IT DOES MATTER WHO YOUR FRIENDS ARE: A CASE STUDY OF NETFLIX AND "FRIENDS" LICENSING

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CASE DESCRIPTION

The primary subject matter of this case concerns using managerial accounting in business decision making. This case has a difficulty level appropriate for sophomore or junior level managerial accounting courses. The case is designed to be taught in one class hour and is expected to require one hour of outside preparation by students. The case is designed to be presented and completed during the one hour of class time.

CASE SYNOPSIS

Netflix changed the way consumers watched movies and tv shows and became a global leader in streaming entertainment. The majority of Netflix's content library of movies and tv shows is not Netflix original content but rather content owned by third parties. Netflix is allowed to use this content under licensing agreements. One of its most popular streaming shows, "Friends", is licensed content. Upon renegotiation of the show's license and facing possible removal of the show, Netflix agreed to pay $100 million for a one-year license for "Friends". This was a $70 million increase in the license from the prior year. This case provides a real-world setting for applying managerial accounting concepts, for example cost-volume-profit and cost-benefit analyses, to aid in short-term decision making.

INTRODUCTION

Kelly opened the door of her dorm room to the familiar sound of the TV show "Friends" theme song.

"Hey, you can't watch that without me! We agreed to go through the series together," sulked Kelly to her roommate Jade.

"Don't worry. I was just cuing it up so it would be ready when you got back from class. I also ordered pizza for our Friends-a-thon tonight," replied Jade.

"I love this show!" exclaimed Kelly.

"Me too and I'm glad we found it when we did because it may not be on Netflix for too much longer," said Jade.

"Why not?" asked Kelly.

"I read somewhere that Netflix had to pay $100 million just to keep the show this year and they may not be able to keep it past this year," answered Jade.

"Wow! That's a lot of money!" said Kelly. "If they paid that much, Netflix must have had a good reason to keep it. I wonder why they would pay so much money for just one year."

"You accounting majors! I just want to know if Ross and Rachel are going to get back together or not," Jade replied.

"I want to know that too! But now I'm really interested in finding out more on this Netflix and "Friends" deal. Let me look up a few things before the pizza gets here," said Kelly. This is what Kelly found as she started researching.

COMPANY BACKGROUND

Netflix was formed in 1997 by Reed Hastings and Marc Randolph as an available-by-mail DVD rental company. It was rumored that the origin of the company came about after Mr. Hastings had to pay a $40 late fee to Blockbuster for his delinquent return of the movie "Apollo 13". Mr. Randolph later confessed that this was a fictional account but was an effective way to highlight one of their company's advantages over its competitors – no late fees (Castillo, 2017). Netflix's plan was simple. For a flat monthly fee, subscribers could rent movies and keep them for as long as they wanted without worrying about late fees. Subscription prices were tiered based on the subscriber's preference for receiving one or multiple DVDs at a time as well as the number of rentals allowed each month. Once finished, customers would mail the DVDs back in provided envelopes and the next DVD on their list would be sent to them.

The company added a streaming service in 2007 providing instant access to movies and television shows. Within three years, Netflix's subscriptions rose to 20 million (Brief History, 2014). Today, Netflix is the leading provider of internet home entertainment streaming (Iqbal, 2018; Levenson & Waniata, 2019). Users can stream content on a wide variety of internet-ready devices such as smartphones, tablets, computers, smart TVs, gaming consoles, set-top boxes, and streaming media players (i.e. Amazon Fire TV, Roku).

Netflix provides a multitude of viewing choices via its streaming service. The company produces a number of original movies and series in addition to its vast library of licensed content. One of the company's first original series, "House of Cards," premiered in 2013 (Brief History, 2014). The first season earned nine Emmy nominations and won three (Sottek, 2013). These were the first such nominations and wins for a show created for and viewable only online. Netflix earned a total of 112 Emmy nominations in 2018 surpassing HBO and ending that network's 17-year leading record (Watercutter, 2018). In 2019, Netflix finally hit "gold" at the Academy Awards by bringing home four Oscars: three for "Roma" and one for "Period. End of Sentence." (Accolades, n.d.; Kay, 2019). This was on the heels of winning more at that year's Golden Globe awards (five) than any other contender (Feiner, 2019). Other nominated and award-winning Netflix original content includes "Orange is the New Black", "The Crown", "Stranger Things", "Master of None", "Unbreakable Kimmy Schmidt", and "Bloodline" (Accolades, n.d.).

MEMBERSHIP

Netflix has more than 139 million streaming subscribers in over 190 countries streaming a total of more than 140 million hours of content per day (Iqbal, 2019; Netflix, 2019a). U.S. subscribers account for over 58 million of these total subscribers and have three subscription plans from which to choose - Basic, Standard, and Premium. The plans are priced based on simultaneous streaming ability. The basic plan is $8.99 a month and allows a subscriber to stream content on one screen in standard definition (SD). The standard plan is $12.99 a month and allows a subscriber to stream content on up to two screens simultaneously in high definition (HD). The premium plan is $15.99 a month and allows a subscriber to stream content on up to four screens simultaneously in HD and Ultra HD (Netflix, 2019b). While Netflix does not disclose the breakdown of each subscription composition, it is estimated that 27% of subscribers are on the basic plan and 30% of subscribers are on the premium plan (Seitz, 2018). Membership data and selected financial data for Netflix's domestic (U.S.) streaming segment is detailed in Exhibit 1 below.

Exhibit 1
Domestic Streaming Segment

	As of/ Year Ended December 31,		
	2018	**2017**	**2016**
	(in thousands, except revenue per membership and percentages)		
Memberships:			
Paid memberships at end of period	58,486	52,810	47,905
Paid net membership additions	5,676	4,905	4,504
Free trials	2,065	1,940	1,526
Contribution profit:			
Revenues	$ 7,646,647	$ 6,153,025	$ 5,077,307
Cost of revenues	4,038,394	3,470,859	2,951,973
Marketing	1,025,351	603,746	412,928
Contribution profit	2,582,902	2,078,420	1,712,406
Contribution margin	33.8%	33.8%	33.7%

Consolidated (All Segments)

	As of/ Year Ended December 31,		
	2018	**2017**	**2016**
	(in thousands, except revenue per membership and percentages)		
Revenues	$ 15,794,341	$ 11,692,713	$ 8,830,669
Cost of revenues	9,967,538	8,033,000	6,257,462
Marketing	2,369,469	1,436,281	1,097,519
Contribution profit	3,457,334	2,223,432	1,475,688
Other operating expenses	1,852,108	1,384,753	1,095,895
Operating income	1,605,226	838,679	379,793
Other expense	(378,768)	(353,358)	(119,286)
Provision for (benefit from) income taxes	15,216	(73,608)	73,829
Net Income	**$ 1,211,242**	**$ 558,929**	**$ 186,678**

Source: Netflix, Inc. 10-K for Year Ended December 31, 2018

COMPETITION

Netflix operates in a highly competitive market. Other streaming services such as Hulu and Amazon Prime Video vie for consumer dollars and loyalty. A 2018 survey reports that Netflix is the leader in subscribers with Amazon and Hulu trailing behind having approximately 60% and 37% of the number of subscribers compared to Netflix (Iqbal, 2019). Hulu and Amazon have similar services as Netflix offering subscribers a library of shows and movies from which to choose and stream. However, they each have a different competitive advantage. Hulu offers a library of content both old and new but can serve as an alternative to traditional cable tv. Hulu gives subscribers access to currently aired shows once they have aired live on their respective networks and subscribers can also choose the Hulu Live option which is live tv offering 60+ channels with DVR capabilities in addition to the Hulu library. Amazon Prime Video is a component of the Amazon Prime membership and, as such, offers many additional benefits such as free shipping on Amazon purchases, Prime Video, and Prime Music all for the same membership price.

Netflix's claim to fame is the vastness and diversity of its content. Netflix pays an estimated $13 billion a year for content (Levenson & Waniata, 2019). Part of that goes to produce original content as previously discussed. Both Hulu and Amazon Prime Video have begun competing with their own original content. Notables include "The Handmaid's Tale" on Hulu and "The Marvelous Mrs. Maisel" on Amazon Prime Video. However, neither Hulu nor Amazon Prime Video have the volume or the level of acclaim and award status with their original content as Netflix (Levenson & Waniata, 2019).

The majority of Netflix's content is not original content but rather licensed content (Spangler, 2018). Netflix must pay the owner of the content a fee to gain the right to use that content. For example, "The Office" is owned by NBC. In order to offer this show, Netflix must pay NBC a specific amount and is then allowed to use it for a certain amount of time such as a year, three years, etc. Once the time period ends, the license can be renegotiated or either parties (Netflix or NBC) may choose not to renew the license and the show would be dropped from Netflix's content. Licenses may be exclusive or non-exclusive. If Netflix negotiates an exclusive license, they will be the only service allowed to show that content. However, exclusive licenses are also more expensive than non-exclusive (Beers, 2019).

Several of the licensed content providers that Netflix has agreements with are in the process of launching their own streaming services creating additional competition for Netflix and possible content issues. Both Disney and AT&T/WarnerMedia have announced plans to offer streaming services in 2019 (Gates, 2019; Sorrentino & Solsman, 2019). Disney's service launches in November 2019 and is called Disney Plus. The service includes the films from Disney, Pixar, Marvel, and Star Wars. Disney also now owns 21st Century Fox and, as such, is including holdings from this entity such as "The Simpsons" and "The Sound of Music" in the Disney Plus platform. WarnerMedia's streaming service will be called HBO Max. Offerings will include content from HBO, Cinemax, TNT, TBS, and Warner Bros. It is likely that these companies will remove some, if not all, of their content from Netflix once these services are up and running.

"FRIENDS" LICENSE

One of the shows that Netflix licenses from WarnerMedia is "Friends". The show is based in New York City and chronicles the lives of six friends as they transition from their 20s to their 30s and all the challenges, change, and antics that entails. The show originally ran from 1994 until 2004 (Lee, 2018). Often hailed as one of TV's most popular comedies, the show had a strong following throughout the series ending with the fourth largest finale audience at that time with more than 52.5 million viewers (Carter, 2004).

Netflix began offering "Friends" as part of its content library in 2015 (Lee, 2018). Fans that had watched the show in its original heyday were happy to see their old friends again. In addition, the inclusion of the series on Netflix opened it up to an entire new generation of viewers. People that were in diapers or were not even born when the series finale originally aired were now getting to know, and love, Rachel, Chandler, Monica, Ross, Phoebe, and Joey – the friends of "Friends". The renewed popularity of the show caught notice. In 2016, the New York Times published an article entitled "Is Friends Still the Most Popular Show on TV?" noting the show's resurgence and continued success (Sternbergh, 2016). Netflix does not make available their viewership for individual offerings. However, an independent source has ranked "Friends" as the third most highly watched series on Netflix as of 2018 (see Exhibit 2) (Spangler, 2018).

Exhibit 2
Top 10 Watched Series on Netflix

Rank	Title	Owner
1	The Office	NBC
2	Chilling Adventures of Sabrina	Netflix
3	Friends	Warner
4	Grey's Anatomy	ABC
5	House of Cards	Netflix
6	The Great British Baking Show	Netflix
7	Marvel's Daredevil	Netflix
8	Narcos: Mexico	Netflix
9	The Haunting of Hill House	Netflix
10	Criminal Minds	CBS

Source: 7Park Data

WarnerMedia also took notice. The license between Netflix and WarnerMedia gives Netflix exclusive rights to stream the series. Prior to 2019, the price tag for this license was approximately $30 million a year (Lee, 2018). With plans for WarnerMedia to launch its own streaming service, the renewal of the "Friends" license was not certain for 2019. Rumors of a potential drop from Netflix's content created a social media outcry from fans with some even bemoaning that they only have a Netflix account to rewatch Friends episodes (Lee, 2018). One survey taken concerning the potential loss of customers in connection with content offerings indicated that approximately 30% of respondents would cancel their Netflix subscription if "Friends", "The Office", Marvel movies, and Disney content were removed (Shevenock, 2019).

Netflix was quick to reassure fans that they were in negotiations to keep the popular show and eventually did come to terms with WarnerMedia. However, it came at an increased price. Instead of paying the $30 million as in previous years, Netflix paid an estimated $100 million to keep “Friends” in its content library for 2019 (Lee, 2018). The license is only good for that year. After 2019, the show may no longer be on Netflix or WarnerMedia and Netflix may continue their license under non-exclusive terms allowing it to be on both WarnerMedia’s streaming service and on Netflix.

CONCLUSION

“Pizza’s here!” yelled Jade, breaking Kelly’s concentration.
“Okay,” replied Kelly. “I’ll be right there.”

Her research had given her a lot of information and a lot to think about. There was a lot more to Netflix and the “Friends” deal than at first glance. The competitive environment in which Netflix operates is a lot more complex than she realized. Having a competitive advantage and differentiating oneself from other competitors is important. Netflix’s content library was certainly one way they had stood out from the rest in the past. In light of these developments with “Friends” and other licensing, that may or may not be the case in the future. There was certainly a customer outcry to keep “Friends” as part of the Netflix content library. However, there was also the uncertainty of keeping the show past 2019. Kelly could certainly use this situation in her accounting class. She could use the information and apply some managerial accounting analyses to answer the question: Was it worth it to pay $100 million for one year to keep “Friends”?

SUGGESTED QUESTIONS

1. What factors are involved in deciding to extend the “Friends” license for 2019? What are the potential benefits of extending the license? What are the potential costs of extending the license?

2. Various managerial accounting concepts and methods are often used by businesses considering large expenditures. These concepts assist in cost-benefit evaluations. One managerial accounting method that could be used in the decision to extend the “Friends” license agreement is cost-volume-profit (CVP) analysis. Determine the following CVP calculations that could assist in this decision.
   a. What is the 2018 consolidated operating income of Netflix**?**
   b. What are the 2018 fixed expenses of Netflix? (Hint: Other operating expenses should be used for fixed expenses.)
   c. What are break-even sales in dollars for Netflix for 2018?
   d. What is Netflix’s margin of safety in 2018?

3. Another managerial accounting method that could be used to aid in this decision-making process is differential analysis. Firms use this analysis to weigh the incremental revenue

and incremental cost of a decision option and an alternative. The decision in reference to the "Friends" licensing is to continue with the license agreement for 2019 under the new contract terms and pricing or to discontinue the agreement. Construct a differential analysis for these two options considering

   a. the consolidated company.
   b. the domestic segment only.

4. Based on the above analyses, would you recommend that Netflix pay the $100 million to keep "Friends" for a year? Why or why not? What factors do you think influenced Netflix's decision?

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