevant standard to apply is shown in Figure 1 followed by application examples.

Our theoretical view when considering the first distinction – that is, between IAS 38 and IAS 2 – is that film development and production generally falls more naturally under the remit of IAS 38 (e.g. example 1), except in circumstances where a film company is producing content that could be sold to anyone and for which the producer expects to retain no or little intellectual property rights (e.g. example 2). However, the diversity in practice among film companies when presenting film costs as either intangible assets or inventories is driven less by this theoretical distinction than by other factors, notably the treatment under local GAAP prior to transition to IFRS. We believe that the theoretical classification as either intangible assets or inventory is generally of less concern than the more critical practical judgements on when to start and stop capitalising costs, which costs to include, and how to amortise them.

(That said, we explain in the amortisation section of this paper that film companies – indeed, all media companies – should carefully examine the amendments to IAS 38, effective 1 January 2016, to ensure their selected amortisation policy is compliant with this new guidance.)

In contrast, the distinction between IAS 38/IAS 2 and IAS 11 (or IFRS 15) is highly important since whereas intangible asset and inventory costs are capitalised on to the balance sheet, costs developing content under a construction contract are recognised in the income statement as incurred with the corresponding revenue booked at the same time.

Figure 1: Classifying film development and production costs





Example 1: Film production where certain rights are retained

Film producer A, from a non-English market, is creating and producing a niche film that it intends to distribute locally and worldwide in theatres and subsequently as DVDs and via digital platforms. Producer A also intends to retain and license the post-release television broadcast rights in its own country to a national broadcaster, but will sell to another party the (much smaller) international television broadcast rights.

How should the film development and production costs be classified?

In this case, the film costs would meet the definition of an asset (assuming all asset recognition criteria are met), while the revenues generated from theatres, DVDs, digital platforms and retained licensing of national television broadcast rights are likely to be much higher in this instance than the international broadcast television rights. The most appropriate treatment in our view would be to recognise an intangible asset under IAS 38 (although in practice some film companies might present this asset as inventory).

Example 2: Film production for sale with no rights retained

Film producer B produces documentary films with the primary intention to sell them to studios for distribution. At the time of development and production there is no sales arrangement in place but producer B has a successful track record of producing and selling documentary films. Producer B does not expect to retain any rights to the film documentaries following their sale.

How should the film development and production costs be classified?

The documentary films are identifiable non monetary asset without physical substance, but are produced for sale in the ordinary course of business. Given that there is no specific arrangement in place with a third party (i.e. not an IAS 11 construction contract), producer B would probably account for the production costs as inventory in accordance with IAS 2.

(In practice, more complex funding approaches exist e.g. the film production might be part-funded by a third party in exchange for a large advance or majority share of outcomes, which might sometimes leave the film producer with minimal rights in practice. In such a scenario, an assessment is required as to whether the film costs are more properly classified as intangible assets or inventory or fall under example 3 below.)

Example 3: Film production for hire

Producer C is commissioned by a film studio to develop and produce a film and earns a fixed fee for the service. Producer C retains no rights to the film.

How should the film development and production costs be classified?

The rights to the finished film are identifiable non monetary assets without physical substance that are produced for sale in the ordinary course of business, but they are also specific to one contract. Assuming that the outcome can be estimated reliably, costs are recognised as incurred and revenues are recognised based on the percentage of completion under IAS 11. Projects within the scope of IAS 11 will be considered in a separate MIAG publication on the new revenue standard IFRS 15.

In summary, where the costs relate to the development and production of a film that will be sold in full with no rights retained, the film costs might be classified as inventory under IAS 2; and where the production company retains the rights to the film and will be able to exploit these rights over a period of time, the expenditure is probably an intangible asset under IAS 38. In practice, there is diversity in balance sheet presentation but the more critical judgements are scope and timing of cost recognition and amortisation, as set out in the rest of this paper.

Film cost capitalisation

When and which costs?

Having determined the appropriate standard to follow, at what point should film costs start to be capitalised and which costs should be capitalised? (This section considers projects within the scope of IAS 38 and IAS 2 only. 'Construction' and 'service' projects will be considered in a separate MIAG publication on IFRS 15.)

Figure 2: Stages of film development, production and sales production costs



When should costs be capitalised? (And when should they cease?)

As described earlier, IAS 38 and IAS 2 set out similar criteria that must be met in order to capitalise content development costs. The fundamental premise under both standards is it must be probable that the asset capitalised will bring future economic benefit of at least the amount capitalised. Determining the point at which the asset recognition criteria are met will usually require judgement and will be dependent on past experience.

Selling, promotion and marketing costs are always expensed. Although such expenditure is intended to generate future economic benefits, these benefits are not separable from overall business development and do not meet the definition of an asset. Similarly, costs incurred as a result of sales (e.g. lead actors participating in a share of the film's revenues or profits) are also usually recognised as expenses when the revenue is earned.

The following examples illustrate the application of the capitalisation criteria to film development and production costs.

Film development and production costs

In this scenario a film producer creates and produces a film that is intended to be distributed globally, and retains the intellectual property rights i.e. the international format, distribution and ancillary rights, etc. Figure 2 sets out the development and production stages for this film.

(In more complex real-life scenarios, the distributor might have provided an advance and the residual intellectual property rights will only have value if and when the distributor can recoup its initial outlay.)

The start point of capitalising costs occurs when there is evidence that all the recognition criteria set out in the 'background' section above are met.

On the assumption that the film producer has the access to the financing and other resources to complete and distribute the film and the systems to measure reliably the expenditure, the key judgements will include both which costs to capitalise and the forecast revenues. Provided the film is expected to generate profits, the film producer is likely to have the intention and ability to complete and distribute the film.

The pitching phase is likely to be 'research' that is undertaken with the prospect of understanding the potential market for such a film and the availability of talent to direct and star in it. As no intangible asset will arise from research phase any cost shall be expensed as incurred.



The ability to complete the film and reliably generate profits is likely to come at some point between the start and the end of pre-production phase, but before actual filming starts. Considerations for the start point of capitalisation may include:

- Ability to complete the project: e.g. commitment of key talent and script writers, or 'locking-in' of financing such that all or most budgeted costs are now funded
- Existence of a market: e.g. prior evidence of successful film productions.
- Generate profits: e.g. history of accurate forecasts of revenues from theatres, DVDs, licensing, etc.

Once the recognition criteria are fulfilled, directly attributable internal and external costs **must** be capitalised.

The point of starting to capitalise film costs might vary between producers. For some, the internal approval process may mean that an idea for a film is never progressed unless there is high degree of certainty of success, which means that capitalisation of film costs may start relatively early in the process. For others, there may be multiple smaller film projects where there is no certainty of success until near the end of the process and hence film costs may never qualify for capitalisation.

Capitalisation of eligible costs should cease when the asset is capable of operating in the manner intended. In practice this means that film cost capitalisation would usually cease once the film is ready for release.

Capitalised costs for cancelled films are recognised as an immediate expense in the period of cancellation.

Film sequels

When a sequel is developed, a producer can look to historical experience with the feasibility and success of the previous title, plus the general experience of successful sequels. In addition, funding will be easier to obtain and key talent might be locked in already. Therefore, capitalisation of costs might start earlier in the process.

Which film costs can be capitalised?

Examples of 'directly attributable' film costs that can be capitalised could include:

- Direct labour: e.g. actors, film crew, security
- Production costs: e.g. editing, visual effects
- Production overhead costs: e.g. studio rent, costumes, catering
- Production-related administrative costs: e.g. insurance
- Interest costs: if directly attributable (see scenario 3 below)

The following four scenarios explore some of the judgements in these areas.

Scenario 1: What costs should be included in the production overhead allocation?

The identification of production overhead costs to be included in such overhead pool requires careful judgment. There is diversity in practice on what gets included in overhead depending on the studio's size, structure and operating practices.

Production overheads are not specifically defined in IFRS but can reasonably be expected to align with the US GAAP concept as being the 'costs of individuals or departments with exclusive or significant responsibility for the production of films'. In other words, labour and overhead costs that are closely aligned with, and closely related to, production activities should be capitalised. Labour costs would include both cash and share-based payments.

The following film activities and costs are generally not considered capitalisable:

- Corporate senior management costs e.g. finance director and other non-production-related senior management costs, because such costs are considered general and administrative
- Central costs e.g. human resources
- Marketing expenses, selling expenditures, and distribution costs
- Costs associated with overall deals (see scenario 2 below)

Scenario 2: How should overall deals be treated?

An 'overall deal' is fairly common in the film industry; it is one in which the studio compensates a producer or creative talent for the exclusive use of that party's creative services. An overall deal likely covers several films and can entail a significant time commitment.

A studio would expense the costs of overall deals that cannot be identified with specific projects as they are incurred; a reasonable proportion of costs that are specific and directly related to a certain film can be capitalised.



In determining whether activities and costs are specific and directly related to a film, 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 post-production activities such as review and approval of film editing
- Performance that is measured based on specifically identified films

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. A film producer should not re-capitalise amounts it expensed in previous years.

Scenario 3: Should interest be capitalised?

IFRS requires film producers to account for interest costs in accordance with IAS 23. The standard requires interest capitalisation where there are specific financing arrangements or where those borrowing costs would have been avoided if there had been no expenditure on the asset. This requires judgement since even interest arising on general borrowings should be considered for capitalisation into the cost of the film.

Assuming the film costs are themselves being capitalised, then interest capitalisation should generally commence and cease in the periods when film production begins (i.e. film is set for production) and ends (i.e. film is substantially complete and ready for distribution), respectively. Generally, the interest cost subject to capitalisation includes stated interest, imputed interest, and interest related to capital leases as well as amortisation of discounts, premium, and other issue costs on debt. Unless there is a specific new borrowing that can be attributed to the financing of the film, a weighted average capitalisation rate should generally be applied.

Scenario 4: How should film tax credits be accounted for?

Film tax credits arise where national or local government agencies provide incentives for producing films that meet certain criteria. There is often a time delay in receiving these benefits and, as they are large in nature, the timing of recognition can significantly affect the income statement from one period to another. The terms of tax credit schemes can vary widely so they warrant careful consideration to determine the appropriate accounting. Some credit schemes are effectively government grants recoverable through the tax system (that is, they are available regardless of the level of a company's taxable profits) while others offer tax credits that are only recoverable if the entity has sufficient taxable profits (and liabilities) against which the credit can be applied.

Tax credits that are really government grants (because they are available regardless of taxable profits) are within the scope of IAS 20 *Government Grants*, which permits two treatments:

- The tax credit can be deducted from the intangible assets held in relation to the production costs; or
- The tax credit can be recognised as deferred income and then recognised in the income statement evenly over the period of amortisation of the related film asset.

Both treatments spread the benefit received from the tax credit over the useful economic life of the film. In the first treatment, the benefit is recognised over time via a reduction in amortisation; in the second, as other income.

In contrast, tax credits that depend on taxable profits are within the scope of IAS 12 *Income Taxes*. Investment tax credits are scoped out of IAS 12 and although not specifically defined in IAS 12 they are usually considered to be tax benefits received for investment in specific qualifying assets. In this case, there is generally an accounting policy choice whether to recognise the tax credits in the period in which the tax deduction is earned or to treat as akin to *government grants* and defer to the balance sheet (either as a deduction in asset value or as deferred income).

Whichever treatment is adopted, clear disclosure of the policy choice and its impact will be key.



Application in practice: policies and procedures

In summary, judgement is required in determining when to start (and stop) capitalising costs and which costs to include. Factors that can help in practice include:

- Establish a clear policy regarding the threshold, start point and nature of cost capitalisation
- Communicate this policy
- Where appropriate, include a list of factors to consider to help staff apply this guidance
- Set up the systems, month end and year end processes to reflect the policy in the accounts
- Once the policy is set, insist it is followed consistently

Application in practice: identifying costs to capitalise

Companies often have an authorisation processes at each stage of film development and production. These 'gates' can help set a suitable start point for cost capitalisation. However, gathering all the cost data to quantify capitalisation can be a challenge, for example because:

- Contributing costs can come from a number of different general ledger codes, or be a part of a general ledger code. This is frequently the case with payroll cost where individuals may be working on a number of different projects at different stages, some capitalisable and others not.
- The relevant approval to move to a capitalisation is unlikely to fall neatly on a reporting period end date, which requires additional processes or amendments to a system to ensure all relevant data is captured appropriately.

Application in practice: treatment in the cash flow statement

Costs qualifying for capitalisation as inventory under IAS 2 should be classified as an operating item. But the treatment of costs qualifying for capitalisation as an intangible asset under IAS 38 is less clear. Depending on how the company defines its operating cycle, the cash flows may be classified as either operating or investing.



Film cost amortisation

Does cost classification impact amortisation?

In practice, regardless of whether film producers present their capitalised film costs as intangible assets under IAS 38 or inventories under IAS 2, they select the amortisation method that most appropriately reflects underlying economic reality subject to pragmatic constraints such as simplicity of application and the availability of reliable data. In that sense, the presentation as inventories or intangible assets is irrelevant.

However, although the timing and magnitude of the related expense is unaffected, its disclosure can vary. The cost associated with an intangible asset is invariably described as 'amortisation' whereas those film producers who classify capitalised film costs as inventories sometimes do refer to them as being amortised but sometimes use other terms (e.g. 'content costs') and sometimes do not separately disclose the related expense at all. Comparing EBITDA between companies is a complex and hazardous task, with some reversing such amortisation out of EBITDA while others leave it in.

(Throughout this paper, we use 'amortisation' to refer generically to the expensing of capitalised film costs in the income statement, even where they are classified on the balance sheet as inventories.)

How should the film cost intangible asset be amortised? Has this changed with the amendment to IAS 38?

Under IAS 38 amortisation is defined as the systematic allocation of the depreciable amount of an intangible asset over its useful economic life. The allocation method should reflect the pattern in which the asset's future economic benefits are consumed by the

company. If that pattern cannot be measured reliably the straight-line method must be used. Under IAS 2 costs are recognised in the income statement as revenue is earned. These approaches are theoretically different but historically have often generated the same result in practice provided the method of amortisation used reflects the underlying economic reality.

An amendment to IAS 38, effective 1 January 2016, introduced a rebuttable presumption that revenue-based amortisation is not appropriate for intangible assets. To rebut the presumption, film companies would need to show that the consumption of the economic benefit of the intangible asset, and the resulting revenues generated, are 'highly correlated'. Revenue is affected by other inputs (sales, marketing, etc.) so 'highly correlated' is a high hurdle; it is not enough to simply demonstrate a relationship between the revenues and the intangible.

A common industry practice is to use an accelerated amortisation profile for film costs based on the observable decline in value of the film asset after its initial or early showings. This practice continues to be an acceptable and conceptually sound approach, based on an analysis of the remaining useful economic life and the recoverable amount of the underlying film cost asset. Such an approach - of accelerating amortisation based on the decline in asset value - does not fail the IAS 38 prohibition on revenue-based amortisation because it is not based on direct matching of revenue and amortisation.

What revenues should be included when assessing amortisation methods?

Under the approach outline above - of accelerating amortisation based on the decline in asset value - we would expect that film producers will continue to model expected revenues to help them assess appropriate useful economic lives and to support the carrying value of film cost assets at each reporting date.

Generally, film revenues should include estimates of revenues from all markets and territories where persuasive evidence exists that such revenue will occur e.g. because the film producer can demonstrate a history of earning such revenues. These revenues can typically include revenues associated with theatrical release of the film, DVD sales, licensing sales to broadcast or cable networks and release via digital platforms. In some instances, revenues from other sources - such as video games and other merchandising revenues from the sale of consumer products - may be included, if they can be reasonably estimated based on historical experience with similar films.

How long should the forecast period be?

There is no time limit on the forecast period, but its use must be supportable based on historical evidence from previous experience. The period is likely to differ depending on the type and expected success of a film and could vary depending on the film genre (e.g. blockbusters, animation films, action films, comedies, etc.). The period of time for which revenue is included in the forecast model is, by definition, the useful economic life of the asset for accounting purposes.

The useful economic life of an asset is required to be reassessed in accordance with IFRS at least at each financial year end. Where this results in a change in estimate, this is required to be accounted for prospectively from the date of reassessment.

IAS 38 explicitly states that film publishing assets will not have a residual value on the basis that there is not an active market for a film as each title is unique. Therefore, the film asset will amortise to zero over the useful economic life.

When should revenue from licensing arrangements be included in the forecasts?

The inclusion of licensing revenue can be a challenging issue, as these scenarios illustrate:

Scenario 1: Licensing to fast-food restaurant

Film producer A enters into a licensing arrangement with a fast-food restaurant to license characters from a soon-to-be-released film to be used on the children's meal box. Exploitation of the characters by the fast-food restaurant begins two weeks before theatrical release of the film and ends six weeks after theatrical release.

Since the arrangement is closely linked to the soon to-be-released film, we believe this revenue should be included in the forecasts, provided they can be reasonably estimated.

Scenario 2: Pre-existing contracts involving 'library' characters

Film producer B creates a film involving characters that reside in its intellectual property library. The producer has longstanding pre-existing license arrangements with a fast-food restaurant involving these characters, which were entered into without specific consideration of the new film.

In this scenario, we believe it would be inappropriate to include these revenues in the forecasts since these licensing arrangement significantly predated the film.

Judgment is required in determining what revenues to include in forecasts when licensing contracts are entered into contemporaneously with the production and release of a film. For example, a new blockbuster film using pre-existing library characters may include an overall marketing campaign that includes the production and sale of toys specific to the film. It might then be reasonable to include revenues from these toys in the revenue forecasts.

Scenario 3: New intellectual property generated from a film

Film producer C creates a film 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 film's release. The film is a box office success, and the initial one-year licensing contract is extended to five years.

Consistent with the fast-food restaurant example, we believe that licensing revenues expected to be earned from contracts entered into as part of the overall exploitation strategy for the film can be included in the forecast film revenues. However, subsequent renewals of licences involving these characters are less straightforward. 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.

Film cost impairment reviews

When is an impairment review required?

An impairment test is performed when an event or change in circumstance indicates that the carrying amount of unamortised film costs may exceed their recoverable amount. The recoverable amount is the higher of the estimated fair value less costs to sell or value in use.

Any write-off is calculated as the carrying amount by which unamortised capitalised film costs exceed the recoverable amount.

The impairment indicators can be external or internal. Examples include:

- An adverse change on the expected performance of a film prior to release
- Actual costs substantially in excess of budgeted costs
- Substantial delays in completion or release schedules
- Changes in release plans, such as a reduction in the initial release pattern
- Insufficient funding or resources to complete the film and market it effectively
- Actual performances subsequent to release (e.g. poor box office performance or weak DVD sales) fails to meet that which had been expected prior to release
- Restrictions under media law affecting the usability of films

The impairment test should be performed at the individual asset level; and where the recoverable amount cannot be determined for an individual asset, the test is done at the level of a 'cash generating unit ('CGU'). A CGU is the smallest identifiable group of assets that generates cash inflows largely independent of the cash inflows from other assets or group of assets.

We would expect that, in many cases, an individual film will be the appropriate level at which to assess the carrying value. However, consideration should be given to the level of interdependence of revenue earned between films and with other assets.

What cash flows should be included in the recoverable amount?

The recoverable amount of a film represents its greatest value to the producer in terms of the cash flows that it can generate. That is the higher of:

- fair value less costs to sell (the amount for which the asset could be sold in an arm's length transaction between knowledgeable and willing parties, net of estimated costs of disposal); and
- value in use (the present value of the future cash flows that are expected to be derived from the asset. The expected future cash flows include those from the film's continued use by the company over its useful economic life and based on present value calculations).

The value in use methodology is usually used to determine the impairment of films, since it is easier to determine the value to that film producer than its hypothetical value to another.

The value in use represents the future cash flows expected to be generated by the film over its useful life discounted to present value. IAS 36 requires that the number of years included in the discounted cash flow model is limited to the remaining useful economic life of the film, indicating that no terminal value should be included.

Cash inflows should include all sources of reasonably estimable revenues. Such sources might include theatrical releases in one market or multiple markets, revenues associated with DVD sales (net

of reserves for anticipated sales returns), licensing sales to broadcast, release via digital platforms and merchandising revenues from the sale of consumer products.

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

The cash flow projections require management's judgments which should be based on realistic assumptions and which should be applied consistently. The cash flows should be based on the most up-to-date budgets and forecasts that have been formally approved by management.

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

The film producer should assess at each reporting date whether there is any indication that any film cost impairment recorded in a previous period either no longer exists or has decreased.

If there is any such indication the film producer should first estimate the revised recoverable amount. The film producer can then restore all or a portion of the film costs and based on

the revised cash flow projection increase the carrying value of the film to the carrying value that would have been recognised had the original impairment of film not occurred (i.e. after taking account of normal amortisation). Due to the amortisation effect, any impairment reversals will not be as large as the original impairment charge.

If there is an indication that a previously recognised impairment charge has decreased or ceased to exist, the film producer should also consider if the useful life or amortisation method of the film should be reviewed and adjusted.

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

A key consideration in determining the net outflows involves the remaining distribution costs. The major film producers have mature distribution networks with minimal incremental distribution costs for individual films; whereas for an independent producer's perspective, the cash outflows from distribution could be significant because it will be need to pay a distribution fee (typically 8-15% of revenues, often in the form of an advance funding payment from the distributor that will be recouped from theatre and broadcast revenues).

This variation in distribution costs indicates that a value in use calculation can lead to different values depending on who is producing and distributing it. The judgements inherent in a value in use calculation will include the company-specific estimated costs of distribution efforts. The model should then be applied consistently to the valuation of films in similar situations for that film producer.

What discount rate should be used in determining a film's value in use?

The discount rate for value in use calculations should be calculated on a pre-tax basis and applied to pre-tax cash flows. The rates are adjusted to take account of the way in which the producer would assess the specific risks in the estimated cash flows for that film and to exclude risks that are not relevant or for which the estimated cash flows have already been adjusted.

In the determination of the appropriate discount rate to use in a film valuation, the discount rate is principally 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 its expectations and be generally accepted by critics and the film-going public. After a film's theatrical release, the timing and amount of cash flows are generally known with a strong level of certainty based on initial reactions and the producer's prior history.

Accordingly, we believe that the discount rate used for valuing an unreleased film (e.g. in a pre-release write-down valuation) would generally be higher than the discount rate used for valuing a released film.

What are the considerations for a 'pre-release' 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:

- Film 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 similar recent films in the marketplace, that indicate a write-down may be necessary

In such situations, an estimate of recoverable value of the film is necessary. This analysis will be based on the determination of the value in use of the estimated net present value of future cash flows related to the non-released film. The future cash flows should include an estimate of the future cash flows expected to be incurred before the film will be released and the expected cash inflows and outflows once the film is released. An impairment write-down would then be necessary for the amount by which the carrying value of the film cost exceeds its recoverable value.



Conclusion

The costs of developing and producing films, particularly blockbusters, are significant and the outcome of the film as a hit or miss can be unpredictable. Companies that are adept at navigating the intricate accounting and reporting practices can tell their story in a clear and compelling manner, building public trust in their performance with stakeholders such as investors, analysts, employees, suppliers, partners and audiences.

This paper has explored the critical considerations relating to the classification, capitalisation, amortisation and impairment of film costs under the applicable IFRS standards IAS 38 *Intangible Assets* and IAS 2 *Inventories*. The examples in our paper are clearly not designed to be exhaustive; but they will hopefully provide food for thought for film companies when considering how to account for their film development and production costs.

The answers for complicated real life arrangements will depend on the specific facts and circumstances in each case. Where transactions are significant, management should include disclosures in the financial statements that enable users to understand the conclusions reached. As always, planning ahead can prevent painful surprises.

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

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

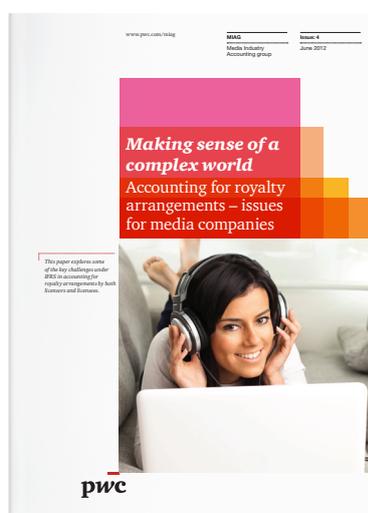
Publications/further reading



MIAG Issue: 3

Broadcast television: Acquired programming rights

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



MIAG Issue: 4

Accounting for royalty arrangements – issues for media companies

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



MIAG Issue: 5

Content development and cost capitalisation by media companies

This paper explores the critical considerations relating to the classification, capitalisation and amortisation of content development spend under the applicable IFRS standards IAS 2 Inventories and IAS 38 Intangible Assets, focusing on the television production, educational publishing and video game sectors.



MIAG Issue: 6

Revenue recognition: principal/agent arrangements – issues for media companies

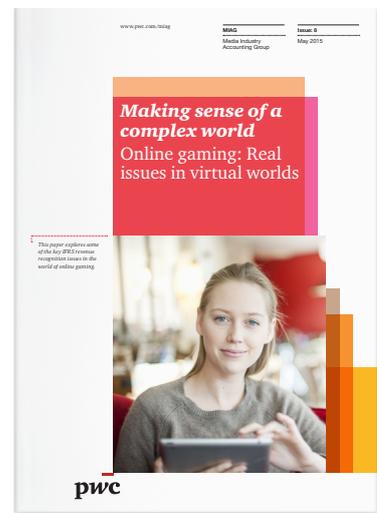
This paper considers the assessment of the key principal/agent considerations in various practical examples, covering physical books, eBooks, television content and film production.



MIAG Issue: 7

Revenue recognition: payments to customers – issues for media companies

This paper explores some of the key IFRS accounting considerations for payments by media companies to their customers, covering the purchase of advertising space, physical and digital 'slotting fees', outsourced advertising sales and video game prizes.



MIAG Issue: 8

Online gaming: Real issues in virtual worlds

This paper explores some of the key IFRS revenue recognition issues in the world of online gaming, covering principal/agent considerations, virtual items and virtual currencies, and multiple element arrangements.



MIAG Issue: 9

Media investments in technology companies

This paper explores some of the key IFRS accounting issues that can arise when making investments in technology companies.

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