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Media & Entertainment Spotlight
Navigating the New Revenue Standard

March 2015

Contents

Executive summary

- On May 28, 2014, the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) issued their final standard on revenue from contracts with customers. The standard, issued as Accounting Standards Update 2014-09 (and codified as Topic 606 in the FASB Accounting Standards Codification) by the FASB and as IFRS 15 by the IASB, outlines a single comprehensive model for entities to use in accounting for revenue arising from contracts with customers and supersedes most current revenue recognition guidance, including industry-specific guidance.
- On February 16, 2015, the Ministry of Corporate Affairs (MCA), notified the Companies (Indian Accounting Standards) Rules, 2015 (the 'Rules') (pending publication in the Gazette of India). The new standard notified as Indian Accounting Standard (Ind AS) 115, Revenue from Contracts with Customers is applicable for specified class of Indian entities and is similar to IFRS 15.
- The new standard's requirements related to transaction price, including the measurement of variable and non-cash consideration, may change the manner in which revenue is recognised for arrangements in the industry, and management may need to use significant judgment when estimating transaction price.
- The new standard's guidance on licenses, including whether license revenue should be recognised at a point in time or over time, could result in significant changes to the timing of revenue recognition for arrangements in the industry. When consideration consists of sales-based royalties or payments; however, the timing of revenue recognition may not differ significantly from that under current practice.
- In addition to considering the new standard's potential impact on their accounting policies, entities should begin assessing factors such as resource requirements and the needs of financial statement users.
- This Media & Entertainment Spotlight discusses the framework of the new revenue model and highlights key accounting issues and potential challenges for media and entertainment (M&E) entities.

The new standard's guidance on licenses, including whether license revenue should be recognised at a point in time or over time, could result in significant changes to the timing of revenue recognition for arrangements in the industry.

Background

The goals of the new revenue recognition standard are (1) streamlining and removing inconsistencies from, revenue recognition requirements; (2) providing “a more robust framework for addressing revenue issues”; (3) making revenue recognition practices more comparable; and (4) increasing the usefulness of disclosures. The new revenue recognition standard states that the core principle for revenue recognition is that an “entity shall recognise revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services.”

The new standard indicates that an entity should perform the following five steps in recognising revenue:-

- “Identify the contract(s) with a customer” (step 1);
- “Identify the performance obligations in the contract” (step 2);
- “Determine the transaction price” (step 3);
- “Allocate the transaction price to the performance obligations in the contract” (step 4); and
- “Recognise revenue when (or as) the entity satisfies a performance obligation” (step 5)

As a result of the new standard, entities will need to comprehensively reassess their current revenue accounting and determine whether changes are necessary.

Thinking It Through

As a result of the new standard, entities will need to comprehensively reassess their current revenue accounting and determine whether changes are necessary. In addition, the new standard requires significantly expanded disclosures about revenue recognition, including both quantitative and qualitative information about (1) the amount, timing, and uncertainty of revenue (and related cash flows) from contracts with customers; (2) the judgment, and changes in judgment, used in applying the revenue model; and (3) the assets recognised from costs to obtain or fulfil a contract with a customer.

Key Accounting Issues

This media & entertainment spotlight discusses the new revenue model and highlights key accounting issues and potential challenges for M&E entities.

Identifying the Performance Obligations in the Contract (Step 2)

Some arrangements in the M&E industry involve multiple goods or services. For example, a license arrangement may provide rights to multiple films, markets, or territories; or the sale of a consumer good may include a digital extension (i.e., access to related digital content). These goods and services may be promised in a single contract or in separate contracts, and may be explicitly stated in the contract or implied by a vendor's customary business practices or specific statements.

The new standard provides guidance on evaluating the promised "goods or services"[1] in a contract to determine each performance obligation (i.e., the unit of account). A performance obligation is each promise to transfer either of the following to a customer:

- "A good or service (or a bundle of goods or services) that is distinct."
- "A series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer."[2]

A promised good or service is distinct (and therefore a performance obligation) if both of the following criteria are met:

- *Capable of being distinct* — "The customer can benefit from the good or service either on its own or together with other resources that are readily available to the customer."
- Distinct within the context of the contract — "The entity's promise to transfer the good or service to the customer is separately identifiable from other promises in the contract." The new standard provides the following indicators for evaluating whether a promised good or service is separable from other promises in a contract:
  - "The entity does not provide a significant service of integrating the good or service with other goods or services promised in the contract. . . . In other words, the entity is not using the good or service as an input to produce or deliver the combined output specified by the customer."
  - "The good or service does not significantly modify or customise another good or service promised in the contract."
  - "The good or service is not highly dependent on, or highly interrelated with, other goods or services promised in the contract. For example, a customer could decide to not purchase the good or service without significantly affecting the other promised goods or services."

The requirement that a good or service be "separately identifiable from other promises in the contract" is a new concept under which entities must further evaluate a good or service for separability.

[1] Although the new standard does not define goods or services, it includes several examples, such as goods produced (purchased) for sale (resale), granting a license, and performing contractually agreed-upon tasks.

[2] A series of distinct goods or services has the same pattern of transfer if both of the following criteria are met: (1) each distinct good or service in the series would meet the criteria for recognition over time and (2) the same measure of progress would be used to depict performance in the contract.

Thinking It Through

In applying the new standard, M&E entities will first need to carefully examine their contracts with customers to identify all promised goods and services (both explicit and implied). Items that are viewed as perfunctory or inconsequential under current practice might need to be identified and accounted for under the new standard. After identifying all goods or services promised in the arrangement with a customer, the entity would then determine which of those constitute a performance obligation. The requirement that a good or service be "separately identifiable from other promises in the contract" is a new concept under which entities must further evaluate a good or service for separability. In performing the separability evaluation, M&E entities may need to use significant judgment to determine whether the goods or services in a contract are "highly dependent on, or highly interrelated with" or "significantly modify or customise each other.

Options

Certain arrangements in the M&E industry, such as licenses, may contain options. Under the new standard, an option given to a customer to acquire additional goods or services represents a performance obligation if it provides a "material right" to the customer that it otherwise would not have received without entering into the contract (e.g., "a discount that is incremental to the range of discounts typically given for those goods or services to that class of customer in that geographical area or market"). If an option is deemed to be a performance obligation, an entity must allocate a portion of the transaction price to the option and recognise revenue when control of the goods or services underlying the option is transferred to the customer or when the option expires.

Thinking It Through

M&E entities may need to use significant judgment in evaluating whether options, in the context of licenses or other arrangements in the industry, convey a material right to a customer. Options that are deemed performance obligations are likely to result in a deferral of revenue.

Determining the Transaction Price (Step 3)

The new standard requires an entity to determine the transaction price, which is the amount of consideration to which the entity expects to be entitled in exchange for the promised goods or services in the contract. The transaction price can be a fixed amount or can vary because of "discounts, rebates, refunds, credits, price concessions, incentives, performance bonuses, or other similar items."

Variable Consideration

Arrangements in the M&E industry may contain substantial amounts of variable consideration, including deductions (e.g., discounts and concessions) and contingent payments (e.g., milestones and royalties). When the transaction price includes a variable amount, an entity is required to estimate the variable consideration by using either an "expected value" (probability-weighted) approach or a "most likely amount" approach, whichever is more predictive of the amount to which the entity expects to be entitled (subject to the constraint discussed below).

Under the new standard, some or all of an estimate of variable consideration is included in the transaction price (i.e., the amount to be allocated to each unit of account and recognised as revenue) only to the extent that it is highly probable[3] that subsequent changes in the estimate would not result in a "significant reversal" of revenue (this concept is commonly referred to as the "constraint"). The new standard requires entities to perform a qualitative assessment that takes into account both the likelihood and magnitude of a potential revenue reversal and provides factors that could indicate that an estimate of variable consideration is subject to significant reversal (e.g., susceptibility to factors outside the entity's influence, a long period before uncertainty is resolved, limited experience with similar types of contracts, practices of providing concessions, or a broad range of possible consideration amounts). This estimate and the consideration of the constraint would be updated in each reporting period to reflect changes in facts and circumstances.

Under the new standard, some or all of an estimate of variable consideration is included in the transaction price.

[3] "Highly probable" in this context has the meaning "event or events are likely to occur." In IFRS 15 and Ind AS 115, the term "highly probable is used," which has the same meaning as the U.S. GAAP's "probable."

Thinking It Through

To comply with the new standard's requirements for estimating the transaction price and determining what amount, if any, is subject to potential reversal (and should be excluded from the transaction price), management may need to use significant judgment, particularly since the transaction price must be updated in each reporting period. Furthermore, for each arrangement, management will need to consider which measurement approach (i.e., expected value vs. most likely amount) is most predictive.

Sales- or Usage-Based Royalties

Under the new standard, the variable consideration constraint does not apply to sales- or usage-based royalties derived from the licensing of intellectual property (IP); rather, for such royalties, contingent consideration is recognised as revenue only when (1) the performance obligation is satisfied or (2) the uncertainty is resolved (e.g., when subsequent sales or usage occurs), whichever occurs later.

Thinking It Through

This exception will generally result in the recognition of sales-based royalties and payments in a manner consistent with current practice. However, there may be certain exceptions. For example, an entity may conclude that because of its fixed nature (e.g., a guaranteed minimum), a portion of the consideration under the arrangement does not constitute a sales- or usage-based royalty and therefore may potentially be included in the transaction price at the inception of the arrangement (if the requirements for the constraint are satisfied) and recognised as revenue upfront (if the license represents a performance obligation satisfied at a point in time for which a transfer of control has occurred).

Non-cash Consideration (Barter Advertising)

Arrangements in the M&E industry may involve non-cash consideration in the form of barter advertising. For example, a television show producer may license a series to a cable network in return for consideration that is partially cash and partially on-air advertising. M&E entities typically do not recognise advertising rights as assets and only recognise revenue from such items when they are subsequently sold to a third party. The new standard requires entities to measure consideration at fair value whenever a contract includes non-cash consideration.

The new standard could significantly change practice when consideration is in the form of barter advertising.

Thinking It Through

The new standard could significantly change practice when consideration is in the form of barter advertising. For example, entities may be required to recognise revenue from non-cash consideration received when control of a performance obligation in the contract is transferred to the customer. M&E entities may need to use significant judgment when determining the fair value of the non-cash consideration received.

Significant Financing Component

Entities are required to adjust for the time value of money if the contract includes a "significant financing component" (as defined by the new standard). No adjustment is necessary if payment is expected to be received within one year of the transfer of the goods or services to the customer. However, when an entity concludes, on the basis of the payment terms, that there is a significant financing component, the entity should adjust the sales price when recording revenue to present the amount that would have been attained had the buyer paid cash for the goods or services on the date of sale.

Thinking It Through

For M&E entities, a significant financing component may be present in arrangements involving the license or sale of IP or other arrangements in which there are variations in the timing of payments versus the satisfaction of the performance obligation. For example, a financing component could exist when a significant up-front fee is received in connection with the license of IP that is deemed to be a performance obligation satisfied over time. However, the new standard also indicates that when a "substantial amount" of consideration is variable and not "substantially within the control" of either party to the contract, a contract would not have a significant financing component. Therefore, if such a license arrangement also requires the payment of sales-based royalties (that are viewed to be a substantial portion of the total consideration), a significant financing component would not be present. M&E entities may need to use judgment in applying the notions of "substantial amount" and "substantially within the control" in a licensing arrangement to determine whether the transaction price is adjusted for a significant financing component.

Recognising Revenue When (or as) the Entity Satisfies a Performance Obligation (Step 5)

Under the new standard, a performance obligation is satisfied (and the related revenue recognised) when control of the underlying goods or services (the "assets") related to the performance obligation is transferred to the customer. The new standard defines "control" as "the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset." An entity must first determine whether control of a good or service is transferred over time. If so, the related revenue is recognised over time as the good or service is transferred to the customer. If not, control of the good or service is transferred at a point in time.

A performance obligation is satisfied (and the related revenue recognised) when control of the underlying goods or services related to the performance obligation is transferred to the customer.

If a performance obligation is satisfied over time, an entity recognises revenue by measuring progress toward satisfying the performance obligation in a manner that best depicts the transfer of goods or services to the customer. The new standard provides specific guidance on measuring progress toward completion, including the use of output and input methods.

Thinking It Through

M&E entities that sell virtual goods will need to (1) assess whether each virtual good represents a distinct performance obligation (step 2) and (2) recognise revenue when such a performance obligation is satisfied (step 5). Some virtual goods are consumed by customers immediately or shortly after they gain access to them, and others are consumed over time. In an online gaming setting, entities typically recognise revenue for virtual goods on the basis of their best estimate of the life of (1) the virtual good, (2) the gamer (i.e., the period during which the gamer is expected to play the game), or (3) the game. Under the new standard, entities will need to revisit their policies regarding the pattern of revenue recognition for virtual goods.

Given the typical volume of transactions involving virtual goods, entities may find it challenging to individually account for each sale. While the new standard's guidance applies to "individual" contracts with customers, entities can use a portfolio approach to account for contracts with similar characteristics if management "reasonably expects" that the financial effects of applying the new standard to a portfolio of contracts would not materially differ from those of applying the guidance to individual contracts.

Licenses

The new standard's guidance on assessing whether a license represents a performance obligation that is satisfied over time or at a point in time applies if the license is distinct from other promised goods or services in the contract, as determined under step 2. If a license is not distinct (i.e., the license is combined with other

goods or services into a unit of account), an entity would apply the general criteria in step 5 for evaluating whether control of that unit of account is transferred over time or at a point in time.

For distinct licenses, an entity must determine whether the license gives the customer the "right to use the entity's [IP] as it exists at the point in time at which the license is granted" (a "static" license for which control is transferred at a point in time) or "a right to access the entity's [IP] as it exists throughout the license period" (a "dynamic" license for which control is transferred over time).

For a distinct license to represent a right to access the entity's IP, all of the following criteria must be met:

- "The contract requires, or the customer reasonably expects, that the entity will undertake activities that significantly affect the [IP]."
- "The rights granted by the license directly expose the customer to any positive or negative effects of the entity's activities."
- "Those activities do not result in the transfer of a good or a service to the customer."

If these criteria are met, the consideration allocated to the license is recognised as revenue over time. If the criteria are not met, the license is deemed a right to use, and the consideration allocated to it is recognised at a point in time.

Under certain license agreements, customers' contractual rights to use the IP may be limited to specific periods, geographic locations, or frequencies. Generally, these restrictions are considered attributes of the license itself and do not necessarily affect the classification of the license or the subsequent recognition of revenue related to the license.

In classifying a license as static or dynamic, M&E entities will need to use significant judgment to determine which activities they are required (or reasonably expected) to perform.

Thinking It Through

In classifying a license as static or dynamic, M&E entities will need to use significant judgment to determine which activities they are required (or reasonably expected) to perform as well as whether those activities significantly affect the IP that is subject to the license, particularly since the new standard does not define "significantly affect." In assessing required activities, entities are not permitted to treat as activities additional goods or services offered under an arrangement that are considered distinct performance obligations since they result in the transfer of an additional good or service to the customer.

Under certain license agreements, M&E entities may be required or reasonably expected to perform activities that directly affect the licensed IP. For example, a sports team that licenses its logo to an apparel manufacturer may assert that its activities to promote and expand the recognition of the sports team directly affect the public's perception of its logo, which consequently exposes the apparel manufacturer to the positive and negative impacts of those activities. In such circumstances, an entity would conclude that the license is dynamic. In other cases, depending on the activities that are reasonably expected to be performed, this may be difficult to assert, especially for more complex IP such as a television series. For example, the activities a production company may reasonably be expected to perform in connection with a television series vary depending on factors such as the content of the series, how established the series is, the target audience, and its current level of success. Thus, it may be more difficult for M&E entities to assess whether the production company's activities "significantly affect" a particular television series.

M&E entities will need to carefully consider the new standard's criteria in determining how to recognise license revenue. Even when licenses qualify for revenue recognition at a point in time, the variable consideration constraint — and, more specifically, the exemption from including sales-based royalties and payments in the transaction price as described under step 3 — may still result in the recognition of revenue over time. For example, if a license represents a performance obligation satisfied at a point in time (i.e., at inception) but payments under the license are sales-based royalties, revenue would still be recognised over time (i.e., as the royalty payments are triggered). However, if the license includes fixed up-front payments, assessing whether it is "static" or "dynamic" will be particularly significant in the determination of the pattern of recognition for those payments.

When a license is a performance obligation satisfied over time, an M&E entity may also need to use judgment in determining how to measure progress toward completion, particularly if the license contains multiple films/series, markets, or territories that are accounted for as a single performance obligation.

Other Accounting Issues

Contract Modifications

Certain M&E entities such as film producers or distributors may enter into agreements that amend provisions of a master or original agreement. The new standard provides guidance on accounting for "approved" modifications to contracts with customers. The approval of a contract modification can be in writing, by oral agreement, or implied by customary business practices, and a contract modification is considered approved when it creates new or changes existing enforceable rights or obligations.

A contract modification must be accounted for as a separate contract when (1) it results in a change in contract scope because of additional promised "distinct" goods or services (step 2) and (2) the additional consideration reflects the entity's stand-alone selling price of those additional promised goods or services (including any appropriate adjustments to reflect the circumstances of the contract).

If an entity determines that the modification is not a separate contract, the entity would, depending on the specific facts and circumstances of the "modified contract" (as defined in the new standard), apply one of the following methods:

- *The prospective method (i.e., treatment as a new contract)* — If the remaining goods or services are distinct from the goods or services transferred on or before the date of the contract modification, the remaining transaction price and any additional consideration promised as a result of the modification are allocated to the remaining performance obligations in the modified contract.
- *The retrospective method (i.e., a cumulative catch-up adjustment)* — If the remaining goods or services are not distinct and are part of a single performance obligation that is partially satisfied as of the date of the contract modification, the performance obligation's measure of progress toward completion is updated, which may result in a cumulative catch-up of revenue.
- *A combination of these two methods* (if the conditions for both are satisfied).

M&E entities with contracts subject to modification will need to assess whether changes are "approved" modifications.

Thinking It Through

M&E entities with contracts subject to modification will need to assess whether changes are "approved" modifications and whether each modification should be accounted for (1) as a separate contract or (2) under the prospective or retrospective methods outlined above. In either case, the new standard may change the way entities currently account for such modifications.

Principal-Versus-Agent Considerations

An M&E entity such as a film producer or distributor may involve other parties in providing goods or services to its customers. Such an entity must determine whether "the nature of its promise is a performance obligation to provide the specified goods or services itself (that is, the entity is a principal) or to arrange for the other party to provide those goods or services (that is, the entity is an agent)." An entity is a principal when it controls a promised good or service before the entity transfers the good or service to the customer. The new standard provides indicators and other implementation guidance to help an entity determine whether it is acting as a principal (revenue is recognised on a gross basis) or as an agent (revenue is recognised on a net basis).

The new standard provides indicators and other implementation guidance to help an entity determine whether it is acting as a principal or an agent.

Thinking It Through

While the new standard's indicators for determining whether an entity is acting as the principal or agent in an arrangement may be similar to those in current guidance, the new standard differs slightly since it provides an overall principle for making this determination on the basis of the new standard's "control" notion. However, these changes are not expected to significantly affect the principal-versus-agent aspects of an entity's accounting.

Disclosures

The new standard requires entities to disclose both quantitative and qualitative information that enables "users of financial statements to understand the nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers." The standard's disclosure requirements, which are significantly more comprehensive than those in existing revenue standards. Indian M&E companies will also have to show a reconciliation of the amount of revenue recognised with the contracted price showing separately each of the adjustments made to the contract price, for example, on account of discounts, rebates, refunds, credits, price concessions, incentives, performance bonuses, etc., specifying the nature and amount of each such adjustment separately. This disclosure requirement can be quite onerous and is in addition to those to be followed by companies reporting under U.S. GAAP or IFRS.

Considerations and Challenges for M&E Entities

Increased Use of Judgment

Management will need to exercise significant judgment in applying certain of the new standard's requirements, including those related to the identification of performance obligations and allocation of revenue to each performance obligation. It is important for M&E entities to consider how the standard specifically applies to them so that they can prepare for any changes in revenue recognition patterns.

Systems, Processes, and Controls

To comply with the new standard's new accounting and disclosure requirements, M&E entities will have to gather and track information that they may not have previously monitored. The systems and processes associated with such information may need to be modified to support the capture of additional data elements that may not currently be supported by legacy systems. Further, to ensure the effectiveness of internal controls over financial reporting, management will want to assess whether it should implement additional controls. M&E entities may also need to begin aggregating essential data from new and existing contracts since many of these contracts will most likely be subject to the new standard.

To comply with the new standard's accounting and disclosure requirements, M&E entities will have to gather and track information that they may not have previously monitored.

Note that the above are only a few examples of changes M&E entities may need to make to their systems, processes, and controls; such entities should evaluate all aspects of the new standard's requirements to determine whether any other modifications may be necessary.

Thinking Ahead

M&E entities should start carefully examining the new standard and assessing the impact it may have on their current accounting policies, procedures, systems, and processes.

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