

Academy Speaker Series

Putting accounting theory into practice for film producers and distributors*

October 27, 2009

*connectedthinking

PRICEWATERHOUSECOOPERS 

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Agenda

- Introduction
- Our firm and the industry
- Recent industry developments
- Accounting guidance:
 - Production
 - Distribution
 - Exhibition
 - Broadcasting

Introduction

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Introduction

We would like to know more about you!

Production

Distribution

Film exhibition

Broadcasting

Our firm and the industry

As one of the world's largest professional services firms, PricewaterhouseCoopers offers insights gained from years of experience working with a broad range of industry clients, a tightly woven global network, and an extraordinary breadth of services, including:

Assurance Services

Providing accounting and auditing services, serving a wide range of clients from the largest global entertainment and media companies to start-ups. Our professionals can support companies in providing accurate and understandable financial information.

Tax Services

We understand the environment in which our clients operate, and how concerns such as transfer pricing strategy and documentation, Internet sales taxation, intellectual property management, as well as mergers, acquisitions and divestitures impact tax planning and compliance requirements.

Advisory Services

We assist clients with central operational and business issues that are part of enterprise management, such as convergence, transaction support, process and performance improvement, attracting and retaining customers, analysing and managing information associated with digital assets, compliance, and risk management, across key corporate functions including IT, HR, legal and finance.

Our firm and the industry

PwC's position in the entertainment & media marketplace

Our industry coverage includes -- but is not limited to -- the following sectors:



Our firm and the industry – selected clients

PwC's worldwide entertainment and media practice is the largest dedicated practice of its kind. In Canada and globally, PwC is the leading professional services organization for the Entertainment and Media (E&M) industry, we specialize in providing professional services to a wide variety of entertainment and media clients, including major broadcasters, distributors, studios, production companies, video game developers, on-line service providers, cable operators, publishers and new media companies:

Selected Relevant Canadian Entertainment and Media Clients:	
<ul style="list-style-type: none"> Aboriginal Peoples Television Network Academy of Canadian Cinema & Television Alliance Films Inc AOL Time Warner CTVglobemedia Inc. Canadian Academy of Recording Arts & Sciences Canadian Satellite Radio Inc Canadian Television Fund CanWest Global Channel M Cineplex Entertainment Limited Partnership Comedy Central Corus Entertainment DHX Media Limited 	<ul style="list-style-type: none"> Electronic Arts Entertainment One Fox Entertainment Peace Arch Entertainment St. Joseph Communications Telefilm Canada Telelatino Network Thomson Reuters Torstar Ubisoft Universal Warner Brothers Walt Disney
Selected Relevant Global Entertainment and Media Clients:	
<ul style="list-style-type: none"> ABC Academy of Motion Pictures AOL Time Warner BBC Bertelsmann Bloomberg LP Chancellor Media Dow Jones and Company European Broadcasting Union Fisher Broadcasting Corp. Interpublic 	<ul style="list-style-type: none"> Pax Communications Pearson Reuters Sony Corporation South African Broadcasting United News and Media US News and World Report Viacom Vivendi Walt Disney

Our firm and the industry

Some examples of key initiatives:

- **Thought leadership**

We frequently publish thought leadership and white papers on thinking gathered from the knowledge of our global E&M teams.

- **Industry events**

We sponsor and host a number of industry events that provide opportunities to both gain insight on a number of relevant topics, demonstrate commitment to the industry and allow our clients to network.



Some of the more significant are:

- Key sponsor of Stratford Institute and Canada 3.0
- Ballot accountant in Canada to Gemini, Genie and Juno awards, as well as the Oscars in the U.S.
- Entertainment and Media Outlook 2009-2013



Recent industry developments



PwC's Global entertainment and media outlook publication 2009-2013

- Canadian growth in filmed entertainment at 4.2% compound annual growth rate between 2009 – 2013
- Filmed Entertainment
 - Forecasted to grow 4.2% CAGR from \$3.4 billion to \$4.2 billion
- Television Subscriptions
 - Relatively slow growth, 3.8% CAGR to \$5.4 billion
 - Bright lights are growth in video on demand forecasted at 14.9% CAGR to \$163 million in 2013
- Advertising
 - Television: Sharp decline in 2009 of 11.2%, followed by rebound in 2010-2013 reaching \$3.1 billion in 2013

Industry structure – Production Stages



- Acquire, evaluate and develop script
- Negotiate and close talent deals
- Obtain clearances
- Prepare financial support
- Develop production and distribution agreements with third parties

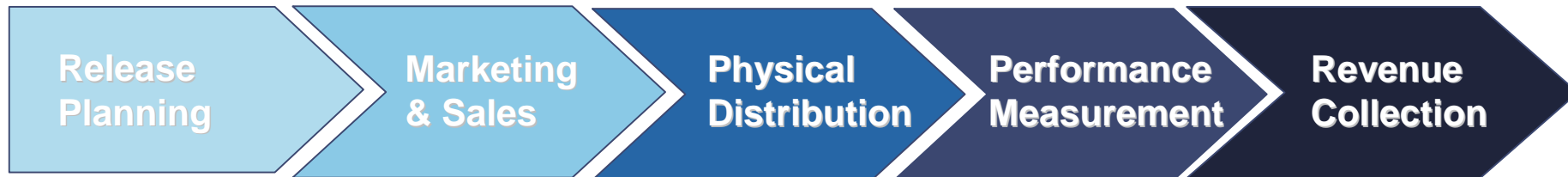
- Cast secondary talent
- Organize below the line activities (i.e. locations and set design)
- Plan physical production
- Prepare detailed budgets
- Procure insurance

- Execute principal photography
- Organize logistics
- Develop financial support for accounting and cash reimbursements

- Arrange film editing
 - Select facility
 - Develop optical and titles
- Develop sound track
- Duplicate negatives
- Obtain MPAA rating
- Create trailers

- Broadcast
- Film & television shows
- Amortize rights

Industry Structure – Distribution Stages



- Make decisions regarding:
 - Release dates
 - Markets and locations
 - Prints/units volume
- Develop print distribution logistics
- Negotiate exhibitor terms
- Arrange licensing deals
- Prepare competitive assessment

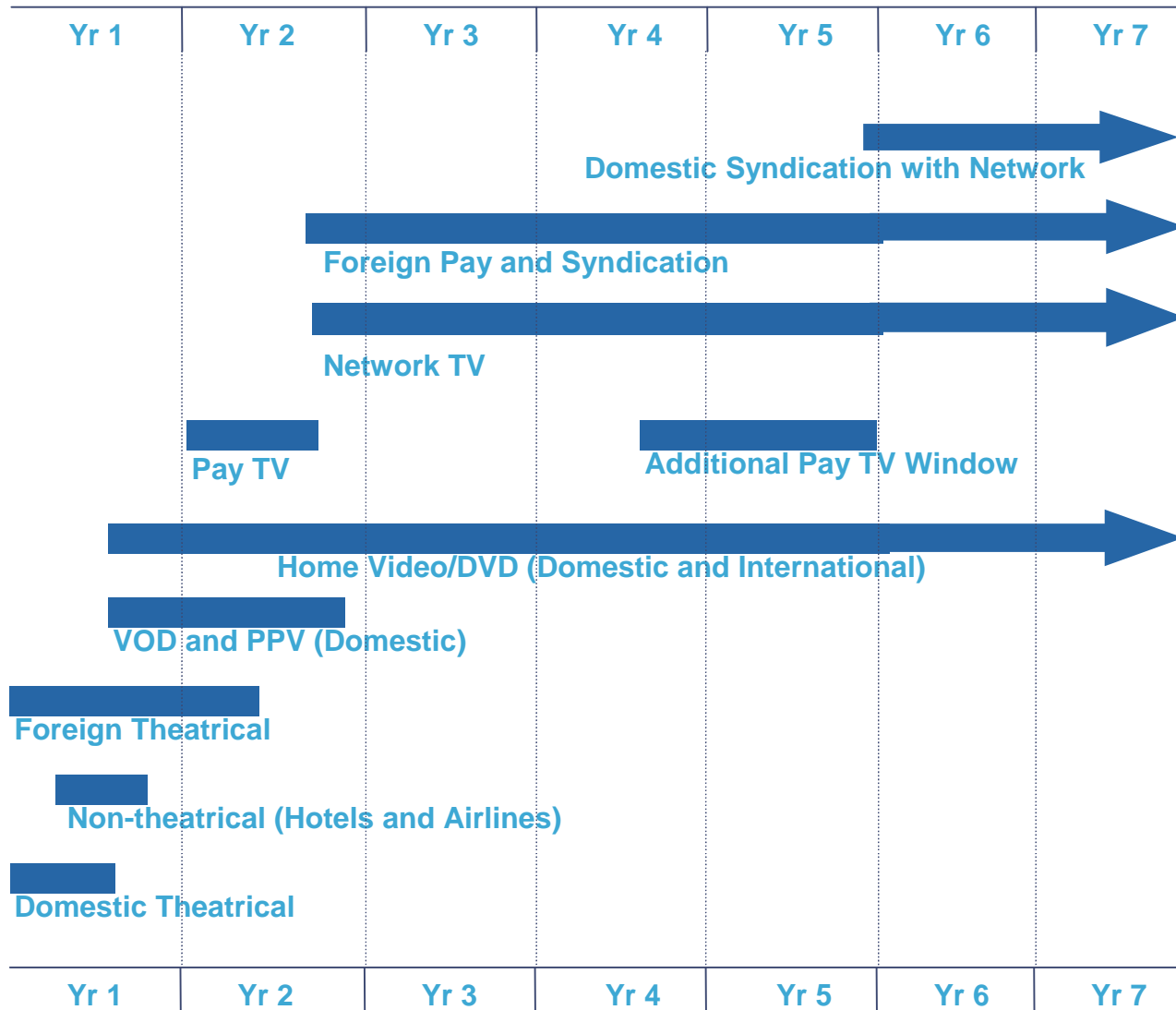
- Organize, create and execute:
 - Advertising
 - Point of sale material
 - Sales
 - Packaging
 - Detailed budgets
 - Marketing strategy
 - Market research
 - Publicity

- Ship prints and point of sale material
- Track and manage prints

- Prepare point of sale data analysis
- Revise revenue ultimates
- Analyze revenues
- Evaluate competitive product

- Manage accounts receivable
- Control cash transactions
- Amortize inventory on balance sheet
- Account for and pay participants

Industry structure – Distribution stages: Typical distribution windows



Industry structure – Distribution

Distributors - Types of costs

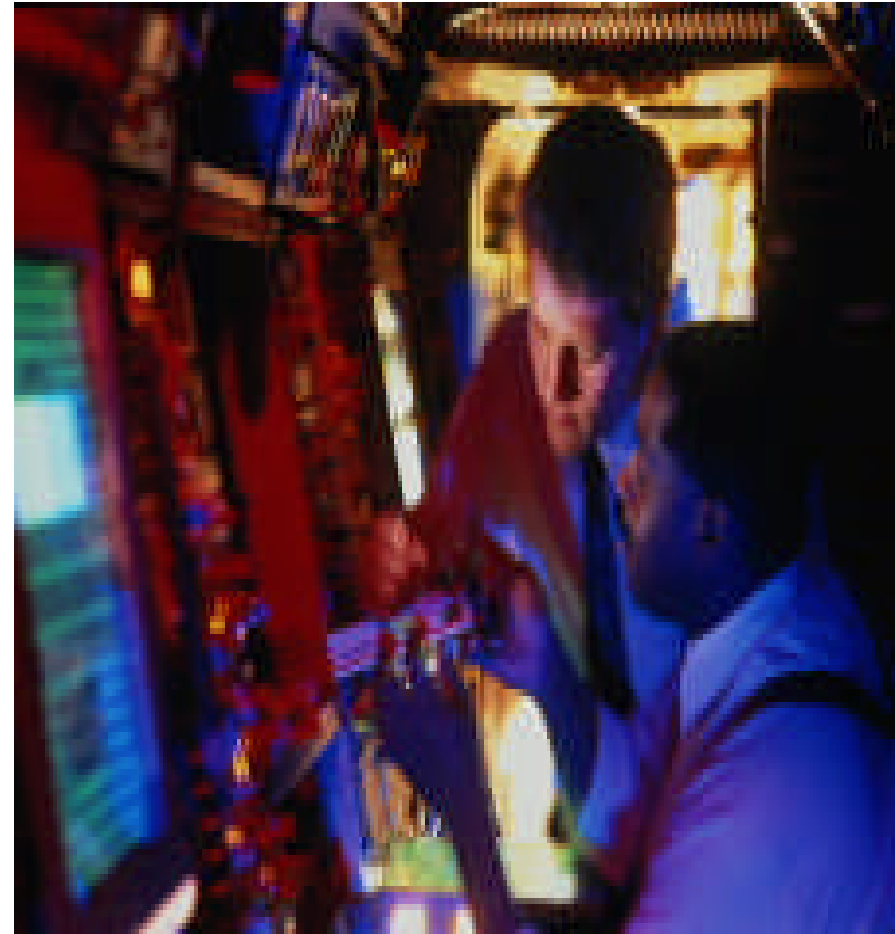
- **Exploitation costs** are incurred to market the film and are typically referred to as print and advertising costs or P&A costs.
- **Acquisition costs** are incurred when certain rights to a film produced by a third party are purchased. These intangible assets are often referred to as distribution or licensing rights (investment in film and TV) and may include either individual films/titles or film libraries.
- **Participation costs** are forms of royalties or deferred compensation paid out of the revenues generated by the film after certain costs are recouped.



Accounting guidance

Contents

- Keys practices used in the industry
- Sources of Canadian GAAP
- Revenue recognition
- Costs and expenses
- Amortization of film costs
- Impairments
- Participation costs
- Recap of costs, expenses, amortization and impairments
- Production cost accounting and audit issues
- Co-production and Co-financing arrangements
- Film exhibitors' accounting and business issues



Key practices used in the industry

Film accounting involves a high degree of accounting estimates:

- Estimates of ultimate revenues from films drive the film amortization and recoverability tests as well as the participation accruals
- Fair value of films (where lower than unamortized film costs)

Revenue recognition consistent with general principles

- Certain distribution arrangements require further analysis to determine substance

Different accounting for different types of costs

- Film costs (capitalized and amortized)
- Costs for insignificant changes (expensed)
- participation costs (expensed on accrual basis)
- exploitation costs (expensed)
- film prints (capitalized and amortized)
- manufacturing costs (inventoried and charged to cost of sales on a unit-specific basis)

Sources of Canadian GAAP guidance

No specific comprehensive industry guidance

Canadian guidance – accounting based on general principles and related guidance:

- Revenues – CICA Section 3400, EIC 141 and 142
- Film costs, exploitation costs and film prints – CICA Sections 3062, 3063 and 3064
- Manufacturing costs – CICA Sections 3030 and 3031
- Participation costs – no specific Canadian guidance
- Broadcast rights – CICA 3064, 3031 and FAS 63

Additional guidance from the United States - AICPA Statement of Position (SoP) 00-2, Accounting by Producers and Distributors of Films

- Used by most companies in the industry
- Caution – certain requirements of Canadian GAAP may differ from the SoP 00-2 guidance

NOTE: With the implementation of IFRS, this may change current practices significantly as SoP 00-2 is not consistent with IFRS.

Revenue recognition

Basic principles

Recognize when all the following conditions are met:

- i) Persuasive evidence of an arrangement exists
- ii) Film has been delivered
- iii) Fee is fixed or determinable
- iv) Collection of the fee is reasonably assured

Revenue recognition

i) Persuasive evidence of an arrangement exists

Contract or other legally enforceable documentation, including as a minimum

- License period
- Film(s) affected
- Rights transferred
- Consideration to be exchanged

Verifiable evidence should exist to document terms of the arrangement

- Contract
- Purchase order
- Email/fax
- Online authorization
- Correspondence from the customer detailing mutual understanding of the arrangement or that the customer has acted in accordance with such arrangement

Revenue recognition

ii) Production or film has been delivered

When has delivery occurred?

- Physical delivery required
 - When required by arrangement terms and conditions
 - When arrangement silent about delivery
- Exception to physical delivery if film is complete and available for immediate delivery
 - Arrangement provides for immediate and unconditional access to a film print from the producer or distributor
 - Lab access letter authorizing customer to order the film from a film laboratory immediately and unconditionally

Revenue recognition

ii) Production or film has been delivered

Remember!

- Delivery condition not met until license term begins **AND** the product has been physically delivered
- Examples include:
 - Street dates for home entertainment products (fixed or relative date)
 - Restrictions on initial exhibition, exploitation or sale of film in a particular territory or market
 - Holdbacks (not always contractual since some countries have legislated holdbacks for certain commercial arrangements)
 - License period for broadcast

Revenue recognition

iii) Fee is fixed or determinable

Flat fees:

- Single film or programs are considered fixed and determinable
- Multiple films or programs require consideration of multiple elements accounting guidance in EIC 142 and SoP 00-2

Consideration:

- Packages and output deals

Revenue recognition

iii) Fee is fixed or determinable

Variable fees

- Examples:
 - Percentage or share of the customers' revenue from exhibition or exploitation of the film
 - Fees based on broadcaster ratings
- Not fixed or determinable until the customer exhibits or exploits the film
- Fee required to be determinable within reasonable limits according to CICA Section 3400:
 - Best estimates based on historical evidence and other available information adjusted to actual receipts
 - Actual receipts

Revenue recognition

iii) Fee is fixed or determinable

Rights of return – contractual or based on past practice

- Revenue precluded if conditions for rights of return set out in EIC 141 not met (including ability to make reliable estimates)

Price concessions (price protection, inventory credits, rating rebates)

- Similar concerns as for rights or return
- If reliable estimates cannot be made, revenue is not fixed or determinable

Revenue recognition

Key areas for consideration:

Delivery:

- If delivery terms unclear in contract – revenue can not be recognized until the physical delivery date
- License period commences on the first telecast determined by the broadcaster – delivery not considered to have occurred until this period begins
- Legislated holdbacks for certain media – delivery not considered to have occurred until the broadcaster has right to telecast

Multiple element arrangements:

- Determination of fair value for multiple element arrangements as applicable to ensure appropriate revenue recognition is identified from the start/amortization of film costs and participation/period of recognition

Production cost accounting and audit issues

Key issues

- Labour costs - payroll usually the most significant component of the costs
 - Residency - Canadian labour component critical for certain tax credit calculations - residency forms
- Foreign exchange - gains and losses on financing including unrealized foreign exchange
- Telefilm - sets treatment and disclosure requirements
 - locked items (budgets approved by Telefilm in advance and they lock certain specific costs, which are the maximum or minimum allowable amounts)
- Interim financing and other accruals – often soft estimates
- Assets acquired in the course of production need to be disclosed. Can charge cost less any residual value
- Different reporting requirements for different agencies (i.e. CAVCO)

Co-production and co-financing arrangements Basics

- Co-production and co-financing arrangements are often made to share risks and rewards of producing and distributing films
- Account for in accordance with substance of arrangement considering the facts, circumstances and contractual terms

Accounting issues to consider:

- Is there a collaborative arrangement? I.e. a principal versus an agent
- Does this qualify as a joint venture? If so, proportionate consolidation may be appropriate
- Is this entity controlled by one party? Is consolidation the appropriate measure
- Have the financing arrangements be assessed for financial instrument implications?

Co-production and co-financing arrangements Consolidation of variable interest entities (VIEs)

What are VIEs?

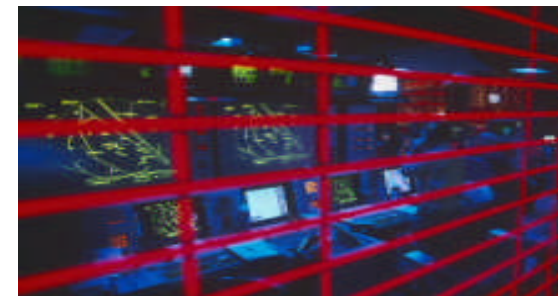
Exposure to majority expected losses based on the variability of the possible cash flows related to the film or possible fair value of the film. Common VIEs in the industry include production companies and tax shelters.

- Accounting Guideline 15 – Qualitative and quantitative considerations

What are variable interests in a VIE?

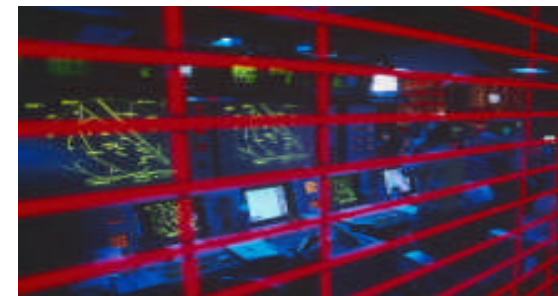
- Equity interest in the entity
- Minimum guarantees or payments for first broadcast rights
- Loans and advances
- Management arrangements
- Role as de facto producer
- Related party interests

Costs and expenses



Types of costs	How to classify under Canadian GAAP?
Films acquired from others to be licensed to several other parties over varying periods of time and film prints	Capitalize as a separately acquired intangible assets
Films produced in-house to be licensed to several parties over varying periods of time (including development)	Capitalize as an internally generated intangible assets (i.e. Investment in Film)

Costs and expenses



Types of costs	How to classify under Canadian GAAP?
Films produced to be sold outright to third party	Expense as part of costs of services provided
Exploitation costs (i.e., advertising, promotional and launch expenditures)	Expense as incurred
Broadcast rights	Record as an asset when originally acquired and expense over the period of use or rights period.

Costs and expenses

Specific guidance in SoP

Film costs (as defined - costs commonly referred to as negative costs) include:

- Direct production overhead, which includes the allocation of costs of individuals or departments with exclusive or significant responsibility for the production of a film
- Interest capitalization (required)
- Set assets as part of the cost of the first season for episodic television series

Costs and expenses

Specific guidance in SoP

Overall deals

- defined per SoP 00-2 as compensation to producers for the exclusive/preferential use of their creative services for several projects
- costs of overall deals that cannot be identified with specific projects to expense as they are incurred

Film prints are accounted for as a separate asset and amortized over the theatrical release period

Film production costs

Government assistance and investment tax credits

Other assistance and ITCs

- Cost reduction method to reduce current/future expenses or film costs
- If amounts supplement selling prices, recognize as revenues
- Accrued when there is reasonable assurance that the entity qualifies for the ITC conditions
- Disclosure required of the amount of assistance, where credit was recorded, relevant terms and conditions and contingent repayable amounts

Loans with normal commercial characteristics (not government assistance) and subject to CICA Section 3855, Financial Instruments – Recognition and Measurement

Film production costs

Government assistance and investment tax credits

Please join us at the next Academy Speaker Series seminar on Tuesday, November 3, 2009 where the topic will be **Tax credits and other production financing**

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Amortization of film production costs

Basics

Intangible assets are to be amortized over their useful lives using the best estimate of their lives

Method used should reflect the pattern in which economic benefits are used up

- Straight-line method only permitted if pattern of economic benefits cannot be reliably determined
- Industry has used the individual film forecast method (IFFM)

Amortization of broadcast rights

- Straight-line or over the expected number of plays
- If benefits are earned upfront, the accelerated basis of amortization may be appropriate

Amortization of film production costs Individual film forecast method

Film costs are amortized in the same ratio that current period actual revenues bear to estimated total remaining unrecognized revenue as of the beginning of the fiscal period (ultimate revenue)

Amortization commences when film is released and revenue is recognized

$$\text{Unamortized film costs} \quad \times \quad \frac{\text{Actual revenues in current period}}{\text{Ultimate revenue at the beginning of the period}}$$

Key – Recording of amortization affected directly by management assessment of ultimate revenue. The next several slides will therefore provide further guidance on ultimate revenues.

Amortization of film production costs

Ultimate revenue

SoP 00-2 provides detailed guidance on determining ultimate revenues to be used for computing amortization of film costs

Ultimate revenue

- estimates of revenue expected to be recognized by an entity from the exploitation, exhibition, and sale of a film in all markets and territories subject to certain limitations
- foreign currency denominated revenues included in ultimate revenue are based on current spot rates at period-end
- Multiple seasons of a television series, which have qualified secondary revenues, are considered a single product for the IFFM

Amortization of film production costs

Ultimate revenue

Limitations on ultimate revenue based on time periods

- Films – not to exceed ten years from initial release
- Television series
 - not to exceed ten years from date of delivery of first episode, or
 - if still in production, five years from date of delivery of most recent episode
- For an acquired film library, maximum period of 20 years from acquisition for titles that were initially released three years prior to being acquired from a third party

Note: Films may be amortized over a shorter period based on expected revenues.

Amortization of film production costs

Ultimate revenue

CICA Section 3064 requires the estimates for amortization to be reviewed annually with revisions reflected prospectively from the period of change

CICA Section 1751 requires amortization to be based on assets owned during the interim period with changes in estimates applied prospectively

SoP 00-2 requires ultimate revenue to be reviewed and revised as applicable at each reporting date

- Ultimate revenue is revised prospectively as of the beginning of the year of the change
- Revised ultimate revenue factor is applied to the unamortized cost as of the beginning of the year with the difference charged or credited to income

Impairments

Film costs

Triggering events – events or circumstances indicating an impairment assessment should be made:

- An adverse change in the expected performance of a film
- Actual costs substantially in excess of budgeted costs
- Substantial delays in completion or release schedule
- Change in release plans, such as a reduction in the initial release pattern
- Insufficient funding or resources to complete the film or market it effectively
- Actual performance subsequent to release fails to meet that which was expected prior to release
- Change in expected exploitation or ultimate revenue of film
- Significant adverse change in business climate

SoP 00-2 indicates subsequent triggering events before the release of financial statements are presumed to have existed at the balance sheet date, unless it can be demonstrated that conditions did not exist at that date

Impairments

Film costs

For incomplete films (not yet amortized), an annual review is required under Canadian GAAP whereas a review is only required under SoP 00-2 when triggering events occur

Recoverability test

- Under Canadian GAAP, if carrying value of film exceeds undiscounted expected future cash flows (inflows less outflows) directly associated with film, film is impaired
- Under SoP 00-2, if the carrying value of film exceeds fair value of film, the film is impaired

Broadcast rights

- Net realizable value of undiscounted cash flows

Impairments

Film costs

Impairment is measured as carrying value less fair value

- Follow general guidance for estimating fair values
- Use of discounted cash flow valuation techniques
- Must consider all anticipated cash inflows and outflows
 - Cash inflows vs. ultimate revenues
 - Outflows for WIP, advertising, overhead, tax
- Discount rate is not incremental borrowing rate – consider time value of money and risk premium for individual factors

Participation costs Basics

Participations may be given to creative talent, such as actors or writers or to entities from whom distribution rights are licensed

SoP 00-2 indicates this is compensation for parties involved in the production:

- Participations – contingent payments based on financial results of a film pursuant to contractual formulas
- Residuals – contingent amounts due under provisions of collective bargaining agreements

No specific Canadian guidance, but SoP 00-2 accounting consistent with guidance on accounting for contingent payments outlined in CICA Section 1751, Interim financial statements

Participation costs Accruals under SoP 00-2

Accrue participation costs only if probable they will be settled

- Estimate the total amount of participations and residuals to be paid based on expected ultimate revenue (Ultimate Participation Cost) to be consistent with amortization of film costs

Accrue and expense using IFFM

Unaccrued ultimate X
participation cost

Actual current period revenues
Ultimate revenue
at the beginning of the period

Key – Accrual Affected directly by the assessment of ultimate revenues

Accrual commences when film is released and revenue is recognized

Participation costs Accruals under SoP 00-2

Participations' liability should not be less than the amount that the entity is obligated to pay as of that date (legal liability)

If participations' liability exceeds the estimated amount to be paid, the excess is applied against unamortized film costs. If unamortized film costs are reduced to \$nil, recognize any residual in income

- Under Canadian GAAP, changes in the estimates of liabilities are generally included in income

Changes in estimates of ultimate revenue during a year are reflected prospectively as of the beginning of the year with adjustments reflected in income in the period of change

- For Canadian GAAP, changes in estimates are reflected only from the period of change

Recap of costs, expenses, amortization and impairments Some implications for producers and distributors

Cut-off on accrual of film print costs and advertising and marketing (exploitation costs) becomes critical as they directly impact earnings

Recognition, treatment and cut-off of supplier bonuses rebates or other incentives – implications for assessment of unamortized film costs

Impairment of films results in a write-down that is not reversed

Cash flows used to determine fair value for impairments can be different from the ultimate revenue used for IFFM and include cash outflows

Monitoring of the ultimate revenue on a regular basis becomes critical as it is expected that revisions to ultimate revenue be reflected in interim periods, regardless of whether there are current revenues recognized

Film exhibitors' accounting and business issues

Lease accounting:

- Leases of premises – operating vs. capital lease assessments
- Lease escalation clauses – straight-line rent expense
- Percentage rent clauses – ensure accrued at period-end
 - If amounts based on certain level of annual sales, based on expected sales for the annual period

Concessions:

- Cut-off and completeness of costs
- Accounting recognition of various rebate programs

Film exhibitors' accounting and business issues

Film settlement is key – cut-off and cost of sales:

- Film costs are a percentage of box office revenue; may change on a weekly basis or may be finalized at the end of the final showing
 - Need history of settlements to assess reasonableness of film cost estimates
 - Terms range approximately from 40% to 60% of box office revenue with higher film cost for blockbuster hits
 - Need to know standard rate for distributor

Film exhibitors' accounting and business issues

Real estate/property matters:

- Construction of new theatres/refurbishments of old theatres
 - Tenant inducements are recorded as a liability and amortized into occupancy cost
 - Asset accounting issues – cut-off and completeness of construction accruals
 - Capitalization of interest costs (permitted, but not required)
- Impairment of theatre assets – based on lowest level of independent cash flows which may be each theatre (assessed using criteria in CICA Section 3063 – Impairment of Long-lived Assets)
- Potential classification as discontinued operations for disposed of theatres
- Theatre property transactions such as sale and leaseback – impact on earnings and comparability

Television broadcasting - other issues

- **Advertising revenues:**
 - Recognize when the spots air
 - Rating commitments for advertisers
 - Pricing and volume commitments for advertisers
 - Contra/barter agreements
- **Subscriber revenues**
 - Out of contract periods
 - Most favoured nation clauses
- **Regulatory obligations**

Questions?

Thank you.