

# *Making sense of a complex world*

## Media investments in technology companies

*This paper explores some of the key IFRS accounting issues that can arise when making investments in technology companies.*









# Contents

<b><i>Introduction to MIAG</i></b>	<b><i>1</i></b>
<b><i>Media investments in technology companies</i></b>	<b><i>2</i></b>
<b><i>Example 1: An opportunistic investment</i></b>	<b><i>3</i></b>
<b><i>Example 2: A strategic investment</i></b>	<b><i>7</i></b>
<b><i>Example 3: A collaborative approach</i></b>	<b><i>9</i></b>
<b><i>Example 4: A new market</i></b>	<b><i>11</i></b>
<b><i>Conclusion</i></b>	<b><i>13</i></b>
<b><i>Publications/further reading</i></b>	<b><i>15</i></b>
<b><i>Contacts</i></b>	<b><i>17</i></b>



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# Introduction to MIAG

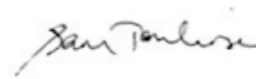
*Our Media Industry Accounting Group (MIAG) brings together our specialist media knowledge from across our worldwide network. Our aim is to help our clients by addressing and resolving emerging accounting issues that affect the entertainment and media sector.*

With more than 4,200 industry-dedicated professionals, PwC's global entertainment and media (E&M) practice has depth and breadth of experience across key industry sectors including: television, film, advertising, publishing, music, internet, video and online games, radio, sports, business information, amusement parks, casino gaming and more. And just as significantly, we have aligned our media practice around the issues and challenges that are of utmost importance to our clients in these sectors. One such challenge is the increasing complexity of accounting for transactions and financial reporting of results – complexity that is driven not just by rapidly changing business models but also by imminent changes to the world of IFRS accounting.

Through MIAG, PwC<sup>1</sup> aims to work together with the E&M industry to address and resolve emerging accounting issues affecting this dynamic sector, through publications such as this one, as well as conferences and events to facilitate discussions with your peers. I would encourage you to contact us with

your thoughts and suggestions about future topics of debate for the MIAG forum, and very much look forward to our ongoing conversations.

Best wishes



Sam Tomlinson  
PwC UK

Chairman, PwC Media Industry  
Accounting Group



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**Sam Tomlinson**

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<sup>1</sup> PwC refers to the PwC network and/or one or more of its member firms, each of which is a separate legal entity

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# Media investments in technology companies

*PwC's 18th Annual Global CEO Survey revealed that 33% of media companies are already working with technology start-ups, the highest of any sector, with a further 25% of media CEOs considering such activities. Our ninth MIAG paper explores some of the key IFRS accounting issues that can arise when making investments in technology companies.*

According to a Financial Times report in August 2014, traditional media companies are committing hundreds of millions of dollars to investing in digital start-ups as they look for ways to diversify away from stalling growth in their core media businesses.

These media investments in technology can have different objectives and structures. Some media companies are looking for 'strategic' technology investments, such as small digital companies that can assist their television or publishing arms, whereas others are looking solely for financial returns. And while most media companies invest capital, some offer their surplus advertising inventory instead – one famously successful example saw publisher Axel Springer take a minor stake in accommodation site Airbnb.

This variety of objectives and structures can result in a number of IFRS accounting challenges. This paper considers various practical examples covering opportunistic and strategic investments, joint ventures, and entrance into new markets. Our scenarios are clearly not designed to be

exhaustive; but they will hopefully provide food for thought for media companies when making investments into technology companies.

We hope that you find this paper useful and welcome your feedback.

Best wishes



Sallie Deysel  
PwC UK



Gary Berchowitz  
PwC South Africa

PwC Media Industry Accounting Group



Sallie Deysel



Gary Berchowitz

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**PwC's Media Industry Accounting Group (MIAG) is our premier forum for discussing and resolving emerging accounting issues that affect the entertainment and media sector – visit our dedicated website: [www.pwc.com/miag](http://www.pwc.com/miag)**

## Example 1: An opportunistic investment

**“What happens if I swap my back catalogue or spare advertising space for shares in a start-up?”**

*In example 1, we consider how to account for an equity investment that is acquired in exchange for goods or services. When established media companies transact with technology start-ups that want access to their content or to their advertising space, it is often the case that the start-up is cash poor and therefore would like to pay with equity, rather than cash. Media companies are increasingly taking the opportunity to acquire equity interests in companies that might be the ‘next-big-thing’ in exchange for their traditional goods or services, particularly where the incremental cost of delivery of such goods or services is low.*

### Scenario

OnlineCo is an unlisted technology start-up owned by its founders and a few other private investors. OnlineCo was established 24 months ago and has developed an innovative new model to deliver digital music to consumers. MusicCo agrees to sell OnlineCo a five-year, non-exclusive global licence to its back catalogue covering all artist releases 1980–2000. MusicCo has no ongoing obligations in connection with the licence.

In exchange, OnlineCo agrees to issue shares that will give MusicCo a 5% economic interest in the company. This also gives MusicCo 5% of shareholder votes, but this gives only a very limited right to participate in the policy decisions of the company since the founding investors own more than 50% of the voting shares and MusicCo has no special rights e.g. no right to appoint a director. MusicCo will also receive a 1.5% sales based royalty on sales of the back catalogue by OnlineCo.

MusicCo receives the shares on the day that the licence is granted, which is also the first day of the licence term. The nominal value of the shares is €100. OnlineCo had recently completed a

round of fundraising, for which an independent third-party valuation was obtained, showing that the music technology start-up was valued at €10 million. The new shares issued in that round of fundraising were based on €10 million valuation and included the rights to appoint a board director. The valuation report, which has been shared with MusicCo, indicates that the range of reasonable valuations is between €2.5 – €15 million (with €10 million being the valuer’s best estimate within that range). At the end of the first year of the licence term, OnlineCo has significantly exceeded its budgets and the best estimate based on a similar valuation methodology is now €15 million, but again with a similarly wide valuation range. OnlineCo’s results for the first year of the MusicCo arrangement included sales of the back catalogue of €500,000.

MusicCo has not received shares as consideration for a licence before. MusicCo’s revenue recognition policy for similar licences of back catalogue in exchange for (non-refundable) cash is to treat the licence as a sale, with revenue recognised at the point that the licence is granted. Sales based royalties are recognised as revenue when the licensee makes sales.

### How much revenue does MusicCo recognise in the first year of the contract?

MusicCo’s policy is to recognise revenue for similar licences at the point that the licence is granted. The same policy should therefore be applied to this licence i.e. revenue is recognised when the licence is granted. That revenue should be recognised at the fair value of the consideration received, i.e. the fair value of the shares plus future royalties.

However, IAS 18 *Revenue* only permits revenue recognition if the consideration is reliably measurable. The entity’s existing policy indicates that a reliable measurement of future royalties is not available. Therefore the future royalties are excluded from the measurement of the amount of revenue recognised at the time that the licence is granted.

The key judgement for MusicCo is therefore whether the fair value of the shares in OnlineCo can be reliably measured. IAS 39 *Financial instruments: recognition and measurement* includes specific guidance on when it is possible to reliably measure the fair value of an unquoted equity instrument. IAS 39 states that reliable measurement is possible if:





- the variability in the range of reasonable fair value measurements is not significant for that instrument; or
- the probabilities of the various estimates within the range can be reasonably assessed and used when measuring fair value.

In this case the range of reasonable fair values is significant so MusicCo must instead assess whether the probabilities of the various value estimates can be reasonably assessed. Based on its review of the valuation report and given the corroborative evidence provided by the shares issued in the recent funding round, MusicCo judges that it can reliably measure the fair value of the shares. It estimates the fair value of its 5% economic interest to be €400,000 based on 5% of the total business valuation of €10 million implying €500,000, to which MusicCo has then applied a 20% discount reflecting the lack of liquidity and inability to participate in OnlineCo's policy decisions.

At the end of the year, MusicCo has therefore recognised revenue of €407,500, comprising a €400,000 estimated value of the shares received plus €7,500 representing the 1.5% royalty on sales of €500,000.

### **Subsequent treatment of investment in OnlineCo**

MusicCo has classified its 5% investment in OnlineCo as an available-for-sale (AFS) equity investment, which must therefore be remeasured to fair value at each balance sheet date. At the first year end, the 5% investment is remeasured to €600,000 based on the business valuation of €15 million, again with a 20% discount. The remeasurement gain of €200,000 is presented in other comprehensive income (OCI), not in the income statement. Had the investment met the criteria to be classified as fair-value-through-profit-and-loss (FVTPL), and had MusicCo chosen to do so, the gain would be reported in the income statement, but not as revenue.

### **Additional scenarios**

Of course, alterations of this scenario's fact pattern could result in different conclusions. For example, if MusicCo had concluded it could not reliably measure the fair value of its new OnlineCo shares, it would then consider the fair value of the licence that it had issued. Whether the value of the licence could be reliably measured would depend on the availability of similar transactions. Ascertaining the fair value of licences can be difficult since the incremental cost of delivery can be low, which means that they are often sold for a wide range of values; and even where they are for the same underlying

intellectual property (IP), licences often have specific terms meaning they are not truly comparable. If, having considered both the shares received and the licence granted, MusicCo could not establish a reliable measurement of fair value, no revenue would be recognised at the time that the licence was granted.

If reliable measurement is not possible, IAS 39 requires that the investment is subsequently measured at cost less impairment. As such it is also likely that no remeasurement gain would be recognised for the AFS investment in the subsequent periods. As a result it might be that no gain is recognised unless and until MusicCo is able to exit its investment in OnlineCo.

In addition, the original scenario in our example 1 is relatively straightforward compared to many real life arrangements. For example, MusicCo might have agreed to receive its 5% in tranches at the end of each year of the licence; MusicCo might have agreed to receive a variable number of shares based on OnlineCo's sales, instead of the 1.5% sales-based royalty; the licence agreement might have included some ongoing obligations for MusicCo; and the licence agreement might have been for MusicCo's full catalogue i.e. with the music library being periodically updated for new releases. Contractual terms such as these could introduce even more

complexity into the accounting. Furthermore, if MusicCo's revenue recognition policy was to recognise licence fees over the licence term rather than as an up-front sale this would also change the conclusions above.

Traditional media companies are also increasingly entering into investments where they exchange advertising inventory for an equity stake in a technology start-up. The accounting considerations above in our MusicCo scenario are all relevant in an equity-for-advertising deal in the same way as the MusicCo catalogue deal. In particular, traditional media companies should be cautious in using the value of the advertising services (rather than the equity acquired) to establish the transaction value. It is often the case that the advertising provided is 'spare capacity' so may have much less value than a theoretical rate card. Robust, granular analysis is needed to support a reliable measurement for either media services provided or equity stake received.

### **Will the accounting change in the future?**

**Revenue:** The new revenue recognition standard IFRS 15, which will be effective from either 1 January 2017 or (more likely) 2018, provides significantly more guidance than IAS 18 on the recognition of licence revenue, distinguishing between revenue recognised as control of the licence passes to the customer (for 'right to use' intellectual property) and revenue recognised over the licence term (for a 'right to access' IP).

This topic of licences has been discussed extensively by the IASB and FASB and it seems likely that both boards will make amendments to the revenue standard

and/or the accompanying guidance. These amendments might not be identical so could cause a divergence between IFRS 15 and its US equivalent for some licences.

IFRS 15 also includes guidance on the measurement of non-cash consideration (such as shares), including the approach that should be taken if the consideration consists of a variable number of shares. This topic has also been discussed by the IASB and FASB in Q1 2015. The FASB proposes to amend the US standard to require that shares to be received as consideration in a revenue transaction should be valued at contract inception with subsequent movement in value being recognised in the income statement, but not in revenue. However, the IASB is not currently proposing a similar change to IFRS 15. If your company currently enters into transactions such as these, or is planning to in the future, we recommend that you reconfirm the IASB's final decision and consult with an accounting adviser as you implement IFRS 15.

**Subsequent treatment of investment:** IFRS 9 *Financial Instruments*, which is effective from 1 January 2018, removes the requirement in IAS 39 to measure unquoted equity investments at cost where the fair value cannot be determined reliably. Given the new guidance provided by IFRS 9, it is not expected that cost will be representative of fair value for an extended period of time. That is, even if a company had concluded cost was a reliable proxy for the fair value of the investment on the date the shares were received, it would need to reassess whether this remains the case at each reporting date and

would most likely need to develop an estimate of fair value for the unquoted equity instruments in future reporting periods.

Under IFRS 9, MusicCo is more easily able to classify the investment as FVTPL. However, if it makes the election in IFRS 9 to present the remeasurements through OCI (as it would today for AFS equity investments), there is an important difference from current IFRS: namely, there is never any income statement recycling of gains, which means that if an opportunistic investment like the one in OnlineCo is successful, when the investment is sold, there will be no income statement effect for MusicCo since all gains will already have been recognised in OCI. (Dividend income, however, will still be presented in the income statement.)

If MusicCo has more than one equity investment, under IFRS 9 it has a choice each time at initial recognition whether to classify its investment as FVTPL or to remeasure through OCI (FVOCI). The election made is irrevocable. Therefore, each time MusicCo acquires an equity investment (either via a revenue transaction as described above, or perhaps simply purchased for cash) it will need to consider whether it wants to risk volatility in its income statement (if classified as FVTPL) or never including the gain on sale from successful investments (if classified as FVOCI).







## Example 2: A strategic investment

**“What happens if the investor acquires significant influence?”**

*In example 2, services are again exchanged for equity. However, this example considers how the accounting might differ if the transaction is not simply an opportunistic revenue transaction that happens to have been settled in shares, but is rather a chance for the traditional media company to have a say in the strategic direction of the technology investee. For example, potentially significant synergistic benefits might have been identified by the media company and the technology investee that can be exploited through cooperation.*

### Scenario

MarketingCo (the investee) was established several years ago to monetise innovative technology that allows television viewers to immediately access information about the shows that they are watching and purchase related products or services. For example, it can identify the destinations in a holiday programme and provide links to relevant travel sites, or the brand of clothes worn by actors and links to clothing companies that sell them.

TVCo would like to explore this marketing model and believes that both parties could benefit from closer cooperation. TVCo and MarketingCo negotiate an agreement whereby TVCo will provide one million advertising spots to be provided over two years and in return will receive 25% of the shares in MarketingCo. The shares give TVCo both a 25% economic interest and 25% of the voting rights, along with one of five directors on the MarketingCo board.

At the date the contract is signed, the fair value of MarketingCo is estimated as €20 million. TVCo incurs €0.5 million in legal fees, which are directly attributable to the transaction. In a cash deal, it is expected that the equivalent one million slots would be sold for €5 million.

### How much revenue does TVCo recognise for the sale of advertising?

As explained in example 1, revenue is measured at the fair value of the consideration received, so long as that value can be reliably measured. In this example, in order to illustrate other accounting complexities, we will assume that the fair value of the investment is reliably measurable – although unquoted, MarketingCo was established several years ago and the value of the advertising corroborates the valuation of the shares – but of course the ‘uncertainty’ factors in example 1 might be equally applicable here in a real transaction.

In this scenario, the advertising is delivered over a two year period. As such, we would expect revenue of €5m to be recognised over that period, probably using a percentage of completion measure of performance.

### What about the investment in MarketingCo’s shares?

The shares that TVCo has acquired would be assumed to give TVCo significant influence over MarketingCo, because it has acquired more than 20%. This presumption is supported by TVCo’s voting rights and ability to appoint one of

five directors. As such, TVCo would likely conclude that MarketingCo is its associate and should be equity accounted.

This means that the investment in associate would initially be recognised at cost, which in this case would be the fair value of the shares plus the directly attributable legal fees. After initial recognition, TVCo equity accounts for MarketingCo following guidance in IAS 28 *Investments in Associates and Joint Ventures*.

### What if there are potential voting rights?

In strategic deals such as the one set out above, it is common for the parties to put in place put or call options. These can significantly change the accounting outcome. For example, if TVCo had also negotiated the right to call a further 30% of the share capital from the other shareholders of MarketingCo (that would give TVCo a 55% shareholding), it would need to consider carefully whether it controls MarketingCo from the date of the transaction and so should consolidate it, rather than equity account for it.



IFRS 10 *Consolidated financial statements*, which has been effective since 2013 (2014 in the EU), includes a significant change from its predecessor IAS 27, namely that potential voting rights must be substantive to impact the assessment of control. TVCo would need to consider, among other things:

- Why has this option been included in the contract i.e. what is the nature and purposes of this arrangement?
- Does TVCo have the right today to exercise its call option, or is it exercisable only after a specified number of years?
- What benefits would TVCo obtain from exercising the call, not just financial, but also synergistic?
- How much does TVCo have to pay for the additional shares – is the call option priced significantly above or below fair value?
- Are there any other parties who also have potential voting rights, and how would those rights interact?

For example, a presently exercisable call that is in the money (i.e. can be exercised at a price below fair value), will most likely confer power to TVCo since it is highly likely to be exercised. This is the case even if TVCo does not currently have enough funds to exercise. Obtaining funding to allow exercise for an in-the-money option is unlikely to be a significant barrier for TVCo.

If the call option is currently exercisable, but significantly out of the money (i.e. the price is above fair value), the conclusion might be different and other factors would need to be considered. For example, if the call option is not expected to be exercised, but has been included to allow TVCo to take control of MarketingCo in exceptional situations, it might not be regarded as substantive. The option would then be unlikely to confer power on TVCo.

Conversely, the guidance in IFRS 10 means that if the call option was not currently exercisable, this would not be enough in and of itself to avoid consolidation i.e. TVCo might still be deemed to have control over MarketingCo even though it will take some time before it can formally assume its majority shareholding. Again, TVCo would need to consider the substance of the arrangement, including all the factors above, to determine whether or not its call option represents a substantive right that confers power.



## Example 3: A collaborative approach

### “When is a ‘joint venture’ not a Joint Venture?”

*Another common way for media companies to collaborate is to establish new businesses with companies from other sectors. There are many structures that might be used. This example highlights some key considerations for media companies that establish ‘joint ventures’ to house their new enterprise.*

#### Scenario

GamesCo and TechCo agree to work together to develop a machine that will allow ‘4D’ game play in a virtual reality holo-room. The companies establish a NewCo, which issues 50% of its share to each of them. In return for its shares, GamesCo contributes non-exclusive rights to storylines, images and soundtracks from its most successful franchise, plus a building that is currently surplus to requirements with book value of €1 million and a fair value of €5 million. TechCo contributes a non-exclusive licence to prototype technology, plus €5 million cash.

The board of NewCo will comprise six directors. Three are appointed by GamesCo and three by TechCo. Decisions are made by majority vote. Neither party has a casting vote. Deadlock provisions require escalation first to each the CEOs of each investing company and then to an independent arbitrator. Each party will be entitled to 50% of the economic returns of the NewCo, although no profit is expected for several years.

#### What type of investment is NewCo in GamesCo’s financial statements?

It appears that GamesCo and TechCo jointly control the NewCo since all decisions require unanimous consent. Assuming this is the case, and since each party has a right to the net assets of NewCo, TVCo concludes that it has an investment in a joint venture. As such, it is required to follow the accounting guidance in IAS 28 on equity accounting.

#### When is a ‘joint venture’ not a Joint Venture?

The scenario above is fairly straightforward, but it is very common for companies to enter into ‘joint venture’ arrangements that are not Joint Ventures as defined by IFRS 11 *Joint Arrangements*.

The most common reason that the IFRS 11 definition is not met is that the investors do not truly have ‘joint control’ and in fact one investor has control. The following factors are indicators that one of the investors actually has control of the investee:

- One party has a casting vote, either through a board member (e.g. the Chairman) or after an escalation process (e.g. if the board cannot decide after three votes, one of the investors automatically prevails)

- The board is set up so that unanimous consent is required to pass motions, but key decisions are not made by the board but by another layer of management, such as an operating committee to which only one of the investors can make appointments
- One party has a substantive call option that allows it to purchase the other party’s shares should they be unable to agree on a strategic decision

Actual arrangements can be even more complex. For example, consider a situation in which the arrangement includes a ‘Russian Roulette’ clause, such that either shareholder (the ‘offering shareholder’) may serve a sale notice on the other shareholder (the ‘recipient’). The notice requires the recipient either to sell all of its shares to the offering shareholder at the price specified in the notice, or to buy all of the shares held by the offering shareholder at the same price.

Exercising the ‘Russian Roulette’ clause in the shareholder agreement will definitely result in one investor selling its shares to the other, but it is unclear who will sell and who will buy. This is a symmetrical right. Provided both parties have the practical ability to exercise the right, it will not give either party the ability to obtain the voting rights held by



the other. Therefore it does not impact the assessment of who has power over the investee. However, there might be situations where one of the investors does not have the practical ability to exercise its right, which would then affect the control assessment.

### ***How does GamesCo account for the establishment of NewCo?***

GamesCo has exchanged non-monetary assets for its investment in NewCo, which it has assessed as a joint venture under IFRS 11. First, GamesCo needs to derecognise the assets that it is contributing to NewCo. The €1 million book value of the property is derecognised. The non-exclusive franchise licences relate to intellectual property that GamesCo generated internally so does not have a book value and, given that the licence is non-exclusive, GamesCo has judged that the fair value of the licences is minimal. Next, GamesCo recognises its investment in NewCo at cost. Since the consideration here is non-monetary, its fair value is used as cost. As such, the cost of GamesCo's investment in the joint venture is €5 million value of the property.

However, GamesCo is required by IAS 28 to limit its profit on disposal by recognising the gain only for the 50% share of the joint venture owned its co-investor TechCo. The unrestricted profit on disposal would be the fair value of the property of €5 million less its book value of €1 million, totalling €4 million. So GamesCo must limit its gain

on disposal of the property to 50% i.e. €2 million, giving GamesCo a joint venture carrying value of €3 million (comprising the €1 million derecognised property book value plus €2 million gain on its disposal).

### ***What might change the conclusions here?***

In the scenario above, we judged that GamesCo and TechCo contributed assets to a NewCo in order to establish a new business. However, it is also common for companies to contribute existing businesses into 'joint ventures' (which may or may not be truly IFRS 11 jointly-controlled entities) and to receive an investment in a joint venture or associate in return.

There is currently an inconsistency between IFRS 10 and IAS 28 with regards to such transactions. As discussed above, when non-monetary assets are sold or contributed to a joint venture or associate, IAS 28 requires that a gain is recognised only to the extent of the co-investor's interest i.e. the gain is only recognised on the portion that has been economically 'given up'. However, IFRS 10 states that when an entity loses control of a subsidiary, a full gain or loss on disposal is recognised.

### ***Will the accounting change in the future?***

From 1 January 2016 both IFRS 10 and IAS 28 are being amended to remove this inconsistency. A full gain or loss will be recognised by the investor where the non-monetary assets contributed into the venture constitute a business. If the assets do not meet the definition of a business, the gain or loss is recognised by the investor only to the extent of the other investors' interests. Judging whether a collection of assets and contracts constitutes a business or not can be highly judgemental, since the definition of a business in IFRS 3 *Business Combinations* is somewhat broad.

## Example 4: A new market

**“We’ve got a real bargain!  
Or do we...?”**

*Sometimes a traditional media company will want to take control of another business to gain exposure to a new geography, to gain additional market share or to take control of part of the supply chain. In this example, we consider a media company that wants to enter into a high-growth geography. As is often the case in the media industry it is important in this scenario for the purchasing company to retain the skills of key management.*

### Scenario

AdCo is a creative advertising agency. AdCo is keen to enter the Brazilian market by acquiring a successful local digital agency, BrazCo. BrazCo was founded ten years ago by the person who is currently the 100% shareholder and acts as CEO. AdCo assesses that the fair value of BrazCo is €135 million, within a reasonable range of €125 – €150 million. AdCo and BrazCo agree a sale-and-purchase-agreement (SPA) with these key clauses:

- AdCo acquires 100% of the shares in BrazCo
- AdCo pays €75 million in cash
- AdCo will also make additional payments of €25 million at the end of years one, two and three, provided an agreed profit threshold is exceeded in each year
- A condition for the signing of the SPA is that the BrazCo CEO signs a formal employment agreement
- The employment contract sets out the terms and conditions of employment including an annual salary and benefits that are in line with market rates

- If CEO leaves employment before the end of year three, she is not entitled to receive any further payments under the SPA that she has not yet received at the date she resigns.

### **AdCo has secured a real bargain! (?)**

When AdCo’s finance team are passed the SPA by their M&A team, they realise that the SPA will result in some slightly unusual accounting outcomes. IFRS 3 provides guidance on when contingent payments are part of the consideration for the business combination and when they are for a separate transaction. In January 2013 the IFRS IC confirmed that, if the contingent payments are automatically forfeited on termination of employment, the standard requires that the payment is treated as remuneration for post-combination services rather than part of the consideration for the business combination, unless the service condition is not substantive.

As such, each of the three potential subsequent payments of €25 million is accounted for as an employee benefit under IAS 19 *Employee Benefits*.

AdCo then has a policy choice. If it views the arrangement as three awards vesting over one, two and three years, it recognises a charge for each over the relevant period. This will lead to the overall charge being front-loaded. If AdCo considers that a better characterisation of the arrangement is that it is a single award, which is earned over the three year period, it will attribute the total cost over that period. This latter approach is likely to result in the expense approximating straight line recognition assuming that it is considered likely that each of the targets will be met.

Regardless of whether the contingent awards are front-loaded or straight-lined, only the initial payment of €75 million is regarded as consideration for the BrazCo business. Including intangible assets, AdCo assesses that the fair value of BrazCo’s identifiable net assets at acquisition is €100 million (i.e. excluding goodwill). AdCo would therefore consider whether there was a ‘bargain purchase’ of €25 million, being fair valued net assets of €100 million less consideration €75 million. Before recognising this bargain purchase as an immediate gain in the income statement, AdCo should reconfirm that it has correctly identified and valued all of the BrazCo assets and liabilities.





### Or has it...?

A small change in the facts might result in a significantly different accounting outcome. If the contingent payments are not automatically forfeit when the CEO leaves employment, AdCo considers the following indicators to help it decide on the nature of the payments:

- **Continuing employment:** If the payments are not affected by whether the person is employed or not, this may indicate that the arrangement is contingent consideration and not remuneration.
- **Duration of continuing employment:** the contingent payment is more likely to be remuneration in the case where the period of required employment is the same as or longer than the contingent payment period.
- **Level of remuneration:** in the case where the remuneration of the selling employee-shareholders is reasonable compared to other key employees when the contingent payment arrangement is excluded, this may indicate that the contingent payments are additional consideration for the business.
- **Incremental payments to employees:** selling shareholders who do not become employees may receive lower contingent payments (on a per-share basis) than the selling shareholders who become employees of the combined entity. This indicates that the incremental amount of contingent payments to the selling shareholders who become employees is remuneration and not consideration.
- **Number of shares owned:** the contingent payment arrangement is more likely to be a profit sharing remuneration arrangement if the selling shareholders owned substantially all of the shares in the acquiree and became employees.
- **Linkage to the valuation:** the acquirer and acquiree will often negotiate within a range of valuations. A contingent payment arrangement is more likely to be consideration in the case where the amount of consideration transferred at acquisition date is at the low end of the valuation, with further contingent amounts payable.
- **Formula for determining consideration:** a formula that is based on an earnings multiple is more likely to be contingent consideration, because it is intended to establish the fair value of the acquired business. Alternatively, a formula based on a proportion of profit earned indicates that the arrangement is a profit sharing agreement and is remuneration for post-combination services.
- **Other agreements and issues:** amounts payable to selling shareholders may be for something other than both consideration and employee remuneration. For example, there may be other arrangements such as non-compete agreements, executory contracts, consultancy contracts and asset lease agreements.

Assuming that the payments are not automatically forfeit if the CEO resigns, the remainder of the indicators above are mixed. AdCo notes that the CEO already receives a market rate salary and that the initial payment is below the reasonable range of valuations for the business. These appear to be strong indicators that the subsequent payments are intended to be consideration for the business. Conversely, the CEO formerly owned 100% of the shares and the employment period is the same as the earn-out period. On balance, AdCo might conclude that the payments are, in substance, contingent consideration for the business combination.

On that basis, at the date of the acquisition, AdCo would recognise a liability for the fair value of future consideration that it expects to pay – say €60 million. The total consideration for the acquisition of BrazCo is, therefore, €135 million. This means that instead of a day one gain of €25 million, followed by remuneration expense of up to €25 million in each of the subsequent three years, AdCo will recognise goodwill of €35 million in addition to the identifiable net assets of €100 million.

If AdCo subsequently revises its estimate of the future payments (i.e. contingent consideration) later in the earn-out period, these re-measurements are recognised in the income statement, and not adjusted against goodwill.

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## Conclusion

Traditional media companies are committing hundreds of millions of dollars to investing in digital start-ups as they look for ways to diversify away from stalling growth in their core media businesses. Such investments can be strategic or purely financial, and be made in cash or in exchange for services such as advertising.

This paper has considered some of the resulting accounting challenges in various practical examples covering opportunistic and strategic investments, joint ventures, and entrance into new markets.

The scenarios in this paper are clearly not designed to be exhaustive; but they will hopefully provide food for thought for media companies when making investments into technology companies.

The answer for complicated real life arrangements will depend on the specific facts and circumstances in each case. Where transactions are significant, management should include disclosures in the financial statements that enable users to understand the conclusions reached. As always, planning ahead can prevent painful surprises.

We hope you find this paper useful and welcome your feedback.

To comment on any of the issues highlighted in this paper please visit our dedicated website [www.pwc.com/miag](http://www.pwc.com/miag) or contact your local PwC entertainment and media specialist.







# Publications/further reading



## MIAG Issue: 3

### Broadcast television: Acquired programming rights

This paper explores the critical considerations under IFRS relating to the recognition, presentation, amortisation and impairment of acquired programming rights.



## MIAG Issue: 4

### Accounting for royalty arrangements – issues for media companies

This paper explores some of the key considerations under IFRS in accounting for royalty arrangements by both licensors and licensees.



## MIAG Issue: 5

### Content development and cost capitalisation by media companies

This paper explores the critical considerations relating to the classification, capitalisation and amortisation of content development spend under the applicable IFRS standards IAS 2 Inventories and IAS 38 Intangible Assets, focusing on the television production, educational publishing and video game sectors.



## MIAG Issue: 6

Revenue recognition: principal/agent arrangements – issues for media companies

This paper considers the assessment of the key principal/agent considerations in various practical examples, covering physical books, eBooks, television content and film production.



## MIAG Issue: 7

Revenue recognition: payments to customers – issues for media companies

This paper explores some of the key IFRS accounting considerations for payments by media companies to their customers, covering the purchase of advertising space, physical and digital 'slotting fees', outsourced advertising sales and video game prizes.



## MIAG Issue: 8

Online gaming: Real issues in virtual worlds

This paper explores some of the key IFRS revenue recognition issues in the world of online gaming, covering principal/agent considerations, virtual items and virtual currencies, and multiple element arrangements

# Contacts

## Global leader

**Marcel Fenez**  
marcel.fenez@hk.pwc.com  
+852 2289 2628

## EMEA leader

**Phil Stokes**  
phil.stokes@uk.pwc.com  
+44 20 7804 4072

## MIAG leader

**Sam Tomlinson**  
sam.tomlinson@uk.pwc.com  
+44 20 7804 0726

## Australia

**Rosalie Wilkie**  
rosalie.wilkie@au.pwc.com  
+61 2 8266 8381

## Brazil

**Estela Vieira**  
estela.vieira@br.pwc.com  
+55 11 3674 3802

## Canada

**John Simcoe**  
john.b.simcoe@ca.pwc.com  
+1 416 815 5231

## China

**Wilson Chow**  
wilson.wy.chow@cn.pwc.com  
+86 755 8261 8886

## France

**Richard Bejot**  
richard.bejot@fr.pwc.com  
+33 1 5657 6039

## Germany

**Christoph Gruss**  
christoph.gruss@de.pwc.com  
+49 69 9585 3415

## Hong Kong

**Cecilia Yau**  
cecilia.yau@hk.pwc.com  
+852 2289 1385

## India

**Smita Jha**  
smita.jha@in.pwc.com  
+91 98 1114 1190

## Italy

**Andrea Samaja**  
andrea.samaja@it.pwc.com  
+39 2 6672 0555

## Japan

**Hideaki Zenba**  
hideaki.zenba@jp.pwc.com  
+81 80 3158 6368

## Mexico

**Miguel Arrieta**  
jose.miguel.arrieta@mx.pwc.com  
+55 5263 6000 Ext 5857

## Netherlands

**Ennel van Eeden**  
ennel.van.eeden@nl.pwc.com  
+31 88792 4540

## Russia

**Natalia Yakovleva**  
natalia.yakovleva@ru.pwc.com  
+7 495 967 6395

## Singapore

**Charlotte Hsu**  
charlotte.hsu@sg.pwc.com  
+65 6236 7668

## South Africa

**Vicky Myburgh**  
vicky.myburgh@za.pwc.com  
+27 11 797 4305

## Spain

**Inmaculada Izarra**  
inmaculada.izarra@es.pwc.com  
+34 915 68 5176

## Switzerland

**Patrick Balkanyi**  
patrick.balkanyi@ch.pwc.com  
+41 587 922 676

## United Kingdom

**Sallie Deysel**  
sallie.deysel@uk.pwc.com  
+44 20 7212 5845

## United States

**Bob Barrett**  
New York  
bob.barrett@us.pwc.com  
+1 703 283 7040











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