

Consultation Paper: Accounting for Revenue and Non-exchange Expenses

Background:

The New Zealand Film Commission (NZFC) is a Crown Entity working to grow the New Zealand film industry. Appropriate accounting treatment of the NZFC's funding commitments is fundamental to the Commission's business objectives.

The NZFC allocates the majority of its annual expenditure to feature film production. It also allocates significant sums to short film production, script development and devolved business development schemes.

It is critical that these funding decisions are reflected in the financial statements in a way that users of the statements can readily understand.

In preparing this submission, we have consulted with Te Māngai Pāho and the New Zealand On Air. We share common concerns about the continuing ability to present financial statements which are meaningful, useful to our users and reflect the underlying reality of our funding expenditure. Many of our interested stakeholders are the same, and comparability both between years and between entities is important. Our financial statements only provide a true reflection of funding expenditure and the use of resources when the expense is recognised on offer and/or acceptance rather than based on administrative staging of payments over time, which, if taken as the recognition point for the expense, artificially distorts the underlying financial performance and position.

Discussion:

Current Accounting Policies:

The NZFC's accounting policy and disclosures for funding, per the Annual Report are:

Grants:

Non-discretionary grants are those grants awarded if the grant application meets the specified criteria and are recognised as expenditure when an application is approved.



Discretionary grants are those grants where the NZFC has no obligation to award on receipt of the grant application and are recognised as expenditure when approved by the relevant NZFC committee and the approval has been communicated to the applicant.

Project commitments:

This amount represents financial commitments and advances for film development, devolved development schemes and production committed by the NZFC, but not paid out at year end.

Users of the Financial Statements

A key objective to the implementation of the PBE IPSAS suite is to provide better information for the users of financial statements.

PBE IPSAS 1 para 15 states:

“Financial statements are a structured representation of the financial position and financial performance of an entity. The objectives of general purpose financial statements are to provide information about the financial position, financial performance, and cash flows of an entity that is useful to a wide range of users in making and evaluating decisions about the allocation of resources. Specifically, the objectives of general purpose financial reporting should be to provide information useful for decision making, and to demonstrate the accountability of the entity for the resources entrusted to it, by:

- (a) Providing information about the sources, allocation, and uses of financial resources;*
- (b) Providing information about how the entity financed its activities and met its cash requirements;*
- (c) Providing information that is useful in evaluating the entity’s ability to finance its activities and to meet its liabilities and commitments;*
- (d) Providing information about the financial condition of the entity and changes in it; and*
- (e) Providing aggregate information useful in evaluating the entity’s performance in terms of service costs, efficiency, and accomplishments.”*

Therefore, it is essential when preparing the NZFC’s annual financial statements to ensure they are useful for the readers and key stakeholders (filmmakers, media, Ministers, MCH, MBIE and Parliament). The readers of the NZFC financial statements are most interested





in seeing how much money was committed to feature film projects during the year, and also how much money remained unallocated at the end of the year.

In order for the NZFC to provide useful information to the readers of the financial statements, the statements need to reflect the obligations created by the NZFC Board. These obligations are the offer of production funding to applicants, determined at Board meetings. These obligations need to be shown on both the profit and loss and the balance sheet to ensure that closing equity is appropriately stated.

Current Accounting Treatment

All significant feature film production funding decisions are made at Board meetings, which generally take place five times per year. Following each board meeting, a letter of conditional offer is issued to successful applicants. Simultaneously the offer is captured in our financial records.

The current accounting treatment is as follows:

- a) the full funding offer is expensed on the profit and loss, and
- b) a corresponding liability is recorded on the balance sheet.

This treatment reflects that these funds are effectively ring-fenced for a particular project, and prevents the funds from being utilised elsewhere. The same accounting treatment is applied to funding committed to short film production, script development and devolved business development schemes.

This means that at the end of each financial year, after the annual financial statements have been issued, readers are able to easily see how much money has been committed to funding film projects over the last 12 months, and importantly, how much is left over. They are also able to look at the balance sheet and see how much of the total funds committed by the Commission to film projects remains unpaid.

If management concludes at any point following the issuing of a conditional funding offer that the film project is not able to go forward into production then the funding offer is terminated and the liability and corresponding expense are reversed (“written back”). If the decision to terminate is made in a subsequent financial year to the offer, the writeback is shown as income rather than a negative expense on the profit and loss. Over the last 5 years the percentage of funds written back has averaged 17% of total offers made.

The effect of the consultation paper – a worked through example

The consultation paper sets out two options to record non- exchange expenses. Below we have assessed the impact that each option would have on our film funding process.





EXAMPLE

The NZFC board meets on the 7th December 2017. At the meeting the board considers a production funding request from a producer. The board agrees to provide production funding of \$1 million to the film project “XYZ”. Following the board meeting NZFC staff send a letter offering conditional production funding to the producer of “XYZ”. The conditional offer sets out a list of conditions that need to be met in order to “close” (i.e. contract) the film before they are able to start production. It also sets out that the conditional offer will expire in September 2018 unless the film has already closed. The producer of “XYZ” countersigns the offer letter on 20 December 2017 and sets about meeting all the NZFC conditions. This process takes several months. Eventually all the parties involved sign a non-conditional formal production financing agreement on 1 July 2018. This agreement incorporates a finance plan which shows that NZFC will pay \$1 million towards the film. An investor funding drawdown schedule is attached as an appendix to the funding agreement. This schedule lists the dates on which each instalment of the \$1 million NZFC funding is required to be paid over to the production bank account.

Option 1 – The Extended Obligating Event Approach

Does the NZFC have an obligating event? And if so when does the obligating event arise?

NZFC currently takes the view that as soon as the \$1M conditional production funding offer is communicated formally by letter to the producer applicant there is a valid expectation by that producer that they will receive \$1 million to help make the film. Therefore, the obligating event arises when the NZFC issues the letter of conditional offer, despite in many cases, the producer not having fulfilled all the conditions set out in the letter at time of issue.

Our interpretation of Option 1 is that the signing of the long-form film funding agreement by all parties would be treated as the obligating event.

At the point of recognising the obligating event, how is it recognised?

The NZFC letter of conditional offer sets out a list of conditions that must be met, before the NZFC funding is able to be released. Therefore, on the 20th of December 2017 the NZFC would recognise a \$1M asset and a \$1M liability on its balance sheet. On 1 July 2018 when the formal financing agreement is signed the NZFC would fully expense the \$1M funding commitment.

However, if milestone requirements were incorporated into this accounting standard, on 1 July 2018, the NZFC would only be able to recognise an expense to the extent that it is





reflected in the drawdown schedule. The expense would be released in line with the drawdown schedule which could potentially be across a period of more than one financial year.

NZFC Comment:

Adopting this approach would create a level of confusion within the NZFC, particularly at board level, as well as amongst our external stakeholders. The NZFC would have to effectively keep two separate sets of books, one for external reporting purposes and one for management purposes. Stakeholders would be confused as they would not be able to tell clearly how much and to what projects the NZFC had conditionally offered funding to.

Requiring milestones to be factored in would increase the ambiguity as to how much had been committed to funding films during any one year. The year-end balance sheet would likely show a misleadingly high equity position. There would be greater variation in the profit and loss account, with some years likely to report large surpluses and other years potentially showing large deficits. Overall, the annual financial statements would be of limited use to readers, with large conditional commitments of NZFC money simply not being fully or clearly reported.

For example, the profit and loss account in the NZFC Annual Report for the year ended 30 June 2016 shows feature film production funding expenditure of \$10.9 million. Of this \$10.9 million total, \$4.35 million was approved at the board meeting in mid-June 2016 and did not have a counter-signed letter of conditional offer at 30 June 2016 meaning it would not meet the expenditure recognition criteria under Option1. Additionally, \$4.3 million of funding had not been fully contracted for various reasons. Therefore, ignoring any flow-on impacts from funding offers arising in the previous year, this option would result in the NZFC profit and loss showing funding expenditure of only \$2.3 million and an equity increase of \$8.6 million. As our total reported expenditure was \$22.68 million this would be a very material change to the year-end financial statements.

Option 2 – Public Sector Performance Obligation Approach

Using the same hypothetical example above,

Step 1: Identify the binding agreement – when the producers have countersigned the NZFC letter of conditional offer a binding agreement is entered into by both parties.

Step 2: Identify the performance obligations – a film cannot be broken down into distinct segments. A film only holds value when it is delivered in its entirety. Therefore, for this reason we consider that feature film projects do not have any performance obligations.

Step 3: Determine consideration – the total consideration is \$1 million.





Step 4: Allocate the consideration – there is no performance obligations to allocate the consideration against.

Step 5: Recognise the expense – \$1 million would be recognised when the conditional offer is agreed/ signed.

NZFC Comment:

It could be argued that the investor drawdown schedule typically attached to the financing agreement sets out performance obligations. The reality is that once a feature film commences production it generally needs to maintain the pre-agreed timetable and complete delivery by the contracted date in order to come in on budget and avoid cost overruns. The NZFC must adhere to the contracted cashflow schedule and release its funds as required to allow the production to be completed on time and on budget. The NZFC has very limited ability to withhold funds, even when producer performance obligations (reporting etc.) are not being met. Any decision by the NZFC to withhold funding to a feature film in production, for whatever reason, would make the completion bond arrangement (essentially an insurance arrangement that guarantees completion of the film in certain circumstances) nul and void.

Conclusion:

The NZFC accepts the need for more clarity and certainty around the accounting for non-exchange expenses. We strongly argue that the proposed new accounting standard needs to ensure that readers of the financial statements can make informed decisions about the organisation.

It is important for the NZFC as a Government funding agency to be able to issue financial statements that are a true representation of financial obligations entered into during the year and that clearly show actual available funds at the end of the year. Substance takes precedence over form.

On this basis, we recommend that the public sector performance obligation approach (Option2) be incorporated into the new accounting standard. This we believe would allow us to continue to prepare annual financial statements that are meaningful to our various external stakeholders, and would avoid unnecessary duplication of accounts internally.



Summary of contract expenditure 2015/16

Funding Type and Characteristics	\$	Liability at 30/6/16	Liability at 30/6/15
Production Finance (Recognised when approved by the Board and a conditional offer is sent to the recipient)	10,981,937	11,135,917	14,285,012
Fresh Shorts	641,083	450,500	693,915
Devolved development (boost)	327,240	1,333,900	1,618,250