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DRAFT EXPOSURE DRAFT
PROPOSED STATEMENT OF POSITION
ACCOUNTING BY PRODUCERS AND DISTRIBUTORS OF FILMS

April 21, 1998

Prepared by the Accounting Standards Executive Committee
American Institute Of Certified Public Accountants

Comments should be received by _______, 1998, and addressed to
Daniel Noll, Technical Manager
Accounting Standards, File 2550
AICPA, 1211 Avenue of the Americas, New York, NY 10036-8775
or via the Internet to DNOLL@AICPA.ORG

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Accompanying this letter is an exposure draft of a proposed Statement of Position (SOP), *Accounting by Producers and Distributors of Films*. A summary of the proposed SOP follows this letter.

The purpose of this exposure draft is to solicit comments from preparers, auditors, and users of financial statements and other interested parties.

The proposed SOP would apply to all producers and distributors that own or hold the rights to distribute or exploit films, and it would replace Financial Accounting Standards Board (FASB) Statement No. 53, *Financial Reporting by Producers and Distributors of Motion Picture Films*.

Areas Requiring Particular Attention by Respondents

Comments are specifically requested on the following issues addressed by this exposure draft:

(1) The proposed SOP requires that, if certain conditions are met, the licensing of film products be reported as sales if substantially all of the fair value for a market or territory has been transferred to the customer on an exclusive basis. AcSEC considered and rejected requiring revenue to be reported ratably over the licensing period. Do you agree with the proposed accounting? Why? (Reference to paragraph _____)

(2) The proposed SOP requires that participations and residuals be accrued in total and included in film costs based on the estimated ultimate gross revenues of a film. Do you agree with the proposed accounting? Why? If not, what alternative method do you believe is more appropriate and why? (Reference to paragraph _____)

(3) The proposed SOP requires capitalization of early release and prerelease exploitation costs of theatrical products, with a limited amortization period. Do you agree with the proposed accounting? Why? If not, what alternative method do you believe is more appropriate and why? (Reference to paragraph _______)

(4) The proposed SOP requires certain disclosures. Do you agree that the disclosures are necessary? Why? What disclosures should not be required? Why? What additional disclosures should be required? Why? (Reference to paragraph _______)

(5) One of the underlying conclusions in the proposed SOP is that films are more like long-lived assets than inventory. Therefore, impairment would be

recognized and measured in accordance with FASB Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of*, cash flows representing additions to film costs would be reported as cash flows from investing activities, and film costs would be classified as noncurrent assets in a classified balance sheet. Do you agree with the underlying conclusion? Why? If not, how would you recognize impairment and why? (Reference to paragraph _______)

(6) Do you agree with the proposed SOP=s approach for loss recognition on episodic television products? Why? AcSEC considered and rejected requiring immediate loss recognition for the total loss expected based on the number of episodes expected to be delivered. Do you agree with the alternative approach? Why? (Reference to paragraph _______)

(7) Do you agree with the proposed SOP=s requirement that a property that has not been set for production within three years from the time of the first capitalized transaction should be considered disposed of with the related losses charged directly to income? Why? Do you agree with the rebuttable presumption that a property to be disposed of by abandonment has zero fair value? Why? (Reference to paragraph _______)

(8) Do you agree with the proposed SOP=s transition provisions? Please comment on the practicability of the cumulative effect approach. If you do not agree with the transition provisions, what transition method do you propose and why? (Reference to paragraph _______)

AcSEC welcomes comments or suggestions on any aspect of the exposure draft. When making comments, please include references to specific paragraph numbers, include reasons for any suggestions or comments, and provide alternative wording if appropriate.

Comments on the exposure draft should be sent to Daniel Noll, Technical Manager, Accounting Standards, File 2550, American Institute of Certified Public Accountants, 1211 Avenue of the Americas, New York, NY 10036-8775, in time to be received by _________. Responses may also be sent by electronic mail over the Internet to DNOLL@AICPA.ORG.

Written comments on this exposure draft will become part of the public record of the AICPA and will be available for public inspection at the AICPA=s offices for one year after _________.

Sincerely,

David B. Kaplan, CPA
Chair
Accounting Standards
Executive Committee

Louis W. Matusiak, Jr., CPA
Chair
Motion Pictures Task Force

Elizabeth A. Fender, CPA
Director
Accounting Standards

Accounting Standards Executive Committee (1997-1998)

David B. Kaplan, *Chair*
Mark M. Bielstein
James L. Brown
Joseph H. Cappalonga
Robert O. Dale
Joseph F. Graziano
James F. Harrington
James W. Ledwith
Louis W. Matusiak
James P. McComb
Charles L. McDonald
Roger H. Molvar
David M. Morris
Benjamin S. Neuhausen
Mark V. Sever

Motion Pictures Task Force

Louis W. Matusiak, *Chair*
Peter Cyffka
John Giesecke
James F. Harrington
Robert Keenan
David Londoner
John Nendick

AICPA Staff

Elizabeth A. Fender
Director
Accounting Standards

Daniel J. Noll
Technical Manager
Accounting Standards

The task force and staff gratefully acknowledge the contributions made to the development of this exposure draft by Richard K. Stuart.

SUMMARY

This Statement of Position (SOP) provides guidance on accounting by producers and distributors of motion picture films. This SOP requires the following:

- Revenue should be recognized if all of the following criteria are met:

  - Persuasive evidence of a sale or licensing arrangement with a customer exists.

  - The film is complete and, in accordance with the terms of the arrangement, either has been delivered or is available to be delivered.

  - The license period of the arrangement has begun and the customer can begin its exploitation or exhibition.

  - The gross revenue is fixed or determinable.

  - Collection is reasonably assured.

  Licensing arrangements that meet all of the above criteria and transfer substantially all of the benefits and risks incident to ownership of the film on an exclusive basis for an individual market and territory should be accounted for as sales.

- The costs of producing a film and bringing that film to market consist of production costs, exploitation costs, and participation costs.

  The present value of participation costs should be accrued when their payment is probable, which is usually determined when the film has been released. Entities should recognize an asset as part of film costs for the initial amount of the participation liability.

Production costs and capitalized participation costs should be amortized using the individual-film-forecast-computation method. The individual-film-forecast-computation method requires estimating remaining ultimate gross revenues as of the beginning of each period. It also requires determining a fraction, the numerator of which is actual gross revenues from the film for the current period and the denominator of which is the estimated unrecognized ultimate gross revenues as of the beginning of the period. This fraction is applied to the unamortized balance of production costs and capitalized participation costs as of the beginning of the period to determine periodic amortization. In this way, in the absence of changes in estimates, production costs and capitalized participation costs are amortized in a manner that yields a constant rate of profit for each film, excluding exploitation costs and other period expenses. Amortization should begin when a film is released and revenues from that film are recognized.

Prerelease and early release exploitation costs incurred on a territory-by-territory basis in the theatrical market should be capitalized and amortized over the expected period of exploitation of the film in that theatrical market and territory, not to exceed three months. Capitalized exploitation costs for a particular territory should be amortized in the same ratio that theatrical gross revenues earned in that particular theatrical territory bear to estimated total theatrical gross revenues for that territory for the shorter of (*a*) three months or (*b*) the theatrical release period in that territory All capitalized exploitation costs should be fully amortized by the end of the theatrical release period or three months (whichever is shorter) After the period leading up to the theatrical release of a film in a

territory and the initial three-month period, all exploitation costs should be expensed as incurred. Exploitation costs incurred in connection with the release of a film in markets other than the theatrical market should be expensed as incurred.

! Unamortized film costs should be reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of the film may not be recoverable, in accordance with the provisions of paragraphs 4 to 13 of Financial Accounting Standards Board (FASB) Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of.*

! Certain disclosures should be made in the financial statements or notes thereto.

This SOP is effective for fiscal years beginning after December 15, 1999, with earlier application encouraged. The cumulative effect of changes in accounting principle caused by adopting the provisions of this SOP should be included in the determination of net income in conformity with paragraph 20 of Accounting Principles Board Opinion No. 20, *Accounting Changes*.

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FOREWORD

The accounting guidance contained in this document has been cleared by the Financial Accounting Standards Board (FASB). The procedure for clearing accounting guidance in documents issued by the Accounting Standards Executive Committee (AcSEC) involves the FASB reviewing and discussing in public board meetings (1) a prospectus for a project to develop a document, (2) a proposed exposure draft that has been approved by at least ten of AcSEC=s fifteen members, and (3) a proposed final document that has been approved by at least ten of AcSEC=s fifteen members. The document is cleared if at least five of the seven FASB members do not object to AcSEC undertaking the project, issuing the proposed exposure draft or, after considering the input received by AcSEC as a result of the issuance of the exposure draft, issuing the final document.

The criteria applied by the FASB in their review of proposed projects and proposed documents include the following.

1. The proposal does not conflict with current or proposed accounting requirements, unless it is a limited circumstance, usually in specialized industry accounting, and the proposal adequately justifies the departure.

2. The proposal will result in an improvement in practice.

3. The AICPA demonstrates the need for the proposal.

4. The benefits of the proposal are expected to exceed the costs of applying it.

In many situations, prior to clearance, the FASB will propose suggestions, many of which are included in the documents.

ACCOUNTING BY PRODUCERS AND DISTRIBUTORS OF FILMS

INTRODUCTION AND BACKGROUND

1. The Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards No. 53, *Financial Reporting by Producers and Distributors of Motion Picture Films*, in 1981. FASB Statement No. 53 extracted specialized accounting and reporting principles and practices from the American Institute of Certified Public Accountants (AICPA) Industry Accounting Guide, *Accounting for Motion Picture Films*, and AICPA Statement of Position (SOP) 79-4, *Accounting for Motion Picture Films*, and established financial accounting and reporting standards for **producers**[1] and **distributors** of **films**.

2. Since the issuance of FASB Statement No. 53 in December 1981, extensive changes have occurred in the motion picture industry. When FASB Statement No. 53 was issued, the majority of a film=s revenue resulted from distribution to movie theaters and free television. Since 1981, numerous additional forms of exploitation (such as video cassettes, satellite and cable television, laser and digital video discs, and pay-per-view television) have come into existence and revenues from various international territories have increased in significance. Concurrent with these changes in the industry, significant variations in the application of FASB Statement No. 53 have arisen. In addition, business failures of certain entities in the industry have raised concerns about the application of FASB Statement No. 53.

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[1] Terms defined in the glossary are set in **boldface** type the first time they appear in this SOP.

3. In response to these concerns, the FASB requested that the Accounting Standards Executive Committee (AcSEC) of the AICPA develop an SOP providing guidance on the accounting and reporting requirements for producers and distributors of films. AcSEC understands that the FASB will rescind FASB Statement No. 53 when the final SOP is issued.

SCOPE

4. This SOP applies to all producers and distributors that own or hold the rights to distribute or exploit films. This SOP does not apply to

a. Entities within the scope of FASB Statement No. 50, *Financial Reporting in the Record and Music Industry*.

b. Entities within the scope of FASB Statement No. 51, *Financial Reporting by Cable Television Companies*.

c. Entities within the scope of FASB Statement No. 63, *Financial Reporting by Broadcasters*.

d. Entertainment products within the scope of FASB Statement No. 86, *Accounting for the Costs of Computer Software to Be Sold, Leased, or Otherwise Marketed*.

e. Entertainment products within the scope of Emerging Issues Task Force (EITF) Issue No. 96-6, *Accounting for the Film and Software Costs Associated with Developing Entertainment and Educational Software Products*.

Conclusions

Revenue Recognition

5. A licensing arrangement for a single film or multiple films may involve the transfer of a single right or a group of rights. Films are licensed to such customers as distributors, exhibitors, or other licensees (including theaters). The terms of licensing arrangements may vary significantly. In some common licensing transactions, the fee that an **entity** will receive may (*a*) be based on a percentage of the customer=s revenue, (*b*) be fixed in amount (a Aflat fee≅), or (*c*) include nonrefundable minimum guarantees for an individual film or a group of films. The producer may exercise direct control over the distribution of the film or may transfer the control to a distributor, exhibitor, or other licensee.

6. The entity should recognize **gross revenue** from a sale or licensing arrangement when all of the following conditions are met:

a. Persuasive evidence of a sale or licensing arrangement with a customer exists.

b. The film is complete and, in accordance with the terms of the arrangement, either has been delivered or is available to be delivered.

c. The license period of the arrangement has begun and the customer can begin its exploitation or exhibition.

d. The gross revenue is fixed or determinable.

e. Collection is reasonably assured.

7. Licensing arrangements that meet all of the criteria of paragraph 6, and transfer substantially all of the benefits and risks incident to ownership of the film on an

exclusive basis for an individual **market** and **territory**[2] should be accounted for as sales. Within this context, Asubstantially all≅ means that the expected fair value of the film in that market and territory at the end of the licensing period is less than 10 percent of the fair value of the film for that market and territory at inception of the licensing arrangement. In arrangements that do not meet the criteria in this and the preceding paragraph, revenue should be recognized ratably over the licensing period unless another systematic and rational basis is more representative of revenue earned.

8. *Persuasive Evidence of an Arrangement.* Except as discussed in paragraph 9, persuasive evidence of an arrangement is solely provided by a contract. However, even when a contract exists, revenue should not be recognized if significant factors raise doubt as to the obligation or ability of either party to perform under the arrangement.

9. If the entity operates in a sector of the industry that traditionally does not rely on contracts (for example, the home video market), the entity must have other forms of evidence to document the mutual understanding of an arrangement (such as a purchase order from a third party or an online authorization). That evidence may include items received from the customer that detail the mutual understanding of the arrangement between the customer and the entity, or the customer has acted in accordance with such arrangement, for example, by paying a material portion of the license fee.

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[2] An entity=s identification of its markets and territories is the establishment of a method of accounting. Changes in either of those identifications should be accounted for as a change in accounting principle in accordance with APB Opinion No. 20.

10. *Delivery.* Except as discussed below, physical delivery of the film is required to record revenue. If the arrangement is silent about delivery, physical delivery of a print is required in order to recognize revenue. If the arrangement addresses delivery, the delivery of the film is deemed to have occurred when the entity has complied with the delivery requirements set forth in the arrangement with its customer. Certain arrangements do not require immediate or direct physical delivery of a film by the entity to its customer. For example, the arrangement may require that the entity provide the customer with access to a film print (if the print is held by the entity itself) or authorization for a film laboratory to make prints or other copies for the customer=s use (a Alab access letter≅). In such cases, granting unconditional and immediate access to a print held by the entity or delivery of a lab access letter satisfies the delivery requirement of paragraph 6, provided, however, that the film must be complete and available for delivery.

11. Certain arrangements, however, always require physical delivery of an item prior to revenue recognition. For example, the revenue of an entity involved directly in distribution in the home video market is generated through the sale of video cassettes or similar home-viewing devices to wholesalers or retailers. In an arrangement that requires physical delivery of an item to the customer, revenue cannot be recognized until delivery is complete.

12. *Availability for Exploitation, Exhibition, or Sale.* A film is considered available for initial exploitation, exhibition, or sale by a customer when the license period of the

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[3] An example of an entity-imposed restriction is the imposition of a Astreet date.≅ A street date is the date before which videos may not be sold by a retailer or displayed for rental by a video store (based on a restriction imposed by the producer or distributor), even if they have been delivered.

arrangement has begun and no entity-imposed restrictions[3] or conflicting licensing arrangements with third parties exist that would prohibit exploitation, exhibition, or sale by the customer. Insignificant factors, such as requirements under the arrangement for an existing film to replace offensive language, remove offensive content, or adjust for running time, screen size, or commercials, are not sufficient bases for delaying revenue recognition when all other conditions of paragraph 6 of this SOP have been met.

13. *Fixed or Determinable Gross Revenue.* If the gross revenue to be earned by an entity under an arrangement is based on a percentage of the customer=s revenue from the exhibition or other exploitation of the film or films, the fixed or determinable criterion in paragraph 6 is met as the customer generates its revenue.

14. If an arrangement covering a single film provides that the entity will receive a flat fee, the amount of that fee is considered fixed or determinable, and the entire amount should be recognized as revenue when all of the other conditions of paragraphs 6 and 7 have been met.

15. If an arrangement provides for a flat fee payable with respect to multiple films (including films not yet produced or completed), the entity should allocate the amount of the fee to the individual films. The allocation to completed films should be based on an entity-specific, product-specific estimate of the relative fair values of those films, based on the entity=s prior experience in licensing the same or similar films in the same or similar territories using the same or similar media, considering the license periods for

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[3] An example of an entity-imposed restriction is the imposition of a Astreet date.≅ A street date is the date before which videos may not be sold by a retailer or displayed for rental by a video store (based on a restriction imposed by the producer or distributor), even if they have been delivered.

the films. If the arrangement includes films not yet produced or completed, the allocations to those films should be based on the amounts refundable to the customer if the films are not ultimately completed and delivered to the customer. In those cases, the flat fee less the refundable amount should be allocated to completed films based on their relative fair values. Once made, allocations should not be subject to later adjustment. The amount allocated to each film should be recognized as revenue when the criteria of paragraphs 6 and 7 of this proposed SOP have been met with respect to each individual film.

16. Certain arrangements, while providing that the fee receivable by the entity is based on a percentage of the customer=s revenue from the exhibition or other exploitation of a film or films, also guarantee to the entity a nonrefundable minimum amount against the variable fee. In accounting for such arrangements for single films or in arrangements for multiple films in which the fees are not cross-collateralized,[4] the entity should consider the minimum guaranteed amount as a flat fee and should recognize the revenue in conformity with paragraphs 14 and 15 of this SOP. Amounts earned in excess of the minimum should be recognized by the entity as revenue as the customer earns the related revenue in conformity with paragraph 13.

17. If an arrangement provides for a nonrefundable minimum guaranteed amount against fees based on the customer=s revenue from a group of films on a cross-collateralized basis, the amount to be allocated to each film cannot be determined. Therefore, no portion of the minimum guaranteed amount should be considered fixed or determinable until the customer earns the related revenue. The

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[4] That is, the fee related to one film is not affected by the performance of any other film.

entity should recognize the revenue on an individual-film basis in accordance with paragraphs 7 and 13. If the aggregate amount of revenue expected to be recognized by the entity for the entire group of films on an individual-film basis is expected to be less than the minimum guarantee amount, the entity should recognize the excess guarantee amount as revenue when the entity can reasonably estimate that such a difference will occur provided that the entity has fulfilled all obligations under the arrangement.

18. The determination of whether a fee is fixed or determinable is affected by the provisions of an arrangement and the entity=s policies and past actions related to granting concessions or accepting returns. For example, an arrangement may require an entity (or it may have a policy) to rebate or credit a portion of the original fee for a video cassette if the entity subsequently reduces its price for the video cassette and the customer still has rights with respect to that video (sometimes referred to as price protection). If uncertainties exist about the entity=s ability to maintain its price or to reasonably estimate future price changes, the arrangement fee cannot be considered fixed or determinable. In such circumstances, revenue from the arrangement should be deferred until the entity is able to reasonably estimate the effects of such policies and the revenue recognition requirements of this SOP have been met.

19. Revenue received from licensing arrangements with third parties to market film-related products before a film is released should be deferred until the film is released.

20. For arrangements that include rights of return, all of the conditions in FASB Statement No. 48, *Revenue Recognition When Right of Return Exists*, must be met in order for the entity to recognize revenue. Those conditions include a requirement that

the amount of future returns can be reasonably estimated by the entity.

21. *Modifications of arrangements*. If at any time the entity and the customer agree to change the provisions of the licensing arrangement, other than by extending its license periods, the revised agreement should be considered a new arrangement and accounted for in accordance with the provisions of this SOP.

22. If an existing arrangement is extended, the accounting for the consideration received for the extension depends on whether the consideration is a percentage of the customer=s revenue or a flat fee. If the consideration is a percentage of the customer=s revenue, the consideration should be accounted for in accordance with paragraph 13 of this SOP. If the consideration is a flat fee, the amount of consideration allocable to each film should be recognized as revenue upon execution of the extension when the criteria of paragraphs 6 and 7 are met.

23. *Barter revenue*. Entities sometimes license programming to television stations in exchange for a fixed (or no) fee plus a specified amount of advertising time on those stations. These exchanges qualify as nonmonetary exchanges and should be accounted for in accordance with Accounting Principles Board Opinion (APB) No. 29, *Accounting for Nonmonetary Exchanges*. Paragraph 18 of APB No. 29 requires that the cost of a nonmonetary asset acquired in exchange for another nonmonetary asset is the fair value of the asset surrendered to obtain it. Revenue should not be recognized, however, until all of the revenue recognition criteria of this SOP have been met and appropriate allowances for ratings shortfalls (A make goods≅) can be reasonably estimated.

24. *Multiple-territory or multiple-market arrangements.* If a film is sold or licensed under an arrangement covering several territories or markets, revenue should be

allocated to the territories or markets based on relative fair values and should be recognized in accordance with paragraphs 6 and 7 for each territory or market. Thus, if the entity or a conflicting license with a third party imposes restrictions on use by the customer in a particular territory or market, revenue allocated to the particular territory or market should not be recognized until the restriction(s) lapses and the other criteria in paragraphs 6 and 7 are met.

25. Discounting. The amount of revenue to be recognized in connection with the licensing of a film should be the present value of the license fee, computed in accordance with APB Opinion No. 21, *Interest on Receivables and Payables*. This present value calculation should be made as of the date that the revenue is recognized in accordance with this SOP.

Costs and Expenses

26. The costs of producing a film and bringing that film to market consist of **production costs**, **exploitation costs**, and **participation** costs.

a. Production costs should be accounted for in conformity with paragraphs 28 to 31.

b. Exploitation costs should be accounted for in conformity with the provisions in paragraph 27.

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[5] Frequently, parties involved in the production of a film are compensated in part by contingent compensation payable based on the financial results of a film, pursuant to contractual formulas (participations) or

c. The present value of participation costs,[5] which relate to the expected future cash flows payable pursuant to contractual formulas for financial performance achieved during the ultimate gross revenue period, should be accrued when their payment is probable, which is usually determined when the film has been released. The discount rate used to compute the present value of participation costs should be based on currently available rates of return on high-quality, fixed-income investments with cash flows that match the timing and amount of expected cash payments. The interest method should be used to accrete interest. Entities should recognize an asset as part of **film costs** for the initial amount of the participation liability (paragraph 41 provides guidance on changes in estimate).

27. Prerelease and early release exploitation costs incurred on a territory-by-territory basis in the theatrical market should be capitalized and amortized over the expected period of exploitation of the film in that theatrical market and territory, not to exceed three months. Capitalized exploitation costs for a particular territory should be amortized in the same ratio that theatrical gross revenues earned in that particular theatrical territory bear to estimated total theatrical gross revenues for that territory for the shorter of (*a*) three months or (*b*) the theatrical release period in that territory. All capitalized exploitation costs should be fully amortized by the end of the theatrical release period or three months (whichever is shorter). Exploitation costs should not be accrued in advance of incurrence. After the period leading up to the theatrical release of a film in a territory and the initial three month period, all exploitation costs should be

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contingent amounts due under provisions of collective bargaining agreements (residuals). Such parties are referred to collectively in this SOP as participants. Participations and residuals are referred to collectively as participation costs.

expensed as incurred. Exploitation costs incurred in connection with the release of a film in markets other than the theatrical market should be expensed as incurred.

28. Production costs and capitalized participation costs should be amortized using the individual-film-forecast-computation method, which requires estimating remaining ultimate gross revenues as of the beginning of each period. It also requires determining a fraction, the numerator of which is actual gross revenues from the film for the current period and the denominator of which is the estimated unrecognized ultimate gross revenues as of the beginning of the period. This fraction is applied to the unamortized balance of production costs and capitalized participation costs as of the beginning of the period to determine periodic amortization. In this way, in the absence of changes in estimates, production costs and capitalized participation costs are amortized in a manner that yields a constant rate of profit for each film, excluding exploitation costs and other period expenses. Amortization should begin when a film is released and revenues from that film are recognized.

29. Ultimate gross revenues to be included in the denominator of that fraction should include the estimated gross revenues from the exploitation, exhibition, and sale of the film in all markets that are expected to be recognized by the entity within a reasonable period of time (not to exceed ten years for individual films[6]) following the date of the film=s initial release. Ultimate gross revenues should also include estimates of revenue from licensing arrangements with third parties to market film-related products. For episodic television series, ultimate gross revenues should include all revenues expected to be realized within ten years from the date of delivery of the first episode or

[6] As discussed in paragraph 32 of this SOP, in determining the revenues to be included in the ultimate gross revenues of a previously released film or group of films that have been acquired, ultimate gross revenues should not include revenues expected to be earned more than *twenty* years from the date of acquisition or valuation.

five years from the date of delivery of the last episode, if later. Ultimate gross revenues also should be limited by the following:

a. Estimates of revenue from a form of exploitation, exhibition, and sale should be included in ultimate gross revenues only if the entity can demonstrate a history of earning revenue from that form of exploitation, exhibition, and sale or persuasive evidence exists that revenue from such exploitation, exhibition, and sale will occur for that particular film.

b. For episodic television programming, estimates of secondary market revenue (that is, revenue from markets following the initial market, whether that *initial* market is network, first-run syndication, cable television, or other) should be included in ultimate gross revenues only if the entity can demonstrate (through experience or industry norms) that the number of episodes already produced, plus those for which a firm commitment exists and the entity expects to deliver, can be licensed successfully in the secondary market.

c. Estimates of revenue from unproven or undeveloped technologies should not be included in ultimate gross revenues. Estimates of revenue from newly developing territories should not be included in ultimate gross revenues unless an existing arrangement provides persuasive evidence that such revenue will be realized.

d. Ultimate gross revenues should not include revenues from the entity=s manufacture and sale of peripheral items, such as lunch boxes, toys, tee shirts, and so forth and should not include promotion or advertising reimbursements received from third parties (these latter reimbursements should

be offset against exploitation costs).

e. Estimates of revenue from licensing arrangements with third parties to market film-related products should be included in ultimate gross revenues only if the entity can demonstrate a history of earning revenue from that form of arrangement or persuasive evidence exists that revenue from that arrangement will occur for that particular film, such as a signed contract to receive a minimum guarantee or nonrefundable advance.

f. Ultimate gross revenues should not include amounts for general terminal values.

30. Production costs, participation costs, and ultimate gross revenues should be based on amounts in current dollars without considering inflation or possible changes in currency exchange rates. Such amounts should not be discounted except as required by paragraphs 25 and 26 of this SOP.

31. In calculating production costs and ultimate gross revenues for a television product, an episodic series is considered to be a single product, and multiple seasons of a series should be combined and treated as a single product. If the application of the individual-film-forecast-computation method to episodic television programming results in the recognition of a loss, the loss should be recognized proportionately as each episode becomes available, based on the number of episodes expected to be delivered. The number of episodes expected to be delivered should not exceed the number of episodes contracted for.

32. The acquisition cost of or value assigned to a previously released film or group of films in connection with the acquisition of a film library should be amortized using the individual-film-forecast-computation method. The ultimate gross revenues and costs

used for purposes of the individual-film-forecast-computation method should be the same as those used to value a film or films. In no event, however, should the ultimate gross revenues for such a film or group of films include those amounts expected to be recognized more than twenty years from the date of the acquisition.

33. If revenue is recognized despite the existence of insignificant factors in an arrangement as discussed in paragraph 12, the costs expected to be incurred related to the requirement to replace offensive language, remove offensive content, and adjust for running time, screen size, or commercials should be accrued and expensed.

34. *Production Overhead.* Production overhead includes the costs of individuals or departments exclusively responsible for the development, production, or acquisition of films, as well as allocable portions of the costs of individuals or departments with significant responsibility for the development, production, or acquisition of films. Production overhead should not include costs related to properties that will not be used in the production of a film, as discussed in the preceding paragraph, or overall deals, as discussed in the following paragraphs.

35. *Overall Deals.* An entity may enter into an arrangement known as an overall deal with another party or parties (such as producers or other creative individuals) in which the entity pays a fixed fee, a fee based on costs incurred by the other party, or both, in return for exclusive or preferential use of that party=s professional services.

36. The costs of overall deals should be capitalized and allocated to specific projects if those costs are related to the acquisition, adaptation, or development of specific projects. These costs are included in the amounts subject to the periodic review discussed in paragraph 39 of this SOP. The costs of overall deals that cannot be

identified with specific projects should be expensed in the period incurred.

Film Costs Valuation

37. Unamortized film costs should be reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of the film may not be recoverable, in accordance with the provisions of paragraphs 4 to 13 of FASB Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of*. The following are examples, in addition to the examples listed in paragraph 4 of FASB Statement No. 121, of events or changes in circumstances that may indicate that the recoverability of the carrying amount of a film should be assessed.

a. An adverse change in expected public acceptance due to subject matter or indicated by market research testing prior to release

b. Actual costs substantially in excess of budgeted costs

c. Substantial delays in completion or release schedules

d. Changes in release plans, such as a reduction in the initial release pattern

e. Insufficient funding or resources to complete the film and to market it effectively

f. Actual performance subsequent to release failing to meet that which had been anticipated prior to release

38. If the examples of events or changes in circumstances listed in paragraph 37 are

present or if other events or changes in circumstances indicate that the carrying amount of a film may not be recoverable, the entity should estimate the future cash flows that will result from exploitation of the film. If the sum of the expected future cash flows (undiscounted and without interest charges) is less than the carrying amount of the film (adjusted for changes in estimates for participations), the entity should recognize an impairment loss in accordance with FASB Statement No. 121. The impairment loss should be measured as the amount by which the carrying amount of the film exceeds the fair value of the film. Films held for sale should follow the impairment guidance in FASB Statement No. 121 related to assets to be disposed of.

39. *Abandoned properties*. Film costs ordinarily include expenditures for properties (such as film rights to books, stage plays, or original screenplays), which generally must be adapted to serve as the basis for the production of a particular film. The cost of the adaptation or development is included in the cost of the particular property. Properties in development should be reviewed periodically to determine whether they will be used in the production of a film. It should be presumed that a property will be disposed of (whether by sale or abandonment) if the property has not been set for production within three years from the time of the first capitalized transaction. When it is determined that a property will be disposed of, a loss should be recognized by a direct charge to income. The loss should be measured as the amount by which the carrying amount of the project exceeds its fair value less cost to sell. Unless management, having the authority to approve the action, has committed to a plan to sell such property, the property should be presumed to be abandoned and as such its fair value should be zero.

Changes in Estimates

40. Due to uncertainties in the estimating process, estimates may vary from actual results. All estimates of revenues and costs should be reviewed at each reporting period and revised to reflect the most current available information. When estimates of ultimate gross revenues are revised, the denominator of the fraction described in paragraph 28 of this SOP should be revised prospectively beginning in the period of change (the changes in estimates should not be applied to the beginning of the current fiscal year, if different from the period of change). The revised fraction should be applied to remaining unamortized production and participation costs as of the beginning of the period of change (adjusted for any change in the estimated costs).

41. Changes in estimates for accrued participation costs, and thus related film costs assets, should be accounted for prospectively beginning in the period of change (the changes in estimates should not be applied to the beginning of the current fiscal year, if different from the period of change).

Presentation and Disclosure

42. If a classified balance sheet is presented, film costs should be classified as noncurrent. No receivable under an arrangement for any form of film distribution, exhibition, or exploitation should be reported in the entity=s balance sheet until the time of revenue recognition under this SOP. Payments received under such arrangements prior to revenue recognition should be reported as deferred revenue.

43. Cash flows representing additions to film costs should be reported as cash flows from investing activities in the entity=s statement of cash flows. Noncash transactions (for example, initial capitalized participation costs) should be reported in accordance

with FASB Statement No. 95, *Statement of Cash Flows*.

44. An entity should disclose its method of accounting for revenue, production costs, exploitation costs, and participation costs.

45. The components of film costs (including released, completed and not released, in production, or in development or preproduction) should be disclosed. When an entity has capitalized costs for both theatrical feature films and direct-to-television product, the entity should disclose these amounts separately for each kind of product. An entity also should disclose the percentage of unamortized film costs for released films that is expected to be amortized within three years of the date of the balance sheet. If that percentage is less than 60 percent, additional information should be provided, including the period required to reach 60 percent amortization.

46. An entity should disclose both the total estimated participation costs payable on the balance sheet and the amount of participation costs payable based on contractual provisions and its films= actual performance.

EFFECTIVE DATE AND TRANSITION

47. This SOP is effective for fiscal years beginning after December 15, 1999. Earlier application is encouraged. The cumulative effect of changes in accounting principle caused by adopting the provisions of this SOP should be included in the determination of net income in conformity with paragraph 20 of APB Opinion No. 20, *Accounting Changes*. Disclosure of pro forma effects of retroactive application (APB Opinion No. 20, paragraph 21) is not required. Previously issued financial statements should not be restated.

BASIS FOR CONCLUSIONS

Revenue Recognition

48. AcSEC believes that the economic nature of transactions in the motion picture industry is comparable to the economic nature of similar transactions in other industries, and therefore comparable standards for revenue recognition should be applied. The basic standards for revenue recognition are set forth in paragraph 83 of FASB Statement of Financial Accounting Concepts No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises*, which provides that A ...{revenue} recognition involves consideration of two factors, (a) being realized or realizable and (b) being earned, with sometimes one and sometimes the other being the more important consideration.≅

49. AcSEC also believes that a key concept underlying FASB Statement No. 13, *Accounting for Leases*, (although by its own terms not applicable to films) regarding the timing of revenue recognition when distinguishing between sales-type leases and operating leases is useful in the motion picture industry. Paragraphs 60, 61, and 97 of FASB Statement No. 13 state that the concept underlying the accounting for leases by lessors in that Statement is Athat a lease that transfers substantially all of the benefits and risks incident to the ownership of property should be accounted for as a sale or

financing by the lessor.≅ AcSEC believes this concept is useful when analyzing many licensing transactions in the film industry, where substantially all of the benefits and risks in a particular market and territory relating to a film may be transferred to the customer on an exclusive basis as a result of the licensing arrangement.

50. Persuasive Evidence of an Arrangement. AcSEC understands that practice in the industry varies with respect to contracts. Although certain entities rely on contracts, AcSEC has been informed that a significant number of arrangements in certain sectors of the industry may not be evidenced by contracts. AcSEC has been informed that, in these instances, existence of the arrangement is evidenced by items other than a contract. AcSEC believes that these items or a combination of these items could provide persuasive evidence of the arrangement and, therefore, concluded that a contract is not always required to recognize revenue in certain sectors of the industry.

51. In certain sectors of the industry, such as in direct home video distribution, contracts are not used and other forms of evidence (such as purchase orders from third parties or online authorizations) are used to establish the existence of an arrangement. AcSEC believes that such documentation is sufficient to provide persuasive evidence of an arrangement, particularly when the customer=s actions demonstrate its understanding of the arrangement.

52. *Delivery.* AcSEC believes that, in most industries, revenue should not be recognized until the product is delivered to the customer. Recognition of revenue on delivery is consistent with paragraphs 83(b) and 84 of FASB Concepts Statement No. 5. Paragraph 83(b) provides the following guidance for recognition of revenue:

> Revenues are not recognized until earned. An entity's revenue-earning

> activities involve *delivering* or producing goods, rendering services, or other activities that constitute its ongoing major or central operations, and revenues are considered to have been earned when the entity has substantially accomplished what it must do to be entitled to the benefits represented by the revenues. [Footnote omitted.][Emphasis added.]

Paragraph 84 states that in recognizing revenues and gains:

> The two conditions [for revenue recognition] (being realized or realizable and being earned) are usually met by the time product or merchandise is delivered...to customers, and revenues...are commonly recognized at time of sale (usually meaning *delivery*). [Emphasis added.]

53. As discussed in paragraph 10 of this SOP, rather than requiring immediate or direct delivery of the film print to a customer, certain arrangements in this industry require only that access to the film be granted to the customer. Once access has been provided, the arrangement obligates the customer to pay for the film regardless of whether the customer requests or receives the film. AcSEC believes that when the entity makes a completed film available to the customer, it A has substantially accomplished what it must do to be entitled to the benefits represented by the revenues≅ (as required by paragraph 83(b) of FASB Concepts Statement No. 5). In such arrangements, actual physical delivery of the film is an insignificant factor that is not sufficient in itself to delay revenue recognition, and therefore AcSEC believes that an entity has complied with the delivery requirements of this SOP when the film is made available to the customer. However, AcSEC believes that, if the film is at a laboratory, providing the customer with a lab access letter is a prerequisite for access having been

granted to the customer. If an arrangement is silent as to delivery, AcSEC decided that delivery is an inherent requirement of revenue recognition.

54. *Availability for Exploitation, Exhibition, or Sale.* As discussed in paragraph 12, in certain situations, an entity may place certain restrictions on the exploitation, exhibition, or sale of a film by a customer. One of the more common restrictions is a Astreet date≅ restriction used in connection with sales or rentals of video cassettes. The video cassettes may be shipped to the customer on a certain date, but the entity restricts sales prior to the Astreet date.≅ Because the customer does not have full use of the film in such situations, the film is not considered available for exploitation, exhibition, or sale. Consequently, revenue should not be recognized until the restriction lapses.

55. Fixed or Determinable Gross Revenue and Collectibility. Paragraph 83 of FASB Concepts Statement No. 5 reads (in part), A Further guidance for recognition of revenues and gains is intended to provide an acceptable level of assurance of the existence and amounts of revenue and gains before they are recognized.≅ AcSEC believes that Aan acceptable level of assurance≅ of the amount is attained when the amount of revenue is fixed or determinable. When the gross revenue is based on a percentage of a customer=s revenue, the gross revenue does not become fixed or determinable until the customer=s revenue is known. Because the customer=s revenue is not known until the exhibition or other exploitation of the film, AcSEC concluded that revenue that is based on a percentage of the customer=s revenue from a film should not be recognized until the customer=s exhibition or other exploitation of the film.

56. In paragraph 15 of this SOP, AcSEC concluded that, when an arrangement provides for a flat fee payable with respect to multiple films, that fee should be allocated to the individual films based on the relative fair values of the films. AcSEC believes

that basing the allocation on fair values is consistent with the accounting for commingled revenue in other industries. An example is the following discussion in paragraph 12 of FASB Statement No. 45, *Accounting for Franchise Fee Revenue*.

> The franchise agreement ordinarily establishes a single initial franchise fee as consideration for the franchise rights and the initial services to be performed by the franchisor. Sometimes, however, the fee also may cover tangible property, such as signs, equipment, inventory, and land and building. In those circumstances, the portion of the fee applicable to the tangible assets shall be based on the fair value of the assets.

57. In arrangements covering single films or arrangements covering multiple films in which the fees are not cross-collateralized, AcSEC believes that guaranteed nonrefundable minimum amounts against variable fees based on a customer=s revenue (as discussed in paragraphs 16 and 17 of this SOP) are similar to flat fees. Therefore, AcSEC concluded that such amounts are fixed and should be recognized as revenue when the other criteria of paragraphs 6 and 7 have been met. Amounts in excess of the guaranteed minimums are based on the customer=s revenue and therefore cannot be considered fixed or determinable until the customer earns the revenue.

58. AcSEC believes that when an arrangement provides for a nonrefundable minimum guaranteed amount against fees based on the customer=s revenue from a group of films on a cross-collateralized basis, the portion of the minimum guaranteed amount (and, consequently, the gross revenue) that will be earned by each film cannot be determined. Revenue must be fixed or determinable on an individual-film basis to apply the individual-film-forecast-computation method. Therefore, AcSEC concluded

that revenue from such arrangements should be recognized on an individual-film basis as the customer earns its related revenue.

59. In reaching its conclusions on accounting for revenue related to fixed fees or minimum guarantees, AcSEC considered various methods, including analogizing to lease accounting or applying the guidance applicable to minimum guarantees in FASB Statement No. 50, *Financial Reporting in the Record and Music Industry*.

60. AcSEC concluded that a basic concept in lease accounting would be useful in accounting for revenue related to fixed fees or minimum guarantees. AcSEC believes that exclusive film rights should be viewed on a market-by-market, territory-by-territory basis much in the same way as a lessor may lease a floor of a building that it owns. Viewed in this manner, an arrangement that transfers substantially all of the benefits and risks related to the film in that particular market and that particular territory would qualify for sales-type lease accounting rather than operating lease accounting.

61. In FASB Statement No. 50, a conclusion was reached that licensors should report minimum guarantees as liabilities and recognize revenue as the license fee is earned. AcSEC has been informed that there are differences between minimum guarantees in the film industry and minimum guarantees in the music industry. Minimum guarantees in the music industry generally relate to the rights to distribute the music product of an artist or artists for a specific period of time. Much of this product may not exist at the time the minimum guarantee arrangement is entered into. Minimum guarantees in the film industry may actually represent a sale of rights to exhibit a film in a particular market and territory during that market and territory=s useful life with a potential share in the results above some defined amount. These arrangements are used in connection with customers in lieu of actual results reported by the customer, which may

be untimely, unreliable, or both. Because of the differences between the industries in the nature of the minimum guarantees and in the circumstances under which they are used, AcSEC concluded that the guidance in FASB Statement No. 50 should not be applied to minimum guarantees in the film industry.

62. In paragraphs 18 and 20 of this SOP, AcSEC concluded that because of uncertainties related to concessions granted to customers, if (*a*) the entity=s sales are contingent upon future events, (*b*) uncertainties exist about the entity=s ability to maintain its price or estimate future price changes, or (*c*) the entity may be required (contractually or otherwise) to accept returns, the entity should recognize revenue only if it can make a reasonable estimate of amounts that will be rebated or credited to customers in connection with price protection policies. These conclusions are based on analogies to FASB Statement No. 48, *Revenue Recognition When Right of Return Exists*, and to AICPA SOP 97-2, *Software Revenue Recognition*.

Costs and Expenses

63. Production Costs. Certain costs of making a film (such as **direct negative costs**) are associated clearly with a specific project. Other costs (such as production overhead) may relate to several projects but can be allocated to specific projects on a reasonable basis. AcSEC=s conclusions that (*a*) costs directly related to acquisition and development of a specific film should be capitalized as part of film costs and (*b*) costs that relate to several projects should be capitalized and allocated to the projects to which the costs relate are based on analogies to FASB Statement No. 34, *Capitalization of Interest Cost*, and FASB Statement No. 67, *Accounting for Costs and Initial Rental Operations of Real Estate Projects*.

64. Paragraph 6 of FASB Statement No. 34 reads, in part,:

> The historical cost of acquiring an asset includes the costs necessarily incurred to bring it to the condition ... for its intended use. [Footnote omitted]

65. Paragraph 7 of FASB Statement No. 67 reads, in part:

> Project costs clearly associated with the acquisition, development, and construction of a real estate project shall be capitalized. Indirect project costs that relate to several projects shall be capitalized and allocated to the projects to which the costs relate.

66. *Exploitation Costs*. AcSEC understands that in the motion picture industry the pattern of incurring exploitation costs differs significantly from the pattern in other industries. A high proportion (perhaps as much as 80 percent) of the total lifetime exploitation costs incurred by an entity with respect to a film is incurred in connection with the release of a film into the domestic and international theatrical markets. The most significant expenditures generally are incurred on or before the first weekend to A open≅ the film domestically.

67. Entities in the industry are willing to incur this level of exploitation costs in connection with a film=s theatrical release because industry experience indicates that the theatrical release phase is the most effective time to incur significant exploitation costs. Industry experience indicates that a feature film that performs poorly in its theatrical opening is unlikely to experience a significant improvement in its performance in the remainder of its theatrical release period or in subsequent markets. Further,

advertising is a critical component of a successful film; films are often unsuccessful without advertising.

68. In addition, it is the belief in the industry that expenditures for exploitation in the prerelease and early release phases of the theatrical market are effective in generating revenue in future markets. For example, in most instances, the pay television license fee for a film is based at least in part on a percentage of the film=s theatrical gross revenue. Because of the widespread belief that exploitation costs increase the film=s theatrical gross revenue, it follows that these costs increase the film=s pay television license fee. Similar (albeit not as direct) effects are found in other markets such as home video, network television, and other free television. That is, sales of video cassettes of a particular film increase or decrease based at least in part on the film=s theatrical gross revenue. Because exploitation costs increase the film=s theatrical gross revenue, the costs indirectly increase revenue from the home video market.

69. In paragraph 27, AcSEC concluded that exploitation costs incurred prior to and during the early release of a film in a theatrical market and territory should be capitalized and amortized over the expected period of exploitation in the theatrical market and territory. Capitalized exploitation costs for the theatrical market should be amortized in the same ratio that theatrical gross revenues earned in a particular territory bear to total estimated theatrical gross revenues for that territory. Exploitation costs incurred after the early release of a film in the theatrical market should be expensed as incurred.

70. AcSEC believes that there is a business reality in this industry that conducting advertising in the theatrical release phase of a film=s introduction is required to allow a producer to recoup its production costs investment. In this industry, it is primarily in the

prerelease and early release period that market demand is created. Experience has shown that it cannot be created sufficiently later in an unsuccessful film=s life. Without a certain level of advertising, the investment is unlikely to be recovered. For these reasons, AcSEC believes that it reasonable and practical to capitalize and amortize certain advertising costs over a limited period. AcSEC believes that this requirement will significantly limit diversity in practice.

71. AcSEC reached its conclusions in paragraph 27 related to exploitation costs after considering and rejecting various other proposed methods. The conclusion reached by AcSEC is considered a compromise position based on valid concerns about each proposed method. In SOP 93-7, *Reporting on Advertising Costs*, AcSEC concluded that the costs of advertising (other than direct-response advertising) should be expensed as incurred or the first time the advertisement is shown. That conclusion acknowledges that there is merit to the arguments that probable future benefits often exist from advertising. AcSEC=s conclusion in SOP 93-7 to expense advertising was based on the practical consideration that probable future benefits beyond the first time the advertising takes place are too uncertain and are not demonstrable or measurable with a degree of reliability required to recognize an asset. AcSEC also wanted to limit diversity in practice. AcSEC is concerned that following SOP 93-7 would be too drastic a change from past practice to be adopted at the present time. This would conflict with paragraph 2 of FASB Concepts Statement No. 5, which states, AThe Board intends future change to occur in the gradual, evolutionary way that has characterized past change.≅ In light of the practical considerations noted, AcSEC concluded that the provisions of this SOP as a whole represent an improvement in financial reporting.

72. As discussed in paragraph 66, the majority of exploitation costs are incurred in connection with the theatrical release of a film. AcSEC agrees that these exploitation costs increase gross revenue in the theatrical release phase. AcSEC further agrees

that, because revenue in future markets is based (at least in part) on the theatrical gross revenue earned by a film, exploitation activity in the theatrical phase benefits future markets. However, AcSEC believes that, similar to the logic underlying SOP 93-7, these benefits in future markets are too uncertain and cannot be measured with the degree of reliability required to amortize theatrical exploitation costs over a longer period than the specific theatrical market for which the exploitation costs were incurred.

73. AcSEC believes that the approach discussed in paragraph 27, combined with the impairment test required in paragraphs 37 and 38 results in a reasonable approach to accounting for exploitation costs in this industry for the following reasons:

a. By permitting amortization over the period the film is shown in each theatrical market, AcSEC has addressed (at least partially) the concern of many that expensing as incurred would result in charges to the income statement for prerelease advertising for a film that is not yet in the theaters, and in addition, may result in large losses immediately upon release, even for very successful films.

b. By limiting amortization to the specific theatrical market (rather than over the life of the film), AcSEC has addressed concerns related to the indirect nature and measurability of the benefit that advertising in one market has in subsequent markets.

74. In reaching its conclusion on the accounting for exploitation costs, AcSEC considered and rejected the following alternatives:

a. Expense as incurred

b. Capitalize and expense at first showing of the film

c. Capitalize and expense using the individual-film-forecast-computation method, as discussed in FASB Statement No. 53

d. Capitalize and expense over the first three markets

75. Expense as incurred. The proposal to expense advertising as incurred was based on certain concepts discussed in the basis for conclusions in SOP 93-7. Those supporting this view believe that, because it cannot be demonstrated that an asset exists after advertising (other than direct-response advertising) occurs, there is no basis for concluding that an asset exists for advertising related costs incurred before the advertising occurs.

76. In many instances in this industry, a large portion of exploitation costs are incurred before the initial exhibition of the film (and, therefore, before any revenue is earned from the film). Given (*a*) the timing and magnitude of the expenditures and (*b*) the underlying basis for those expenditures as discussed in paragraph 68, AcSEC concluded that requiring exploitation costs to be expensed as incurred would not be appropriate.

77. Capitalize and expense on first showing of the film. The following discussion related to the option to expense advertising upon the first showing of the advertisement is provided in paragraph 57 of SOP 93-7:

> Some believe that the component costs of advertising activities...result in assets

> until at least the first time the advertising occurs. They believe that such costs are not capitalized under [SOP 93-7] after the advertising occurs because they do not result in *demonstrable* probable future economic benefits, not because they do not result in any probable future economic benefits. However, they believe that the component costs of advertising have, at a minimum, benefits that are received simultaneously with the advertising. They note that there must be some economic benefit to advertising activities because entities continue to undertake them. They also note that there is no opportunity for an entity to benefit from advertising until it occurs. Therefore, they conclude that it is reasonable to defer such costs until the first time the advertising takes place.

78. AcSEC elected not to adopt this method because it does not address the issues of magnitude and timing, as discussed in paragraph 76. As discussed in paragraph 76, in many instances, advertising occurs before the initial showing of the film. This method, as with the option to expense as incurred, would not be responsive to the industry=s need to exploit a film within a very limited time period to increase the likelihood of making the film successful.

79. <u>Capitalize and expense using the individual-film-forecast-computation method.</u> Paragraph 15 of FASB Statement No. 53 reads (in part)

> Costs incurred to exploit a film...that clearly benefit future periods shall be capitalized...and amortized as described in paragraphs 10-13 [of FASB Statement No. 53]. Examples of those costs are film prints, and prerelease and early release advertising that is expected to benefit the film in future markets. Cooperative or other forms of local advertising that are not clearly expected to

benefit the film in future markets...shall be charged to expense in the period incurred.

80. AcSEC has been informed that, over time, entities began to capitalize all advertising costs and amortized the capitalized amount over the expected life of the film in accordance with the individual-film-forecast-computation method. In fact, in applying the individual-film-forecast-computation method, entities factored in and amortized estimated costs that would be incurred at future dates. (These estimated costs, however, were not capitalized as assets in the statement of financial position until incurred.)

81. Proponents of this method note that it would result in a constant rate of gross profit for a film (before period expenses). They also note that, given the magnitude of advertising expenditures and the fact that the greater part of these costs are incurred prior to the film=s opening, this method will result in a matching of revenues and expenses.

82. This method, however, was rejected by AcSEC for the following reasons.

a. As discussed in paragraph 2 of this SOP, since the issuance of FASB Statement No. 53 in 1981, numerous forms of exploitation have come into existence or increased in significance. As a result, the length of time that a film remains in theaters has decreased significantly, to the point that many feature films remain in theaters for periods of only two to four weeks. One consequence of this change is that the concept of an A early release≅ period, as discussed in paragraph 15 of FASB Statement No. 53, became less meaningful. Therefore,

AcSEC concluded that applying the guidance in FASB Statement No. 53 (as written) would not be operational.

b. AcSEC does not believe that all advertising expenditures (including costs expected to be incurred in the future) benefit all markets and should be capitalized and amortized against all revenues. AcSEC believes that there are some expenditures that are specific to a particular market, a particular territory, or both, and therefore should be expensed accordingly.

c. AcSEC does not believe that the pattern of incurrence alone is a sufficient reason to permit capitalization and amortization over an extended revenue period. It was noted that products in many industries are introduced with a marketing blitz, and that advertising costs incurred in connection with the introduction of these products are subject to the provisions of SOP 93-7 (though AcSEC does believe that the pattern of incurrence together with other economic realities peculiar to this industry are an important factor in the method of capitalization and amortization that AcSEC selected).

83. Capitalize and expense over the first three markets. AcSEC also considered a methodology under which exploitation costs would be capitalized and amortized over the first three major markets X not to exceed eighteen months. (At the time of this writing, the first three major markets for a film that is released theatrically are theatrical, home video, and pay television.) It was noted that revenues from these three markets are related and that this method was similar in effect to the model eventually chosen by AcSEC, with the added advantage of providing a constant rate of gross profit for an individual film in each of the three markets initially exploited.

84. However, AcSEC eventually rejected this method for the following reasons.

a. The link between theatrical results and pay TV appears to be verifiable in certain circumstances. In many instances, the revenues from pay TV are related to the theatrical results. However, though the two may be highly correlated, no such direct contractual link exists between theatrical results and video results.

b. The model would be constantly subject to change based on environmental changes. For example, if the Internet or some other market comes to prominence in the future, an SOP with this model would require amendment.

85. *Participation Costs.* AcSEC adopted a new approach to account for participation costs. The approach is based on AcSEC=s conclusion that participation costs are a form of deferred compensation. The participants involved in producing a film often receive both (*a*) current compensation and (*b*) deferred compensation in the form of participations. Participation costs are deferred compensation because the services are rendered at the time the film is completed. AcSEC believes that the amortizable cost of the film should include the total compensation of all participants involved, including the best estimate of the deferred compensation.

86. AcSEC believes that the accounting for participation costs is consistent with FASB Statement No. 5, *Accounting for Contingencies.* The services provided by the participants under contract represent a past event that gives rise to a liability. Industry representatives have asserted that, at the time of a film=s release, an entity can predict with a high degree of accuracy the revenues to be generated from that film during the individual-film-forecast period. This assertion is a key basis for many of the accounting requirements in this SOP. If revenues can be estimated with a high degree of

accuracy, AcSEC concluded that the contractual obligation to pay participation costs can also be reasonably estimated. Therefore, the liability recognition criteria in FASB Statement No. 5 are satisfied.

87. AcSEC considered other methods of accounting for participation costs. One method would have reported liabilities for participation costs only when they become legal obligations of the producer or distributor, that is, when minimum cumulative revenues or profits required to trigger payments are achieved. AcSEC rejected this method because the achievement of minimum amounts is merely the confirming event that determines the exact amounts payable. In other industries, the measurement uncertainties involved might delay recognition of the liability until this point. In the film industry, by contrast, the individual-film-forecast method of accounting is predicated on the ability to make reasonable estimates of future film revenues, and thus participation costs. AcSEC believes that an assertion that participation costs cannot reasonably be estimated would be inconsistent with the film industry=s fundamental accounting model.

88. Another method of accounting for participation costs would have reported participation liabilities at amounts equal to expenses reported under the individual film forecast method. AcSEC rejected this method because it does not faithfully report the producer or distributor=s obligations under participation agreements.

89. Individual-Film-Forecast-Computation Method. In paragraph 29 of this SOP, AcSEC reached conclusions that limited the amount of revenue that is to be included in ultimate gross revenues. AcSEC concluded that ultimate gross revenues should be estimated so as to include only those revenues that an entity expects to recognize within a reasonable period, not to exceed ten years from the date of delivery of the first episode or five years from the date of delivery of the last episode, if later. In addition,

AcSEC concluded that certain other forms of more speculative revenue should not be included in ultimate film revenues.

90. AcSEC acknowledges that the ten-year provision is arbitrary and that most films have lives that extend beyond ten years. AcSEC is concerned, however, about diversity that has arisen in the industry with respect to estimation of gross revenues. AcSEC concluded that such a limitation is needed to provide greater comparability within the industry. AcSEC also notes that, in most instances, the significant majority of a film=s revenues will have been earned within the ten-year period. AcSEC=s other conclusions limiting ultimate gross revenues (as listed in paragraph 29) also are intended to promote comparability among entities within the industry.

91. An exception to the ten-year provision is granted for acquisitions of a previously-released film or films, as discussed in paragraph 32. In many such acquisitions, the ultimate gross revenues used to assign acquisition cost or value to the film or films will be generated over periods exceeding ten years. AcSEC believes that in such situations, the same gross revenues used to value the acquired film or films should be used to apply the individual-film-forecast-computation method. However, to address concerns similar to those discussed in paragraph 90, AcSEC concluded that a limitation should be placed on the gross revenues that could be included in the determination of ultimate gross revenues. AcSEC believes that this limit is needed for reasons similar to those discussed in paragraph 90. AcSEC has also been informed that in applying APB Opinion No. 16, *Business Combinations*, in the motion picture industry, twenty years is the life most often assigned to a film library.

92. Another exception to the ten-year provision is for successful episodic series that are expected to run longer than ten years. In these few instances, AcSEC decided that

entities should include in ultimate gross revenues all revenues expected to be realized through five years from the date of delivery of the last episode (if that point exceeds 10 years from the delivery date of the first episode).

93. AcSEC believes that a longer amortization period for films in a library is appropriate because of the differences between such films and new films exploited individually. In almost all cases, a new film that is exploited individually will earn the vast majority of its revenue within the first several markets, followed by a relatively long stream of lower, level earnings over the remainder of its life. However, a film that is *included* in a library has experienced its initial cycle in all markets and, therefore, has entered into the period of more stable, lower level earnings.

94. AcSEC concluded that, if the application of the individual-film-forecast-computation method results in the recognition of a loss on episodic television programming, such loss should be recognized as each episode becomes available.

95. AcSEC has been informed that, although the terms of contractual arrangements between television networks and companies in the motion picture industry for delivery of episodic series may be binding and noncancellable in form, in practice these contracts often are amended or canceled in the initial years of the series. If a series does not achieve ratings success quickly, the network may wish to cancel the series notwithstanding previously established contractual arrangements. Also, because producers often incur losses while producing episodes in the early years, it is often in their best interests to cancel a series if its syndication is unlikely.

96. Paragraph 8 of FASB Statement No. 5 requires accrual of a loss contingency if

(*a*) information available prior to issuance of the financial statements indicates that it is probable that an asset has been impaired or a liability had been incurred at the date of the financial statements and (*b*) the amount of the loss can be reasonably estimated. FASB Interpretation 14, *Reasonable Estimation of the Amount of a Loss*, provides guidance on accruing loss contingencies in circumstances in which condition (*a*) has been met and a range of loss can be estimated but no single amount within the range appears at the time to be a better estimate than any other amount within the range. In such circumstances, paragraph 3 of FASB Interpretation 14 requires that the minimum amount in the range be accrued.

97. Because the number of episodes to be delivered cannot be determined upon initial contract signing, the minimum point of the range is zero. Because it is in neither of the contractual parties= best interests to continue to produce and exhibit an unsuccessful series, the contracts essentially can be canceled at any time and AcSEC concluded that an allocable portion of the loss should be recognized as each episode becomes available. Certain users of financial information in the industry believe that the approach outlined in the SOP is most useful.

Film Costs Valuation

98. In determining whether FASB Statement No. 121 should be applied to films, AcSEC considered whether films are more like inventory or long-lived assets. AcSEC notes that paragraph 3b of FASB Statement No. 121 states that the Statement does not apply to assets whose accounting is prescribed by FASB Statement No. 53. However, AcSEC believes that a long-lived asset model is more consistent with the manner in which a film is exploited than is an inventory model. Revenues are earned from a film over a long period of time. Additionally, a film is Asold≅ or Aleased≅ repeatedly by the

entity in different markets and territories (unlike inventory, which is sold once). Therefore, AcSEC concluded that FASB Statement No. 121 should be applied to film assets.

99. In paragraph 39 of this SOP, AcSEC concluded that, if a property under development has not been set for production within three years from the first capitalized transaction related to that property, it is presumed that the property will be disposed of. AcSEC also concluded that when it is determined that such property will be disposed of, a loss should be recognized by a direct charge to income. AcSEC considered retaining the provision of paragraph 17 of FASB Statement No. 53, wherein the cost of a property not used in production of a film, after being held for three years, be charged to production overhead. Because AcSEC already concluded that film costs are long-lived assets and FASB Statement No. 121 should be applied, charging any impairment to production overhead rather than to income would be inconsistent with FASB Statement No. 121 and therefore was rejected. Additionally, AcSEC decided that in measuring fair value for capitalized costs of property not set for production within three years of the first capitalized transaction, the rebuttable presumption should be that the property will be disposed of by abandonment (not used) and as such have a fair value of zero. AcSEC concluded that this presumption could be overcome only if management, having the authority to approve the action, had committed to a plan to sell such property. AcSEC believes this provision will minimize the risk of reporting capitalized costs that do not have discernible future benefits and enhance comparability within the industry.

Presentation and Disclosure

100. AcSEC=s conclusions that (*a*) film costs should be classified as noncurrent

assets in classified balance sheets and (*b*) cash flows representing additions to film costs should be reported as cash flows from investing activities are based on AcSEC=s conclusion (as discussed in paragraph 98) that films are more similar to long-lived assets than to inventory.

101. AcSEC concluded that entities should disclose their methods of accounting for revenue, production costs, exploitation costs, and participation costs. AcSEC believes that the film industry and the related accounting in that industry is unique. AcSEC believes that users of financial statements will be better informed if entities are required to make these disclosures.

Transition

102. AcSEC believes that the advantages of retroactive application in prior periods of the provisions of this SOP would not outweigh the disadvantages. Accordingly, AcSEC concluded that the cumulative effect of changes caused by adopting the provisions of this SOP should be included in the determination of net income.

GLOSSARY

Direct negative costs

All direct costs incurred in the physical production of a film. Examples include costs of story and scenario; compensation of cast, directors, producers, extras, and miscellaneous staff; cost of set construction and operations, wardrobe, and accessories; cost of sound synchronization; rental facilities on location; and postproduction costs such as music, special effects, and editing.

Distributor

An enterprise or individual that owns or holds the rights to distribute films. This includes organizations that act only as sales agents for producers or owners of films if the agent=s compensation is dependent upon the completion, delivery, or availability of the film, or collection of the related revenue. However, a distributor of a film would not include those entities that function solely as broadcasters, retail outlets (such as video stores), or movie theaters, for example.

Entity

Producers and distributors that own or hold the rights to distribute or exploit films in one or more territories.

Exploitation costs

Exploitation costs consist of all direct costs (including marketing, advertising, and

duplication costs, such as costs of prints or cassettes) incurred in connection with the release of a film.

Films

All kinds of entertainment product (other than software subject to FASB Statement No. 86 or film costs associated with developing entertainment and educational software products addressed in EITF Issue 96-6, *Accounting for the Film and Software Costs Associated with Developing Entertainment and Educational Software Products*), whether produced on film, video tape, or other recording format. This definition includes feature films, television specials, television series, and similar products that are sold, licensed, or exhibited.

Film costs

The costs of developing a film and bringing that film to market, which consist of production costs, exploitation costs, and participation costs.

Gross revenue

The revenue earned by an entity from the distribution, exploitation, or licensing of a film, whether directly or indirectly, before deduction for any costs (for example, taxes, distribution fees, or costs of distribution) but reduced by estimated returns, refunds, or other similar adjustments. Gross revenues should be computed net of any discount required by APB Opinion No. 21, as discussed in paragraph 25 of this SOP.

Market

A distribution channel within a certain territory. Examples of markets include theatrical, home video, pay television, and free television.

Participation

Participation costs consist of the portion of compensation payable to parties involved in the production of the film that are contingent upon the film achieving certain financial performance, pursuant to contractual formulas.

Producer

A film producer is an individual or an entity that produces and owns or has an ownership interest in films for exhibition in movie theaters, on television, or elsewhere.

Production costs

Production costs include all costs incurred to produce a film, including direct negative costs, production overhead allocations, and capitalized interest (in accordance with FASB Statement No. 34, *Capitalization of Interest Cost*).

Residuals

Contingent compensation payable to a party or parties involved with the film that is payable based on the financial results of a film under provisions of collective bargaining agreements.

Territory

A geographic area in which a film is exploited. In most cases, a territory consists of a country. However, in certain instances, a territory can be defined as countries with a similar language.

APPENDIX

Analysis of a Multiple Film Arrangement

FLOWCHART GOES HERE