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Effects of Accounting Regulations on Economic Decision-Making: A Case Study in the Film Industry

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Abstract

Big actors, big effects, and big budgets all characterize today's movies. Companies that produce these films have continued to increase spending to create better pictures and attract more people to the theatre. As part of the media and entertainment industry, film companies are subject to several specific accounting rules that govern the reporting of revenues and the classification of film expenses. However, many of these rules issued by the Financial Accounting Standards Board (FASB) are subject to a good deal of interpretation. These ambiguities can make it difficult to correctly report earnings in an industry that spends billions of dollars per year, which may also be affecting how firms make strategic decisions. This paper examines how the accounting for revenues and expenses for firms in the film industry affects aspects of their economic decision-making. The actual accounting principles are examined first, followed by a discussion of the changes that have affected studios in the industry. Finally, Time Warner and Walt Disney are analyzed as two of the major film studios in the business. The findings of this analysis help show that accounting principles do affect the strategic decision-making of film studios, which has an impact on both users of financial statements and moviegoers everywhere.

Introduction

The accounting scandals that happened at Enron, WorldCom, and other major companies during the early part of the 2000's shed a new light on the importance of reliable accounting information that is presented in financial statements. The Sarbanes-Oxley legislation that followed these scandals showed that the government of the United States saw a

need for increased responsibility for the information that is reported by company management as well as accountants. This legislation, along with the countless rules, pronouncements, and interpretations that make up Generally Accepted Accounting Principles (GAAP) are designed to ensure that companies report their earnings fairly. In this way, present and potential investors and creditors can accurately assess performance. Despite the breadth and depth of the information concerning GAAP that is in the Financial Accounting Standards Board (FASB) Codification, it is not always easy to determine how and when to report revenue transactions or what cost flow assumption to use. There are many situations where companies and accountants don't have clear instructions about what to do and must interpret GAAP themselves. Naturally, this can cause great variability in how companies decide to report their activities, especially in industries that have their own unique challenges. How these accounting decisions are made may also affect the strategic decision-making that takes place for the future.

One of the industries in the U.S. that faces its own unique reporting challenges is media and entertainment, specifically film studios. Because there are reporting issues for both revenues and expenses for these firms, the FASB has issued special interpretative rules that attempt to make the process more straightforward. Unfortunately, there is still a lot that is open to interpretation. This paper focuses on the link between accounting and strategic decision-making for film studios. First, the revenue recognition principles for studios are analyzed, followed by a discussion of cost capitalization and amortization. The link to company strategy is then analyzed in terms of the changes that have taken place in the industry over the years. Finally, we see how this link manifests itself in two of the industry's major players.

Analysis of Revenue Recognition Principles

For many years, principles of film accounting were largely left unaddressed by the FASB. This changed in 2000 with the issuing of Statement of Position 00-2, *Accounting by Producers or Distributors of Films,* in an attempt to make the financial reporting process more streamlined (Journal of Accountancy 2000). Under this statement, which is now part of Accounting Standards Codification (ASC) 926 – *Entertainment – Films,* movie studios are given several guidelines to follow when recognizing revenue (*PwC Perspectives* Dec 2009). These guidelines generally apply to studios that create licensing arrangements with their customers, who then distribute the film in theatres, on DVD, and sometimes on the internet. Recognizing revenue for these types of arrangements can be complicated because of the various revenue streams that film studios now have access to. Also, because blockbuster films cost so much to produce over a long period of time, matching revenues with these expenses can be a complex process.

The elaborate films that are shown in theatres today require tremendous costs which, based on GAAP, should be matched as closely as possible with the revenue received from the sale and licensing of the films (NACUBO – Accounting). Under GAAP, there are five major conditions that must be met before revenue from a sale or licensing of a film may take place. The first condition is persuasive evidence that a sales or licensing arrangement with the customer actually exists (*PwC Perspectives* July 2009). This means that a large company like Walt Disney Studios must have evidence of an actual arrangement for the sale or licensing of its latest film. This does not necessarily have to be a contract, although having something formal in writing can only help both parties. Having a final written contract also tends to be the

normal business practice for most studios (*PwC Perspectives* July 2009). This condition for revenue recognition is one of the least complicated, although the actual negotiations surrounding the formation of a final contract can take years.

To meet the second condition for recognizing revenue, studios must have a complete film that is readily available to the customer (*PwC Perspectives* July 2009). This condition is subject to more ambiguity than the evidence of an arrangement principle. There are two distinct parts to this condition: the completeness of the film and its availability/delivery. The question of whether the film is complete usually is not difficult to answer. There can be some minor changes made, such as the insertion of subtitles, that won't materially alter the filmed content. Delivering the film, however, can be a more complicated process than it might seem. In general, unless the licensing agreement specifies otherwise, physical delivery of the film is required in order for the studio to recognize revenue (Levine and Siegel 2001). This may not be required as long as the arrangement gives the customer "immediate and unconditional access to the film" in some other manner (Levine and Siegel 2001). In the movie industry today, this can relate to some sort of electronic delivery or transfer. This is an example of an area in the accounting pronouncements that could be improved on with more specific guidelines, especially for studios that are taking advantage of modern technological capabilities to transfer and store their films.

There may be other complex issues associated with delivery of the product if, for example, the licensing arrangement is cross-collateralized. This type of arrangement gives the licensee, or customer, the right to distribute multiple films for an aggregated price payable to

the licensor (*PwC Perspectives,* July 2009). Typically, the individual films would not be available all at the same time since the studio would be producing them over several years. The question that studios must answer is when to recognize revenue from the arrangement. There is not a set rule for how film studios should handle this, but professional experts have suggested an allocation process based on the fair value of each film that is part of the arrangement. So, if an arrangement gives rights to the customer for Films A, B, and C during different periods, the producer could allocate the total revenue to Film A when it is finished based on its relative fair value compared to the other films. The actual process of determining fair value and conducting the allocation is left to management of the producing studio, but some type of reasonable process would be acceptable. It is clear based on this principle that the process of recognizing revenue is fairly judgmental. This is part of the reason for the numerous "Hollywood accounting" cases that have arisen between movie studios and their customers.

Once the licensing arrangement has come into existence and the complete film has been delivered, the licensing period itself must begin before the producer may recognize revenue. This third condition relates to the timing of the licensing arrangement. In many cases, there are no issues with this condition since the delivery of the film begins the licensing period. Some arrangements don't allow the customer to start exploiting the product for a certain time period termed the "blackout period" even though the film may have been delivered (*PwC Perspectives,* July 2009). This can be an important issue for licensees that deal with multiple movie studios at a time since they need to keep track of which rights they still have access to and which ones are in a blackout period or have expired (MACCS International). But, most of these issues relate to arrangements for episodic television series rather than films. In general,

the blackout period will not affect the producer's ability to recognize revenue unless the film may be licensed to another licensee during the blackout period in the same market (*PwC Perspectives* July 2009). In that case, there are effectively two terms in which to recognize revenue and the producer should allocate accordingly based on the relative fair value for each period (*PwC Perspectives* July 2009). The timing of the licensing arrangement is one aspect of it that should be determined by the parties so that each one understands when it is appropriate to account for revenues and expenses. Another important aspect that should be determined in advance is the arrangement fee.

The final two conditions that must be present before revenue can be recognized relate to the arrangement fee. According to the authoritative GAAP, the arrangement fee must be fixed or determinable as well as having a reasonable assurance of being collected by the producer (*PwC Perspectives* July 2009). The provisions for the arrangement fee in a film licensing contract can be quite complicated. Many times there are both fixed and variable fees, including some type of minimum-fee guarantee that must be paid to the producer up front. When producers license their films to customers, the customers will distribute the film and take in their own revenue. Some arrangement fees call for a certain portion of the distributor's revenue going to the producer as a variable fee, but only if this variable fee is higher than the fixed minimum fee (*PwC Perspectives* July 2009). Although it is termed "variable," the portion of the distributor's revenue may become fixed once it is known that it will definitely be paid. Only at that point will it become eligible for revenue recognition under this condition.

The licensing fee is becoming an increasingly important issue for large studios like Walt Disney and Warner Brothers, especially with the increased availability of ways to watch movies other than going to a theatre or renting a DVD. From an accounting standpoint, the fixed or determinable fee requirement forces studios to negotiate on a number that could potentially hurt them if the market for the film or something else in the industry changes during the production process. If they do not determine a firm enough fee, they will have more trouble recognizing the revenue in accordance with GAAP. This is one instance where the accounting rules and guidelines can influence a decision-making process that deals with economic and industry issues. Collection of the arrangement fee should also be reasonably assured, which brings up accounts receivable and allowance concerns. If film studios are having trouble collecting on some of their receivables, it may be an indicator that the revenue itself is unfairly stated which means auditing and analyzing the financial information of these companies becomes even more important in the reporting process. Ultimately, recognizing revenue correctly can be influenced by the studio's economic decision-making and can affect other aspects of financial reporting.

These revenue recognition principles were created as specific guidelines for companies that produce films and television series. Although they offer technical guidance about how and when to recognize revenue in a specialized industry, movie studios still have to do a good amount of judgmental decision-making. This can and has unfortunately resulted in some studio executives manipulating their film numbers. There are numerous gray areas in these revenue principles that many Hollywood studios have taken advantage of, creating an issue that for decades now has "been a source of contention between the studios that release movies and

"the talent" – the actors, directors, and writers – who make them" (Garrahan 2011). The ambiguity that plagues the revenue recognition principles, however, is only one side of the accounting equation. Even more ambiguity can be found in the rules and guidelines for reporting film costs. Cost capitalization, including amortization and impairment assessment principles, is now analyzed to provide the complete picture of the rules for film accounting.

Analysis of Cost Capitalization Principles

In the United States today, there are a handful of major film studios that are the "stars" of their industry. Known as the Big Six, these studios include Columbia Pictures, Walt Disney Studios, Paramount Pictures, Twentieth Century Fox, Universal Pictures, and Warner Brothers (Cieply 2009). These studios and others have produced movies over the years that have cost up to $300 million to put together on screen (Marder 2012). The enormous amount of money that studios spend on creating visually stunning movies in the modern day creates challenges for the accounting and financial reporting side of the movie business. Unlike revenue recognition, which in general seems to be fairly straightforward, the capitalization guidelines are subject to wide interpretations by the Big Six and others. There have been many cases where a seemingly profitable film has shown a loss on the financial statements due to questionable accounting choices. Many of these cases have involved profit-sharing agreements where the studio ended up keeping the profits from the film since it apparently had none to distribute to the contracted artists. The guidelines themselves are not long or filled with complicated equations, but there is a lack of direct, step-by-step rules for studios to follow. There may be no readily apparent solution to this issue since movie studios incur so many types of costs over long periods of time,

but analyzing the GAAP for cost capitalization in the film industry will help in understanding how and why studios make the financial decisions they sometimes do.

In general, cost recognition for film studios must follow the matching principle for revenues and expenses that is present in all GAAP accounting. Companies are instructed by GAAP to follow a "systematic and rational allocation policy" to approximate the matching principle as much as possible (Putra 2010). The issue for movie studios is that they have recurring expenditures over time. So, studio management must decide if it will capitalize the recurring expenditures as part of the film asset on the balance sheet or immediately expense them on the income statement (Putra 2010). To begin the process of accounting for costs, movie studios can break the costs down into different categories including direct film costs and production overhead (Levine and Siegel 2001). The direct film costs consist of categories that directly contribute to the production of the film, such as the acquiring of necessary rights, the compensation of the cast and production staff, and post production costs like music and editing. Like manufacturing overhead for other companies, the production overhead is allocated to the direct film costs. But, it is not always easy to determine what costs can be labeled as part of production overhead. Once again, studios must make their own professional judgments that everyone else hopes are the correct ones.

The accounting principles define these overhead costs as "costs of the individuals and departments that have a significant (or exclusive) responsibility for the production of the film" (Levine and Siegel 2001). This is not very clear guidance about what costs to consider, but accounting professionals have come up with a list of costs that should not be included as part of

production overhead. These mostly include overall costs like compensation of top management and marketing expenses (*PwC Perspectives* Dec 2009). Once the studios determine what constitutes production overhead, these costs are added to the direct film costs and the total is capitalized onto the balance sheet as part of an asset. Since this can be a significant part of a studio's balance sheet, making the determination of capitalizing versus expensing is a very important part of the decision-making process. Along with this determination comes a timing constraint for films that may end up not being produced.

Before any scenes for a new film have been shot, a development period happens in which a studio acquires necessary intellectual property as well as plans out the story and the hiring of the cast. During this developmental period, studios may incur a significant portion of the total costs of the film. But, a film in development may not necessarily be fully produced. The financial situation of the studio may change, or any number of problems may arise with the cast and production staff. According to film accounting principles, the costs incurred during the development stage should be written off as expenses if the film is not set to go for production within three years of the original cost capitalization date (*PwC Perspectives* Dec 2009). However, this three year rule is not set in stone if management has evidence stating that production will still happen even though the time has expired. This type of evidence includes having the financing ready for the project, having the main cast and staff hired, and having management's support for the project (*PwC Perspectives* Dec 2009). The three year rule is also relaxed for feature animations since they typically have a longer development period (*PwC Perspectives* Dec 2009). Because of these loose guidelines, studios have been able to engage in earnings management by keeping costs that should be capitalized off the balance sheet. There

can be many motivations for this type of action. But if the capitalized costs remain on the balance sheet, they must be amortized to expenses over a certain time period.

The idea behind capitalizing costs as part of an asset on the balance sheet is that the costs will benefit future periods by creating revenue in those periods. This is consistent with the matching principle defined by U.S. GAAP (Putra 2010). These costs should therefore be amortized to expense accounts as time passes. For film studios, many of the capitalized costs that get amortized are intangible assets such as rights to a certain story. Determining the useful life of these and other assets requires, once again, a good deal of judgment by management (Putra 2010). There is a method prescribed by the accounting principles for studios to follow when amortizing film costs. The individual-film-forecast method uses the ratio of current period actual revenue over the estimated remaining ultimate revenue that is still unrecognized (ASC 926.20.35-1). This ratio is multiplied by the unamortized film costs to determine how much to amortize for each period. The guidance only allows a straight-line amortization method if "the pattern of economic benefits cannot be reliably determined" (Academy Speaker Series 2009). Using the individual-film-forecast method as stated in the ASC requires a judgment by management about how much ultimate revenue will be earned by a project. There are several other issues that arise when studios amortize their film costs according to this individual-film-forecast method. They must determine what constitutes ultimate revenue, when to change amortization estimates, and how to test for impairments periodically.

The amortization of capitalized film costs under this method is meant to be as systematic and rational as possible. Since the calculation of the ratio involves ultimate revenue, it is important for studio managers to understand this concept. In general, the ultimate revenue for a film includes any estimate of revenue that is likely to be recognized from the exploitation, exhibition, and sale of that film in all markets and territories that the studio intends to target (Academy Speaker Series 2009). While there are some exceptions, the basic task of the studio is to project all of the sources of revenue from the film in all targeted markets. The estimate for ultimate revenue that determines the studio's yearly amortization must also be reviewed periodically and changed if necessary (Academy Speaker Series 2009). This can happen quite frequently since producing and distributing a movie is not always a guaranteed successful business venture. Varying levels of success can affect the capitalized asset through the process of impairment, which should be considered if something unexpected happens during the production process.

For assets subject to impairment, some sort of change in circumstance is usually necessary to trigger the tests. In the movie industry, there may be a substantial decrease in the expected performance of the film based on initial reviews or problems with daily operations (Academy Speaker Series 2009). According to the accounting principles in the Codification, an event that triggers a change in circumstance may indicate that the studio needs to assess whether the fair value of the film has fallen below the unamortized film costs that are capitalized on the balance sheet (ASC 926.20.35-13). There does not necessarily have to be an impairment evaluation each year unless something has happened to warrant one. But, there are are also several factors to consider when determining what the current fair value of the film

should be, including how the story is perceived by the public and the historical results of similar films (ASC 926.20.35-15). Again, film impairment can occur quite frequently in the current market environment. With new ideas and stories coming out all the time, it is difficult for studios and producers to know how popular a film will be especially if it is an entirely original story. Impairment and amortization of the capitalized film asset are important issues for studios as they work to match revenues and expenses as closely as possible while assessing the future performance of their films.

Some of the major accounting principles for revenue and cost recognition for film companies have been examined in order to provide a picture of what studio accountants have to work with when preparing financial statements. Although there are a number of technical definitions made in the accounting pronouncements, a good deal of film accounting requires professional judgment and decision-making. Now that the accounting has been examined, the second half of this topic can be analyzed. The decision-making process for film studios can be very difficult in today's competitive market. Studios must continuously work to produce better films than their rivals, usually by spending more money. How these large costs are accounted for on the financial statements can certainly have an effect on the decision-making of studio management, and management's decisions can also affect the financials in several ways. The next section of this analysis focuses on this decision-making process by studio management. The first part discusses the current situation of the film and entertainment industry, including some of the pressures and difficulties that studios face. Then, specific cases of some of the major players in the industry are examined to see the link between accounting and decision-making in action. Hopefully, this will provide a clearer picture of how management uses

accounting principles to help guide daily operations of the business. This link is essential for all users of accounting information to understand so that the importance of this information becomes clear.

The Film Industry Today – Pressures, Incentives, Innovations

One of the largest changes in the film industry over the past decade has been the increased technology available to watch movies on. Between online streaming and smart phones, movie studios now have many more potential sources of licensing income than they did in the past. Still, many believe that the most critical indicator of a movie's success is how it fares during opening weekend at the theatre box office (Young, Gong, and Van der Stede 2010). Having a successful box office run, though not necessarily in terms of the money, is the first step to continued revenue streams from DVD and merchandise sales, online streaming, and television airings. Movie experts can also be extremely critical, which makes it imperative for studios to do their research and work hard at producing high-quality films for the theatre. Studios face other challenges as well, all of which can affect the decisions they make about what stars and directors to hire, what types of stories to develop, how much to spend on special effects, and where to shoot the film. There is a link connecting accounting principles, decision-making, and industry concerns for movie studios. That link is now explored beginning with an analysis of the current market for movies and how that is affecting studio revenue streams.

When there was no other way to see a new film besides going to the theatre, attendance was regularly high. The abundance of media formats and other entertainment

options that exist in the modern day world has cause movie attendance to drop. This, along with technology, is one of the most impacting changes in the industry. Approximately 65% of the population of the United States went to movie theatres regularly before 1930 and the invention of television; that number has dropped to about 10% over the last decade (Young, Gong, and Van der Stede 2010). This has greatly impacted the monetary success of modern films, especially big-budget features. But even efficiently-produced films have been affected by this decline in theatre attendance. One analysis from 2004 shows that movies produced by the big six studios brought in $7.4 billion in gross box office revenue. But, the actual result of the studios themselves after accounting for marketing and other costs was a $2.22 billion negative gross profit (Epstein 2005). In more recent years, this trend has only continued as theatre attendance continues to decrease. What this means for studios is that they must find alternative sources of revenue.

The most recent advances in ways to earn revenue for film companies have been through online streaming. The giants of that industry like Netflix have been able to stream films online quickly and efficiently. As film studios continue to enter this market more fully, they must be aware of how to account for this new form of revenue. From an accounting standpoint, studios must be concerned with when and how their films meet the delivery requirement discussed earlier for recognizing revenue. For example, recently Walt Disney Studios was in talks with Netflix about negotiating additional payment for licensing of its films. Walt Disney had an arrangement with Starz, who then licensed the films to Netflix. But Walt Disney believed that it would be missing out on a potential revenue stream if it did not receive a licensing fee directly from Netflix (Seeking Alpha 2010). The decision-making process for

Disney executives in this case would have had to include an analysis of potential accounting issues.

The delivery requirement for revenue recognition may have been one of the larger issues in this case, since Disney continued distributing its films to Starz who passed them on to Netflix. So, the question then becomes when the film has been "delivered" for revenue purposes to Netflix – when Netflix receives it or earlier when Disney transfers it to Starz. Depending on Disney's situation with other areas of its business, it may need the revenue sooner than later. This is only one small example, but it shows how the accounting requirements for a particular transaction can affect the decision-making process. In this case, the decision-making resulted from changes occurring in the industry and there will be more of these situations as the market for online streaming heats up. More recently, Google, Hulu, and Amazon have started competing more for online streaming contracts, causing the price that studios charge to increase (Pepitone 2011).

The search for alternative revenue streams will continue if theatre attendance continues to decline. Some say there is no possible way for studios to survive without some mergers and acquisitions, although the United States was still in the midst of the economic crisis at the time of these comments (Sandoval 2010). In any case, the possibility of mergers among film studios brings about even more revenue recognition issues. This is another application of the link between accounting and economic decision-making. Lurking within the revenue problem for studios is another issue: how much to spend on new films. The spending issue is particularly relevant for the big six film studios that have recently spent exorbitant amounts on

blockbusters like *Pirates of the Caribbean* and *Avatar.* The accounting and economic issues surrounding rising film expenditures provide a view into the deep wallets of Hollywood producers and investors.

Big-budget films of the past decade have set a new standard for quality and have raised the spending bar quite a bit. One of the most recent big-budget productions was James Cameron's *Avatar,* which reportedly cost about $240 million to produce (Marder 2012). During the production process, some industry specialists who were attempting to project the total cost of this technology-savvy film believed it would cost even more with the addition of global marketing expenses (Cieply 2009). The film, of course, ended up being one of the highest grossing productions of all time and gave audiences a beautiful film to look at. Another blockbuster that cost even more than Avatar was *Pirates of the Caribbean: At World's End.* This third installment in the lucrative franchise reportedly cost $300 million to produce, making it the most expensive film of all time (Marder 2012). What is behind these rising production costs is once again related to the economy. Film studios must now compete more than they ever had to in order to win praise from critics and fans. Potential revenue sources like television contracts and Netflix arrangements are, of course, also affected by the success of the film. Many studios have seen the increased competition in the industry as a sign that they must spend more money to achieve success. This has accounting implications, especially for the balance sheet.

Increased production costs mean that studios must report them somehow, either by immediately expensing all costs or capitalizing them as part of the asset on the balance sheet.

The capitalization rules discussed earlier state that costs contributing directly to the success and production of the film, such as acquisition of rights and director salaries, should be capitalized and amortized over time when appropriate. As the industry continues to adapt to new technology changes and the effects of the economy, studios will most likely find more unique ways to spend money. Increasing variety in film expenditures means studios must be aware of whether they should expense or capitalize them. One of the newest popularities is for previously released films to come back into theatres in 3-D. Once again, James Cameron has shown that he is adept at mastering new technologies in the entertainment industry. After criticizing film studios for moving too quickly into the 3-D market and sacrificing quality, he achieved his own success with the recent 3-D re-release of *Titanic* (Dobuzinskis 2010). Now he plans to take it even further and try to introduce 3-D capabilities for certain television programs (Velotta 2012). The new technologies that he plans to develop will most likely cost a lot of money, and it may not be immediately clear what to do with these machine costs that benefit many films over a long period.

There is a concept in accounting for film costs called an overall deal. According to the Codification, this type of agreement occurs when a studio compensates a producer or some other creative talent for the "exclusive or preferential use of that party's creative services" (ASC Glossary). If these types of deals exist over time and cannot be identified with a specific film, they should be expensed. In the James Cameron technology example, it may be possible for a studio to hire his creative services to make a film look as stunning as *Avatar* did in an overall deal arrangement. The studio may also try to argue that the technology itself is part of the overall deal if it will be used for a long time. In this hypothetical example, the studio would be

expensing this cost immediately on the income statement. Of course, there are pros and cons for both expensing and capitalizing. A studio may be trying to keep its balance sheet relatively small in order to control the expansion of debt and other liabilities. Also, expensing large costs of course leads to lower net earnings, which the studio may actually want if its goal is to not pay any taxes (Berry 2008). Capitalizing, on the other hand, reduces the impact on earnings since the costs are spread over the useful life of the asset. If new types of 3-D technology become bundled as overall deals for studios, these are some of the accounting issues to consider that relate to decision-making.

The Codification defines exploitation costs as part of the direct cost category for films, specifically related to distribution and marketing. The rules state that all exploitation costs, including marketing costs, should be expensed as they are incurred (ASC 926.720.25-3). Marketing costs for film studios these days have increased quite a bit, once again due to the declining theatre attendance and increased competition that has affected the industry as a whole. One study has found that marketing costs have hurt studios' bottom lines and also confirmed that increased competition in the industry has been affecting these numbers (Dugan 2009). Since these costs must be expensed under the accounting principles, studios have a difficult decision to make when deciding how much to publicize a new film. The decision has to take into account not only how to capture the attention of skeptical audiences, but also how the net earnings will be affected since the marketing costs can't be capitalized. This did not work so well recently for Walt Disney Studios, whose newest blockbuster *John Carter* failed to bring in as much as the company had hoped (Chmielewski 2012). It did not help that the

millions spent on marketing the film had to be immediately expensed instead of placed on the balance sheet and amortized over time.

There is no doubt that the changes taking place in the film and entertainment industry have affected studios over the past decade. They have had to cope with the effects of a struggling economy as well as increasing technology and competition among their rivals. While there are many factors that affect the strategic decision-making of these studios, the way a transaction will be accounted for in the financial statements is an important one to consider. This analysis has shown how some important accounting requirements can affect the daily operations of a studio's business. Now, it will be useful to take a look at some of the actual financial statements of major film studios. This will provide a view into the real world and how these important links have been affecting major players in the industry.

The Real World: A Comparison of Two Major Players

The big six film studios are each owned by parent companies that also have additional subsidiaries. The issues discussed thus far, both in accounting and strategic decision-making, manifest themselves in the annual report (10-K) released by studio parent companies each year. This report represents the end result of all the decision-making that goes on during the period. Some of the most valuable information in the 10-K appears not in the consolidated financial statements but in the footnotes section, where important issues like accounting estimates and assumptions are discussed. For film studios, it is here where readers can clearly see some of the industry decision-making issues in action.

One of the big six studios, Warner Brothers, is owned by Time Warner, Inc. Warner Brothers has produced some of the most successful movies of the past few years, including the *Harry Potter* films that have certainly captivated young and adult audiences alike. In this company's most recent 10-K, there is some important information that can be found in the Management Discussion and Analysis (MD&A) section as well as in the footnotes. In the MD&A section, for example, the managers report that the filmed entertainment division of the company lost a small amount of theatrical revenue but had an 11% increase in revenue from television and electronic delivery contracts (Time Warner 2012). This makes sense based on the increase in alternative revenue streams in the industry during recent years. The managers also state that part of the increase in revenue is related to new arrangements with Netflix for distribution of older films and television shows. Of particular interest is what the company says about revenue recognition in the footnotes section. Here, Time Warner acknowledges that there is a good deal of estimation and judgment involved in recognizing revenue and expenses. Specifically, the footnotes state that theatrical revenue is recognized when the films are exhibited, or shown, in theatres (Time Warner 2012). Assuming their fees are somewhat fixed and they have a good chance of collecting them, Time Warner seems to be following the revenue recognition principles outlined earlier. The footnotes also contain important information about how the company recognizes film costs.

In the area of the footnotes that discusses cost capitalization and amortization, Time Warner states that it capitalizes film costs based on the film forecast computation method, another term for the individual-film-forecast method discussed earlier (Time Warner 2012). It is useful to see that a company doing business out in the real world uses precise accounting

terminology and methods defined by the Codification standards. Another very important process that is discussed in the footnotes is determining what the ultimate revenue of a film should be, both for impairment investigation and amortization purposes. The company states in the footnotes that it determines ultimate revenue before the film is released based on factors such as past performance of similar films, the "star power" of the main cast, the film's genre, and test screenings (Time Warner 2012). This is consistent with what the accounting standards say. Time Warner has developed an appropriate method, which requires a great deal of its own judgment, to comply with the stated accounting principles. And, as discussed earlier, the ultimate revenue estimation must be revised to account for changes in the film's projected success. These changes are in many cases related to the difficult decision-making that takes place in the industry. To get a broader picture of how the accounting applies to real companies, the Walt Disney Studios is now compared with Warner Brothers.

When it comes to providing high-quality family entertainment, there is almost no one that does it better than The Walt Disney Company, which is the parent of Walt Disney Studios. Disney has produced some notable films over the past few years, including *Toy Story 3* and the *Pirates of the Caribbean* franchise. It is interesting to note, however, that Disney actually lost about 15% of theatrical distribution revenue in 2011 compared to 2010 (Walt Disney 2012). Like Warner Brothers, Disney has also gained in the television and electronic distribution category although part of this was due to the recent acquisition of Marvel (Walt Disney 2012). It seems that the changes in revenue streams are having relatively similar effects across the film industry. Disney also reports that it recognizes the revenue from theatres in the same way as Time Warner – when the film has been exhibited (Walt Disney 2012). There are, however,

some differences in Disney's 10-K especially related to its cost amortization and capitalization principles. Perhaps because Disney is made up so many different entities, it has provided some more detailed explanations for its accounting decisions related to costs and ultimate revenue.

The method Disney uses to capitalize and amortize major film costs is once again the individual-film-forecast method, though the company doesn't specify this language in the footnotes of the 10-K. In its description of ultimate revenue, Disney goes into more detail than Time Warner. The company states that ultimate revenues for film productions include "revenues from all sources that will be earned within ten years from the date of the initial theatrical release" (Walt Disney 2012). There is also some information about reassessing the potential earnings of the film regularly. The goal here is to compare the estimated fair value of the film with the remaining unamortized cost to see whether impairment is appropriate. Disney also goes into more detail about ultimate revenues for television contracts and acquired film libraries (Walt Disney 2012). It is interesting to see the differences between two similar members of the industry. Both Disney and Warner Brothers are members of larger parent companies that operate multiple lines of business in the entertainment industry. Both received unqualified audit opinions for their most recent 10-K's, and both seem to have similar film reporting methods though Disney goes into a bit more detail. In the end, both studios have been affected by the changes in the film industry. More importantly, both have used the accounting standards in the Codification as a basis for constructing their reporting methods, which in turn have affected strategic decision-making in an ever-changing industry.

Conclusion

The effects of sound financial reporting cannot be ignored in today's global economy. Investors, creditors, and other interested parties need to have reliable financial information to examine when deciding which companies they want to do business with. This process helps the modern economy function smoothly and healthily. Sound financial reporting is of course tied to the performance of accountants and the rules that they and company executives must follow. In a specialized environment such as the film industry, accountants become even more important for their role in strategic decision-making.

The film industry has undergone numerous changes in technology and consumer preference that have affected how studios do business. When making new decisions, studios must also determine how their financial reporting will be affected based on the accounting principles given under GAAP. This analysis began by looking at these specific principles for revenue and expense recognition. Now, we have seen how the principles tie in with strategic decision-making for some of the largest members of this industry. By linking accounting analysis with strategy and economics, it is easier to see how essential accounting is for a successful company in a country like the United States.

Of course, there may be ways to improve the current GAAP for the entertainment industry. The current principles are rules-based, which means that they are designed to be a step-by-step guide to reporting. The specific rules for film studios do not always do that since studio management must use its own judgment often. One way to improve the efficiency of reporting for these firms would be to create even more specific rules that address the complex situations that currently involve a good deal of judgment. With the possible of International

Financial Reporting Standards (IFRS) in the United States, this may not be the best option. IFRS are principles-based, which means that they don't offer strict rules for reporting. Instead, they include a general description of a transaction and how it should be accounted for. If IFRS are adopted, studio management will most likely have to use even more judgment in its financial reporting process. So, perhaps the best solution is to allow the judgment process to continue but to set some standards for reasonableness in the financial statements. In an industry that is frequently accused of manipulating its accounting, leaving everything up to the studios is probably not the best way to go. At the same time, principles-based accounting may be the new standard in this country soon and firms need to be ready for the change. Allowing studios to continue to use their judgment but in a reasonable manner will help the strategic decision-making process run smoothly. The link between the numbers and the creativity must always be intact for studios to operate at their highest level. This may also carry over to other industries and companies, illustrating the important role that accounting plays in the day-to-day functioning of the economy.

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