

Technical Line

FASB – proposed guidance

The revised revenue recognition proposal – media and entertainment

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What you need to know

- ▶ The FASB and the IASB issued a second exposure draft of their joint revenue model that is closer to current US GAAP than their 2010 proposal.
- ▶ The proposed guidance would replace all of the media and entertainment revenue guidance in the Accounting Standards Codification.
- ▶ The model's use of principles would require media and entertainment companies to make more estimates and use more judgment than under today's guidance.
- ▶ A key estimate of transaction price would include variable consideration.
- ▶ Comments are due by 13 March 2012.

Overview

The revised revenue proposal issued last month by the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) (collectively, the Boards) would supersede all revenue guidance in US GAAP and IFRS, including industry-specific guidance that media and entertainment (M&E) companies follow today.

Film studios, broadcasters, cable television companies, publishers, casino operators, video game companies and music companies would all have to assess the proposal and determine whether it would require a change in their current practice.

The proposed guidance may require changes in practice related to the following items:

- ▶ The concept of “persuasive evidence of an arrangement” does not exist in the proposed guidance, which states that contracts may be written, oral or implied by an entity’s business practices.
- ▶ Free goods (e.g., free advertising) and option arrangements could be considered performance obligations under the proposal. Practice is currently mixed. Some companies treat these items as revenue elements while others expense them as cost elements.
- ▶ Advertising barter transactions appear to fall within the scope of the proposal. However, until the Boards publish the proposed consequential amendments it is unclear whether and how existing practice would be affected.
- ▶ Noncash consideration – including the exchange of network programming for advertising time – would be included in the transaction price.
- ▶ Variable consideration would have to be estimated and included in the allocated transaction price under the proposed guidance. This could affect how an entity allocates minimum guarantees for license arrangements.
- ▶ The transaction price would have to be allocated to each of the performance obligations based on their relative standalone selling prices. This would include films not released and would differ from current industry guidance, which states that the amount allocated to a film not yet produced or completed is based on the amount refundable if the film is not completed. For license fees to furnish music, the assessment may differ from current industry guidance, which states that the earnings process is not complete if a licensor has significant obligations to furnish additional music.
- ▶ Revenue would be recognized when the customer obtains control of an asset or rights to use the asset. This could result in changes to arrangements involving “street dates” or “cover dates” and to licensing arrangements for the sale of film-related products that commence before a film is released.
- ▶ Contract costs (e.g., costs to acquire and costs to fulfill) would have to be capitalized if certain criteria are met.
- ▶ Estimates of uncollectible amounts would be presented adjacent to revenue in the statement of operations rather than in operating expense and would therefore reduce gross margins.

This publication supplements our Technical Line, *Double-exposure: The revised revenue recognition proposal* (SCORE No. BB2231), and should be read in connection with it. This publication considers key implications of the proposed guidance for M&E companies. The discussions within this publication do not represent our final or formal views and additional issues may be identified because the proposal could change based on further deliberation by the Boards.

Background

The Exposure Draft (ED) the Boards issued in November 2011 specifies the accounting for all revenue arising from contracts with customers and affects all entities that enter into contracts to provide goods or services to their customers (unless those contracts are in the scope of other US GAAP requirements).

The principles in the proposed standard would be applied using the following five steps:

1. Identify the contract(s) with a customer
2. Identify the separate performance obligations in the contract(s)
3. Determine the transaction price
4. Allocate the transaction price to the separate performance obligations
5. Recognize revenue when the entity satisfies each performance obligation

The proposed guidance would also provide a model for the measurement and timing of recognition of gains and losses on the sale of certain nonfinancial assets, such as intangible assets, property and equipment.

Step 1: Identify the contract with the customer

To apply the proposed model, an entity would have to first identify the contract, or contracts, to provide goods and services to its customer. Contracts may be written, oral or implied by the entity's customary business practice. This guidance replaces the concept under SAB 104 that there must be persuasive evidence of an arrangement. That would mean that contracts in the advertising or cable network industry may commence upon oral acceptance rather than when there is a final executed contract.

How we see it

Considering oral or implied agreements may be a significant change in practice for some M&E entities. Generally, the existing guidance states that if an entity has a customary business practice of using written contracts to document formal arrangements, evidence of any arrangement exists only when there is a fully executed contract.

The new guidance may result in an entity recognizing revenue earlier if the oral arrangement creates an enforceable right or obligation.

Contract modifications

When the parties to an arrangement modify their contract, the entity must determine whether the modification creates a new contract or whether it should be accounted for as part of the existing contract. A contract modification is described as any change in the scope or price of a contract initiated by any party to the contract.

Customers such as cable or satellite subscribers, retailers, distributors and advertisers may modify contracts to change the transaction prices and/or the terms of an arrangement. The terms of the arrangement may be modified to increase the number and/or timing of advertising placements, increase the number of CDs or DVDs ordered or increase the period of a license arrangement. When a

contract is modified, an entity must determine whether the modification combined with any remaining performance obligations creates a new contract (separate from the original contract) or whether the contract modification should be combined and accounted for as a modification of the existing contract. The determination of a new and separate contract is driven by whether the modification results in both the addition of goods or services that are distinct and whether the price of the additional goods or services reflects the standalone selling price.

For many M&E companies, the additional goods or services would most likely be viewed as distinct (i.e., the company regularly sells the good or service separately), and therefore the key factor would be whether the pricing for the additional product or service represents the standalone selling price.

Illustration 1 – Separate contract for goods

Film Distributor A promises to deliver 100,000 DVDs to Retailer B for \$1,000,000 (\$10 per DVD). The DVDs are transferred to Retailer B at various points in time over a six-month period. The contract is modified after 60,000 DVDs have been transferred; Film Distributor A promises to deliver 20,000 additional DVDs (120,000 DVDs in total) for an additional \$190,000, or \$9.50 per DVD. The pricing for the additional DVDs reflects the standalone selling price of the DVDs at the time of the contract modification. This contract modification for the additional 20,000 DVDs is in effect a new and separate contract for future DVDs that does not affect the accounting for the existing contract.

Alternatively, if the pricing for the 20,000 additional DVDs did not reflect the standalone selling price of the DVDs, Film Distributor A would allocate the modified transaction price (less amounts allocated to the DVDs transferred before the modification date) to all remaining DVDs to be transferred. The amount recognized as revenue for each remaining DVD would be a blended price of \$9.83 $\{(\$10 \times 40,000 \text{ DVDs to be transferred under original contract}) + (\$9.50 \times 20,000 \text{ DVDs to be transferred under the contract modification}) / 60,000 \text{ remaining DVDs}\}$ per DVD.

The concepts discussed in the example above would be similar for a modification to advertising arrangements that provides for additional ad placements that may or may not be priced at an amount that equals the standalone selling price.

Step 2: Identify the performance obligations

Performance obligations are the goods or services promised in a customer contract. Goods or services would be accounted for as separate performance obligations when they are distinct, which means they are sold separately or the customer can benefit from the good or service on its own or together with other resources that are readily available to the customer. If a promised good or service is not distinct, it would be combined with other goods or services. An entity would identify all promised goods and services and determine whether to account for each good or service as a separate performance obligation.

Goods and services would have to be combined as one performance obligation if both of the following criteria are met:

- ▶ The bundled goods or services are highly interrelated, and transferring them to the customer requires a significant service of integrating them

- ▶ The bundled goods or services are significantly modified or customized to fulfill the contract

As a practical expedient, two or more distinct goods or services could be combined as one performance obligation if they have the same pattern of transfer to the customer. For example, a publisher may offer a one-year subscription for a physical newspaper only, a digital copy only or a bundled package of both the physical paper and the digital paper. For the bundled package, although the digital and physical subscriptions relate to separate performance obligations (i.e., each is distinct), the products are both delivered on a daily basis (i.e., same pattern of transfer), and therefore the publisher could account for both products as one performance obligation.

Illustration 2 – Identifying separate performance obligations – free advertisements

Network A enters into a contract to run 50 advertisement spots during a specific program or time slot for Advertiser B for \$100,000. The contract terms also provide Advertiser B with five free advertisements to be included in digital programming on Network A's website. Each of the 55 advertisements would be viewed as separate performance obligations because the free advertisements would be distinct. See page 10 for a discussion of how the \$100,000 transaction price should be allocated to each of the 55 performance obligations.

Illustration 3 – Licenses: service provided to include additional content

Music Company A enters into a two-year license agreement with an online distributor to make its entire existing music library accessible in return for a \$5 million nonrefundable up-front fee and for an additional minimum of \$45 million to be paid over the two-year license period. The license agreement also requires Music Company A to make certain new releases available to the online distributor.

Music Company A likely has two promised goods or services within the arrangement: (1) the delivery of the existing music library and (2) the future delivery of new releases (if and when they are done) over the license period. Music Company A may conclude that the delivery of the separate music libraries is distinct because the online distributor can benefit from each service on its own. Further, the performance obligation related to the delivery of the existing library is likely satisfied as of a point in time (when the music is made available). Conversely, the second performance obligation is likely satisfied over the entire license period. Since these two have separate patterns of transfer, Music Company A would have to treat them as two separate performance obligations. Therefore, Music Company A would have to allocate the total estimated transaction price between the two performance obligations based on their relative standalone selling prices. For the performance obligation satisfied over time, Music Company A would have to determine the amount of revenue to recognize based on either the input or output method (e.g., based on expected number of songs to be delivered).

This would represent a change for certain music companies that currently recognize revenue on a straight-line basis over the license period.

Properly identifying performance obligations within a contract would be a critical component of the proposed revenue model.

Certain arrangements include flat fees or variable fees for multiple films or exhibition markets (e.g., international distribution). These arrangements may also include specific periods (i.e., windows) or markets in which the licensee may or may not exploit the licensed content. For example, an arrangement may allow the licensee to exploit content for two consecutive years, followed by one year of nonexploitation, followed by a final year of exploitation. Careful consideration should be given to assessing whether each of the exploitation periods (e.g., years 1, 2 and 4) or markets represents a separate performance obligation.

How we see it

Some types of M&E companies frequently offer free products or services as an inducement to customers to enter into longer-term contracts. For example, publishers might offer a free book or other goods to customers who purchase a one-year magazine subscription. Under the proposed guidance, this would typically result in some of the subscription revenue being allocated to the free goods or services. If these goods or services are delivered at inception of the contract, this could result in a portion of the revenue being accelerated when compared with current practice, assuming the entity's ability to recognize revenue isn't constrained by the arrangement containing variable consideration to which the entity would not be "reasonably assured" to be entitled.

Customer options for additional goods

Current M&E business practices often incorporate optional purchases into contracts with customers. The proposed revenue recognition guidance would treat an option to purchase discounted goods or services as a separate performance obligation only if the option provides a material right to the customer that the customer would not receive without entering into that contract. If the discounted price in the option is within the range of prices typically offered to other similar customers (separate from any existing relationship or contract), it would not be a material right and the entity would be deemed to have made a marketing offer.

In the film industry, producers may enter into license arrangements for season one of a television show that includes an option to provide additional seasons to a television network. The network's decision to exercise the option for additional seasons depends on the success of the previous season, and therefore the value of each additional season is not likely known when the license period commences. Therefore, it is not likely that the option for additional seasons represents a material right to the licensee (broadcast network).

Options may also include coupons to purchase additional goods at a discount, such as a digital version of a textbook that is offered with the purchase of the physical textbook. See page 12 for a discussion of the measurement of options that are separate performance obligations.

Licensing

A license granted to a customer represents the customer's right to use the intellectual property (IP) developed or owned by the entity for its intended use. In a change from the original ED, the revised proposal would not require an analysis of the customer's rights (i.e., exclusive versus nonexclusive). Instead, all promises to grant licenses would be accounted for as a single performance obligation in which the entity recognizes revenue when the customer obtains the right to use and benefit from the asset.

Licenses are common for M&E companies and include a motion picture studio granting rights to broadcast a film or television program; distribution rights associated with a film; a music company granting rights to distribute an artist's CD; a publisher granting territorial distribution rights; and licenses of music portfolios in commercials or video games. See page 14 for more discussion of licenses and rights to use.

Step 3: Determine the transaction price

The transaction price is "the amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer, excluding amounts collected on behalf of third parties (for example, taxes)." In many cases, this is readily determinable because the entity receives payment at the same time it transfers the promised goods or services and the price is fixed. For variable fee arrangements, the transaction price should either be the expected value (sum of probability-weighted amounts) or the most likely amount, based on whichever best predicts the consideration to which an entity expects to be entitled.

Variable consideration

The transaction price reflects expectations about the consideration the entity will receive from the customer. A portion of the transaction price could vary in amount and timing due to discounts, rebates, refunds, credits, incentives, bonuses or penalties, contingencies or concessions. For example, a portion of the transaction price would be variable at contract inception if it requires meeting specified performance conditions and there is uncertainty about the outcome.

Under the expected value approach, the entity would identify the possible outcomes of a contract and the probabilities of those outcomes. The alternative most likely approach would predict the most likely outcome and use that threshold as the basis for revenue recognition. This may be the better predictor when the entity expects to receive only one of two possible amounts (e.g., a contract where an entity is eligible to receive all or none of a specified performance bonus, but not a portion of that bonus). However, either approach could be used if it better predicts the consideration that the entity will be entitled to.

Variable consideration would be estimated in determining the transaction price.

Illustration 4 – Performance bonus

Advertising Agency A enters into a six-month advertising campaign agreement (\$500,000 fixed fee) that also includes a potential \$100,000 additional performance bonus linked to certain goals. The agency has estimated it is 80% likely to receive the entire performance bonus, and 20% likely to receive none of the bonus.

Using a probability-weighted estimate, Advertising Agency A would include \$80,000 [$(\$100,000 \times 80\%) + (\$0 \times 20\%)$] in the transaction price associated with this potential performance bonus.

Illustration 4 – Performance bonus (continued)

Under the alternative method, Advertising Agency A would include \$100,000 in the transaction price because that reflects the amount the agency believes it most likely will receive. Because of the binary nature of the outcome (the agency either will or will not receive the performance bonus), the agency would likely determine that the “most likely” approach is the better predictor. Therefore, Advertising Agency A estimates the transaction price as \$600,000 and would recognize revenue over the six-month service period as the service is provided. After commencement of the arrangement, any changes in the value of the estimated bonus would be reflected as an adjustment to the transaction price.

Under current US GAAP, the amount considered fixed or determinable would likely include only the fixed fee until the uncertainty about the bonus payments is resolved (depending on whether performance is measured against objective or subjective criteria). Therefore, Advertising Agency A would record \$500,000 over the first six months and at the end of the period would recognize the \$100,000 bonus.

The proposal would require entities to recognize only revenue to which they are “reasonably assured” to be entitled. See page 14 for a discussion of this constraint on revenue.

How we see it

For a number of M&E entities, the treatment of variable consideration under the proposed guidance would represent a significant change from current practice.

Most current US GAAP limits the amount of revenue allocable to identified performance obligations to the amount that is not contingent on the future satisfaction of performance obligations. The proposed guidance would allow variable consideration to be allocated to performance obligations and only provides a restriction on recognizing variable amounts that are not “reasonably assured” to be entitled to.

Nonrefundable up-front fees

In certain circumstances, M&E companies may receive payments from customers before they render the contracted service or deliver a good. Up-front fees are common in the film, publishing and music industries, where contracts often include a nonrefundable minimum fee. Up-front fees themselves do not represent a promised good or service within the arrangement. Like all other consideration, up-front fees would be included in the total transaction price and would be allocated to the identified separate performance obligations.

However, the existence of up-front fees may indicate that there is another good or service in the arrangement. For example, a term license arrangement that includes an up-front fee as well as a renewal option that requires no additional up-front fee upon renewal may indicate that the arrangement provides the customer with a material right for a below-market renewal.

Noncash consideration

Customer consideration might be in the form of goods, services or other noncash consideration. When an entity receives or expects to receive noncash consideration, the transaction price would include the fair value of the noncash consideration.

In certain license arrangements between producers and networks, a network may contribute cash and/or advertising on the network to the producer in exchange for the licensed rights. Today, most producers recognize revenue from the sale of the licensed content when they use the advertising or sell it to a third party (even when the license content was previously transferred). In a change from current practice, the proposed guidance would require the fair value of the advertising to be included in the transaction price. Such amount would be recognized when the licensed rights are transferred, which would likely result in earlier revenue recognition. However, the proposed guidance does not clearly indicate when the fair value measurement should be completed. That is, it does not indicate whether the fair value of the barter advertising for licensed content should be measured at the inception of the contract, when the license period begins or when the advertising is used or sold.

In certain arrangements between broadcasters and networks, a broadcaster may obtain programming from a network in exchange for advertising time. Under current US GAAP, all barter transactions for broadcasters except those involving the exchange of advertising time for network programming are reported at the estimated fair value of the product or service received. The proposed guidance would represent a change from current US GAAP, under which the barter transaction of advertising time for programming is not recognized by the broadcaster or network. The proposed guidance does not include a scope exception for these transactions. Therefore, the fair value of the advertising time and programming transferred by the broadcaster and network, respectively, would be included in the transaction price for each entity.

In other arrangements, advertisers may enter into agreements in which no cash is exchanged, but advertising inventory from each entity is exchanged (e.g., internet advertising exchanged for television advertising). Under current US GAAP, the revenue and expense is recognized at fair value only if the fair value of the advertising surrendered is determinable based on the entity's own historical practice of receiving cash or instruments convertible to cash for similar advertising. Today, an entity should have evidence to support these transactions within the previous six months before the transaction. In addition, the advertising should be similar to the bartered advertising with respect to market, timing, prominence, demographics and duration. The proposed guidance does not include the similar advertising concept and therefore, this accounting may change. Assuming an entity could determine that such an arrangement has commercial substance (that is, that the contract is expected to change "the risk, timing or amount of the entity's future cash flows"), the entity would have to apply this noncash consideration guidance to such transactions.

The requirement to include noncash consideration in the transaction price would generally be a change from current practice.

Consideration paid or payable to a customer

Many M&E companies make payments to their customers from time to time. These types of fees are often used in the film, broadcasting, publishing and music sectors for a variety of reasons, including: placement of DVDs, book releases and CDs in retail stores (slotting fees); cooperative advertising arrangements in which the film company reimburses the reseller for a portion of the costs incurred by the reseller to advertise products; channel placement fees; and launch incentive fees paid by cable networks to multiple system operators (MSOs) or satellite companies to launch a new channel.

Under current US GAAP, M&E companies often recognize these fees as a reduction of revenue, as the fees are generally for product placement (i.e., eye-level or specific displays), which does not meet the current identifiable benefit criteria. Under the proposed guidance, for a payment by the entity to a customer to be treated as something other than a reduction of the transaction price, the good or service provided by the customer would have to meet the criteria to be considered distinct. That is, the customer must regularly sell the good or service separately or the entity must be able to benefit from that good or service either on its own or together with other resources that are readily available to the entity. Otherwise, payments from vendors to customers would be considered a reduction of the total transaction price.

It is unclear whether the Boards intend for there to be a change in practice. While the proposed guidance is not significantly different from existing guidance, the June 2010 ED indicated that product placement was a distinct service and that therefore such amounts should be treated as an expense rather than a reduction of revenue. However, respondents raised concerns about that conclusion, and the current proposed guidance is silent on the issue. M&E companies should carefully assess the “distinct” criteria, as the goods or services received in return for the payment to the customer may benefit the company on its own (e.g., advertising).

Step 4: Allocate the transaction price

Once the performance obligations are identified and the transaction price has been determined, an entity would allocate the transaction price to the performance obligations, generally in proportion to their standalone selling prices (i.e., on a relative standalone selling price basis). As a result, any discount within the contract would generally be allocated proportionally to all of the separate performance obligations in the contract.

The standalone selling price would be the price at which an entity would sell a good or service on a standalone basis at contract inception. The proposal indicates the observable price, when available, of a good or service sold separately provides the best evidence of standalone selling price. However, in many situations, standalone selling prices will not be readily observable. In these situations, an entity would have to estimate the amount for which it would sell each good or service on a standalone basis.

Illustration 5 – Estimated selling price

Broadcaster A enters into an arrangement to provide advertising to a company on multiple platforms for \$100,000. The advertising will include 30-second advertising spots, banner advertisements on the broadcaster's website and in-show placements.

In this example, Broadcaster A regularly sells the 30-second spots for \$80,000 and the banner advertisements for \$30,000. Broadcaster A does not regularly sell the in-show placement advertisement separately, but the ads would be considered distinct because the customer can benefit from them separately. Broadcaster A estimates that the standalone selling price for the in-show placement advertisements is \$20,000.

The aggregate individual standalone selling price (\$130,000) exceeds the total transaction price, indicating there is a discount inherent in the arrangement. That discount would be allocated to each of the individual performance obligations based on the relative standalone selling price of each performance obligation. Therefore, the \$100,000 transaction price is allocated to each performance obligation as follows:

- ▶ 30-second spots – \$61,540 ($\$80,000 \times (\$100,000/\$130,000)$)
- ▶ Banner ads – \$23,076 ($\$30,000 \times (\$100,000/\$130,000)$)
- ▶ In-show placement ads – \$15,384 ($\$20,000 \times (\$100,000/\$130,000)$)

Broadcaster A would recognize as revenue the amount allocated to each performance obligation as each performance obligation is satisfied.

Illustration 6 – Fixed-fee, multiple-film arrangement

Film Company A grants to a customer the broadcast rights to three films under a single licensing arrangement. The arrangement includes a fixed fee of \$30,000. The arrangement provides for a pro rata reduction in the license fee if Film 3 is not completed and made available for delivery. Said another way, the \$10,000 subject to refund represents variable consideration.

At the date of the arrangement, Films 1 and 2 are complete; Film 3 has not yet been produced. The \$30,000 transaction price would be allocated to each film based on the relative selling price of each film. The standalone selling price is the price at which Film Company A would sell each film separately to a customer. Assume the standalone selling prices for films A, B and C represent 40%, 35% and 25% of the total standalone selling price, respectively. The transaction price allocated to each film would be \$12,000 for Film A, \$10,500 for Film B and \$7,500 for Film C.

Current industry guidance requires that the amount that is refundable be allocated to the undelivered film. Therefore, the refundable portion (\$10,000) would be allocated entirely to the film remaining to be delivered (Film C) and the remainder (\$20,000) would be allocated to the completed films (A and B) based on their relative fair value.

How we see it

The requirement to estimate a standalone selling price would not be a new concept for entities that currently apply the multiple-element arrangements guidance in ASC 605-25. What would be eliminated is the hierarchy of pricing evidence to consider when determining standalone selling price.

Measurement of options that are separate performance obligations

An entity that determines that an option is a separate performance obligation would have to determine the standalone selling price of the option. If the standalone selling price is not directly observable, the entity would estimate the standalone selling price, taking into consideration the discount the customer would receive in a standalone transaction and the likelihood that the customer would exercise the option.

The proposal also provides an alternative to estimating the standalone selling price of an option when that amount is not observable. An entity would be allowed to “look through” the option and assume that it is going to be exercised. Under this approach, the entity would estimate the transaction price by including any consideration related to the optional goods or services.

Illustration 7 – Coupon to purchase digital version

Publisher A sells a physical textbook for \$10 and offers the customer a coupon to purchase the digital version of the publication for 50% off the retail price of \$8. If this discount is incremental to the typical discount offered to customers, this may provide the customer with a material right.

Valuation of option

One alternative for accounting for options under the proposed guidance is to treat the option as a separate performance obligation. This approach would require Publisher A to allocate a portion of the transaction price (\$10) to that separate performance obligation. To estimate the standalone selling price of the option, Publisher A estimates a 50% likelihood that a customer will redeem the coupon. Therefore, Publisher A’s estimated standalone selling price of the coupon would be \$2 (\$8 digital price x 50% incremental discount x 50% likelihood of exercising the option).

If the standalone selling price of the physical book is \$10, Publisher A allocates \$1.67 ($\$10 \times [2 / (2+10)]$) of the transaction price to the discount coupon and \$8.33 to the physical book.

Assume option will be exercised

An alternative “look through” approach would assume the coupon will be redeemed and would include the consideration for the digital publication (\$4) in the transaction price. The \$14 estimated transaction price would be allocated to the physical and digital publication based on their standalone selling prices. If the standalone selling price of the physical book is \$10, and the standalone selling price of the digital content is \$8, Publisher A would allocate \$7.78 and \$6.22 to the physical book and the digital content, respectively.

Step 5: Satisfy the performance obligation

An entity would recognize revenue only when it satisfies an identified performance obligation by transferring a promised good or service to a customer. A good or service is generally considered to be transferred when the customer obtains control. Control of an asset refers to the ability to direct the use of and obtain substantially all of the remaining benefits from the asset. The customer's ability to receive the benefit from the good or service is represented by its right to substantially all of the cash inflows, or the reduction of cash outflows, generated by the goods or services.

Certain performance obligations are satisfied as of a point in time. In these cases, revenue would be recognized at that time. Other performance obligations are satisfied over time, and revenue therefore would be recognized over the period the performance obligation is satisfied.

Control transfers at a point in time

For certain products or services in the M&E industry, the determination of when control transfers and revenue should be recognized would be straightforward. For example, when a customer purchases an on-demand movie from a cable company, control transfers to the customer as the movie is provided. However, in other circumstances, the determination of when control transfers may be more complex. To help entities with this assessment, the Boards provided some indicators of when control transfers.

Current accepted industry practice about the timing of revenue recognition may be in conflict with this proposed guidance, as highlighted in the discussion below. M&E companies should carefully assess when the customer has the ability to direct the use of and receive the benefit from an asset. In the film, video game, music and publishing industries, contracts often include certain restrictions on the locations and dates a customer can distribute the product (e.g., street date).

Typically, several of the indicators provided in the proposed guidance would be met at the point of shipment because the customer has an obligation to pay for the product, the customer has legal title and the customer has physical possession. However, depending on restrictions the customer has on its ability to distribute the product, the customer may not have the "present right" to obtain substantially all of the potential cash flows from that asset until the street date. The concept of a street date may also indicate that the customer has not obtained the risks and rewards of ownership. In this scenario, an entity may conclude that the transfer of control of the product would not occur until the street date because the retailer does not have the ability to direct the use of and receive the benefit from the good until it is permitted to sell the product. Today, the concept of street date is included in film industry accounting guidance; however, the assessment of street date and the restrictions the retailer may have vary among M&E industries (e.g., music and publishing). The street date concept is not specifically discussed in the proposed guidance, and therefore entities would have to apply the principle of transfer of control to determine the appropriate point for revenue recognition.

Control transfers over time

Service arrangements and certain other long-term contracts for cable services, creative advertising and online gaming may provide for the continuous delivery of goods and services over the course of the contract period. Consistent with current US GAAP, an entity would recognize the revenue as the promised goods and services are provided, using either an output or an input method to measure progress toward completion.

Output methods recognize revenue on the basis of units produced or delivered, contract milestones or surveys of services transferred to date relative to the total services to be transferred. If an entity has the right to invoice the customer in an amount that corresponds directly to the value of the performance completed to date (e.g., an advertising contract in which the agency bills a fixed amount for each hour of service provided), the Boards have indicated this is akin to an output method and an entity would recognize revenue in the amount to which an entity has a right to invoice.

Input methods recognize revenue on the basis of efforts expended to date (e.g., costs of resources consumed, labor hours expended) relative to total efforts expected to be expended.

Variable fees from license arrangements would be recognized as the customer's subsequent sales occur.

In a change from current practice, the proposed guidance does not include passage of time as a method of measuring progress. However, in certain circumstances, the passage of time could serve as a reasonable proxy for either an input or output method.

Constraining the amount of revenue recognized

Once the estimated transaction price has been allocated to the identified performance obligations, the entity would be constrained, or limited, in the amount of revenue it could recognize upon satisfying a performance obligation. The limit would be the amount to which an entity is reasonably assured of being entitled. An entity is reasonably assured to be entitled to an amount when the entity has experience with similar types of contracts and the experience is predictive of the outcome of the contract.

An entity's experience may not be predictive of the current contract if the consideration is highly susceptible to factors outside the entity's influence, the entity has limited experience with similar contracts or the contract has a large number and wide range of possible consideration amounts.

Licenses and rights to use

Revenue for license arrangements would be recognized when the customer obtains the right to use and benefit from the asset.

Promised consideration from a customer that "varies entirely based on the customer's subsequent sales of a good or service that uses the licensed intellectual property (e.g., a sales based royalty)" is not reasonably assured until the uncertainty is resolved (i.e., when the customer's sales occur). Therefore, the timing of revenue recognition for license arrangements that include variable consideration (e.g., theatrical releases, royalties for publication rights) would be consistent with current US GAAP (in that it would be recognized during the period the film is exhibited or as the publication is sold).

How we see it

Current US GAAP includes certain M&E-specific criteria that must be met for revenue to be recognized. For example, for film sales, the film must be complete, the license period must have begun and the customer must be able to begin its exploitation, exhibition or sale. For music companies, the rights must have been delivered to the licensee, who must be free to exercise them, and there must be no remaining obligations. The proposed guidance is not likely to change the timing of most license arrangements, but it may change certain arrangements that follow current M&E accounting guidance. For example, under current US GAAP, a company does not recognize revenue from license agreements to market film-related products until it releases the corresponding film. If the licensee obtains the right to use and can benefit from the licensed content, revenue may be recognized earlier under the proposed guidance.

Certain arrangements provide for the licensor to provide content or the right to use certain productions over a period of time, while other arrangements provide for additional content to be provided over the license period. Careful consideration should be given to the performance obligations in the contract to determine whether separate performance obligations exist.

Illustration 8 – Most likely amount from multiple outcomes

A music company enters into a contract with a customer to license two of its artist logos on soda cans. Each logo represents a separate performance obligation. For the rights to use artist logo A and logo B, the music company will receive an up-front minimum guarantee of \$100,000 and 5% of the customer's future sales of products using logos A and B. The music company's estimate of total transaction price is \$225,000 (which includes an estimated additional \$75,000 of royalties from logo A and \$50,000 from logo B determined on a probability-weighted basis).

The music company transfers logo A at the inception of the contract and logo B six months later.

The music company applies the relative selling price method to allocate the estimated transaction price. The music company determines the standalone selling price of logo A is \$110,000 and logo B is \$100,000 (based on historical arrangements).

The music company allocates \$118,000 ($(\$110,000 / (\$110,000 + \$100,000)) \times \$225,000$) to logo A and \$107,000 ($(\$100,000 / (\$110,000 + \$100,000)) \times \$225,000$) to logo B.

Under the proposal, because the arrangement includes variable fees, the music company would recognize only the amount of revenue to which it is reasonably assured to be entitled. Therefore, at the time the music company transfers the license for logo A to the customer, although the music company has allocated \$118,000 to logo A, it is limited to recognizing \$100,000. As the sales-based royalties are received, and assuming there are no changes in the estimated variable consideration, the music company would continue to recognize those amounts as revenue until a total of \$118,000 is recognized. Once the music company has recognized all amounts allocated to logo A, additional royalty payments would be deferred until the license period for logo B commences.

Consistent with current US GAAP, nonrefundable minimum guarantees for single films or amounts allocated to individual films in a multiple-film arrangement would be recognized when the customer can benefit from the asset. Arrangements that include nonrefundable minimum guarantees may also include variable fees. Although the variable fees would not be recognized until the third-party sales occur, the minimum guarantee for each license (i.e., performance obligation) can be recognized as each license period begins because the amounts are reasonably assured. Conversely, under current US GAAP, if a license arrangement provides for nonrefundable minimum guarantees that are applied against variable fees from a group of films on a cross-collateralized basis, the amount applicable to each individual film cannot be objectively determined (i.e., it is not fixed or determinable). Therefore, revenue is recognized as the customer exhibits the film.

Illustration 9 – Nonrefundable up-front fees – multiple-fee arrangement

On 1 January 20X1, Film Company A enters into a license arrangement with a customer for the home video rights to five completed films for a period of two years commencing on 1 April 20X1. The licensing arrangement provides a variable fee of up to 20% of the customer's gross receipts from the exploitation of the films during the license period. The licensing arrangement also requires the customer to pay Film Company A a \$25,000 nonrefundable minimum guarantee. The variable fees are cross-collateralized for purposes of determining the amounts due in excess of the \$25,000 nonrefundable minimum guarantee.

Under current US GAAP, the \$25,000 nonrefundable minimum guarantee applicable to each film cannot be determined, and therefore the fee is recognized as revenue as the customer exploits the films. Under the proposed guidance, if there were no additional performance obligations, Film Company A could recognize the \$25,000 guarantee once the license period has commenced rather than defer the fee over the exhibition period.

Other measurement and recognition topics

Onerous performance obligations

An entity would recognize a liability and a corresponding expense when certain performance obligations become onerous. The onerous test would be required for performance obligations that are satisfied over time when that period of time is greater than one year. Performance obligations satisfied at a point in time or satisfied over a period of less than one year would not be subject to the test.

Under the proposed guidance, a performance obligation is deemed onerous when the lesser of the following exceeds the allocated transaction price:

- ▶ The costs directly related to satisfying the performance obligation (i.e., direct costs)
- ▶ The costs the entity would have to pay to exit the performance obligation

The assessment of potential onerous performance obligations would be performed for each performance obligation within a contract, rather than for the contract as a whole. For example, although the costs to produce each episode of a television series may be greater than the network license fee for each episode, the season or individual episode is typically less than one year, and therefore the onerous test would not be required.

Certain contracts to obtain programming (e.g., sports contracts) may be for periods greater than one year. However, the assessment of an onerous performance obligation would be related to the performance obligation with the customer (e.g., the advertiser). Because these advertising arrangements are typically less than one year, an onerous test would not be required for these performance obligations. The costs to obtain programming would continue to be assessed for impairment based on existing US GAAP guidance for the valuation of program rights.

Contract costs

The proposal provides accounting guidance for an entity's costs incurred in obtaining and fulfilling a contract to provide goods and services to customers for both contracts obtained and contracts under negotiation. This differs from existing US GAAP, which generally applies only when an entity has obtained a contract. The proposed guidance does not specify whether contract costs should be recoverable over the stated contractual period or the period of expected performance (i.e., the customer life). This is especially significant when arrangements are contractually on a month-to-month basis but the expected term of the arrangement is longer. Cable operators track customer terminations (i.e., churn) for most of their services and have the ability to demonstrate that a customer stays on longer than the contractual period. While not explicitly stated in the proposed guidance, we believe an entity could consider the period of benefit the costs relate to (which may be longer than the contractual period) when assessing recoverability. This concept is consistent with the guidance in the proposal that states contract costs should be amortized over the period that the entity expects to provide services to the customer, which may exceed the initial contract term.

For example, consider a cable company that incurs incremental costs to obtain a new cable customer. If the customer is not locked into a contractual period for obtaining future cable services, depending on the facts and circumstances, it may be appropriate for the cable company to consider the expected customer relationship period in assessing the recoverability of the costs incurred.

Costs of obtaining a contract

Incremental costs of obtaining a contract (i.e., costs that would not have been incurred if the contract had not been obtained) would be recognized as an asset, but only when it is probable they are recoverable. Recovery of incremental costs can consider both direct recovery (i.e., through reimbursement under the contract) or indirect recovery (i.e., through the margin inherent in the contract). As a practical expedient, the proposal permits immediate expense recognition for contract acquisition costs for contracts of one year or less. While this is not explicitly stated, we believe entities would be permitted to choose this approach as an accounting policy election and, if they did so, would have to apply it consistently to all short-term contract acquisition costs.

Costs to fulfill a contract

An entity would first account for costs incurred in fulfilling a contract with a customer in accordance with other authoritative guidance (e.g., inventory, program costs, property, plant and equipment, software). Otherwise an entity would capitalize the costs to fulfill a contract if all of the following criteria are met:

- ▶ The costs relate directly to the contract (or a specific anticipated contract)

- ▶ The costs generate or enhance resources of the entity that will be used in satisfying performance obligations in the future
- ▶ The costs are expected to be recovered

Cable operators typically incur significant costs for the setup, activation and installation of a customer. Current US GAAP for cable television companies permits installation revenue to be recognized as revenue to the extent of direct selling costs incurred. Such direct selling costs and subscriber-related costs are expensed as period costs. However, under the proposed guidance, the cable operator could capitalize costs it expects to recover, which could result in larger amounts being capitalized than are today.

Illustration 10 – Cable contract costs

A customer signs up with Cable Company A for a television, phone and internet bundle priced at \$55/month, which is provided month-to-month and is cancelable at any time without penalty. Cable Company A has provided these services for many years and has accumulated churn history that shows that customers for this type of plan stay with the plan for an average of three years. The cost of providing the monthly cable, phone and internet services is expected to be \$30/month.

Cable Company A sends a technician to the customer's home to set up the customer's television and internet service and activate the phone service. The technician spends four hours, and his direct labor and material costs are \$500. Cable Company A charges the new customer a \$75 installation fee to recoup a portion of the direct costs incurred. Under current US GAAP, the \$75 installation fee and \$75 of the direct labor and material costs are recognized as revenue and expense in the period the installation is completed.

The average customer life is three years, and Cable Company A expects to receive total consideration of \$2,055 [(\$55/month x 36 months) + \$75 installation fee] over the customer life, assuming no credit losses. The cost of providing the monthly television, phone and internet services is expected to be \$1,080 [\$30/month x 36 months] for the same period. Therefore, the entire \$500 of direct labor and material costs would be considered recoverable and eligible for capitalization.

Amortization

An entity would amortize assets relating to capitalized costs for both the incremental costs of obtaining a contract and costs to fulfill a contract on a systematic basis, consistent with the pattern of transfer for which the service relates. Entities could take into account the expected renewal period in their assessment. For cable operators, a number of the arrangements are contractually on a month-to-month basis, but the expected term of the arrangement is longer due to the expected renewals. Under the proposed guidance, cable operators would amortize the assets over the average customer life.

Transition and effective date

The Boards have not concluded on an effective date for the new standard. However, the Boards have indicated that a final standard would not be effective before fiscal years beginning in 2015. The FASB also concluded that early adoption of the final standard would be prohibited for US GAAP preparers.

For many M&E entities, one of the more problematic areas of the new revenue standard may be the transition from current practice. All entities would be required to apply the proposed standard retrospectively, but the Boards agreed to certain relief from full retrospective application, including no requirement to restate if contracts begin and end within the same accounting period.

The proposed standard would allow full retrospective application for entities that choose not to apply the relief provided. Entities that choose to adopt the final standard using some or all of the types of relief would be required to provide additional qualitative disclosures, such as which types of relief were chosen and the likely effects of applying them.

When considering the potential effects on the proposal, M&E companies should consider not only changes in accounting policies and accounting systems, but changes they would need to make in internal control processes and procedures (e.g., estimation process for variable consideration).

Next steps

Given the potential consequences, we encourage M&E companies to gain an understanding of the proposed guidance, including how it may affect their particular facts and circumstances, and provide the Boards with feedback on the proposal. The comment period ends on 13 March 2012. The Boards also plan to perform various outreach efforts to gather information and obtain the views of interested parties about the proposed guidance. Interested companies should express their interest to the Boards.

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