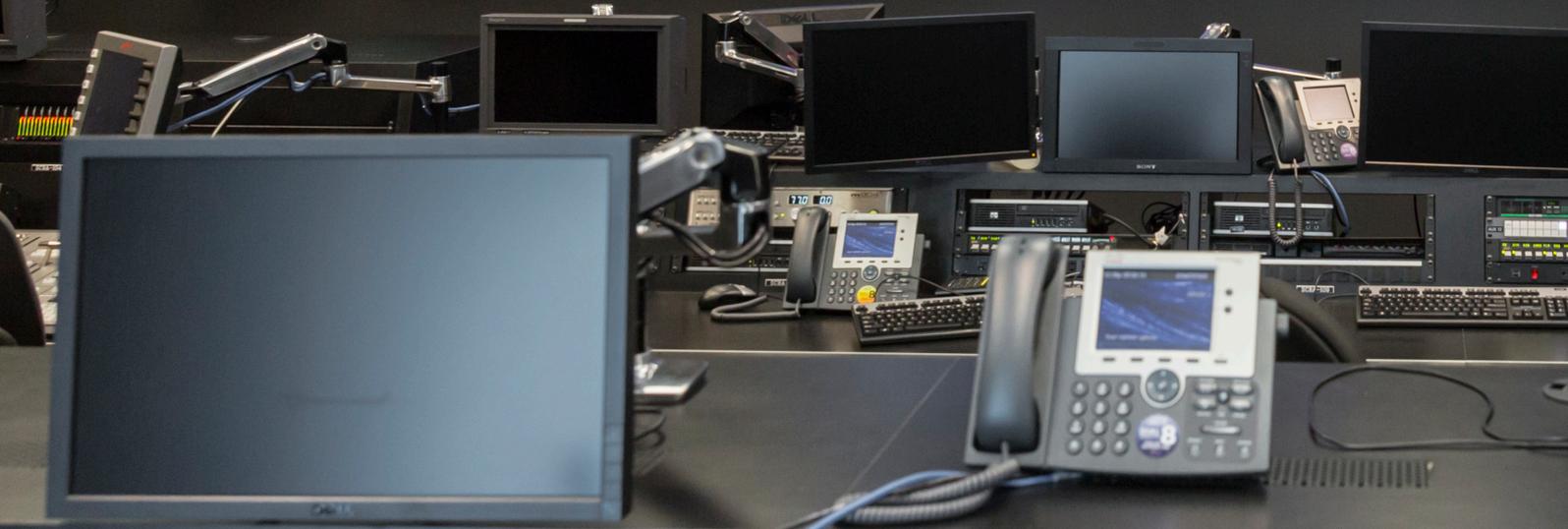


# *Making sense of a complex world*

## Film financing arrangements

*This paper explores some of  
the key considerations  
under IFRS for film  
financing arrangements.*





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## ***Introduction to MIAG***

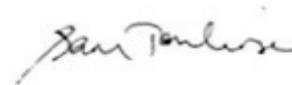
*Our Media Industry Accounting Group (MIAG) brings together our specialist media knowledge from across our worldwide network. Our aim is to help our clients by addressing and resolving emerging accounting issues that affect the entertainment and media sector.*

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**

<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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## Film financing

*The costs of developing and producing films (and, increasingly, television too) can be significant and the underlying financing structures to fund this investment can be very complex. Our 11th MIAG paper explores some of the key considerations under IFRS for film financing arrangements.*

PwC's *Global entertainment and media outlook 2015-2019* forecasts global film revenues to grow at 4.1% annually, reaching US\$105 billion in 2019. Strong growth will be seen in China and in Latin America, but even global leader the US, with one-third of market spend in 2014, will see above-average annual growth of 4.6%. But while Hollywood remains at the heart of film, a trend in the forecasts for many markets, from China to Western Europe, is the increased significance of local films in boosting country box office revenue. Significant investment is required to fund the films that drive this growth. The film industry – and, increasingly, television too – has a long history of encouraging outside investment in film development and production.

The accounting for such film financing arrangements presents challenges such as whether to consolidate a legal entity set up to channel the film funding received from an outside investor; whether to recognise the investor's

interest as non-controlling interest or debt; and how to account for complex contractual arrangements. Companies that are adept at navigating the intricate accounting and reporting practices can tell their story in a clear and compelling manner, building public trust in their performance with stakeholders such as investors, analysts, employees, suppliers, partners and audiences.

This paper explores some of the key considerations under IFRS in accounting for film financing arrangements. The examples in our paper are clearly not designed to be exhaustive; but they will hopefully provide food for thought for film companies when considering how to account for their own film financing arrangements. In addition, we note that the accounting for the actual film development and production costs is covered in a separate paper MIAG 10 *Film cost capitalisation*.

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

Best wishes



Sallie Deysel

PwC UK

PwC Media Industry Accounting Group



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Sallie Deysel

# Background

*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)*

*At its heart, the film industry is about great content – that is, developing and producing films to capture an audience that can be monetised through theatrical release or DVD sales and by licensing to distribution channels such as television or digital platforms. It is the timeless appeal of this content – of great films – that continues to drive film industry growth. PwC's Global entertainment and media outlook 2015-2019 forecasts global film revenues to grow at 4.1% annually, reaching US\$105 billion in 2019.*

Significant investment is required to fund the films that drive this growth. The film industry – and, increasingly, television too – has a long history of encouraging outside investment in film development and production. The increasing cost of blockbuster films and high-end scripted television, coupled with disruption to traditional distribution channels by entrants such as Netflix and Amazon Prime, has accelerated the trend of complex film financing, as have advantageous grant and tax regimes in certain territories. Investment structures often involve multiple contractual arrangements and sometimes the use of legal entities in which investors take equity stakes.

The accounting for such film financing arrangements can present at least three key challenges for the film company:

- If a separate funding entity is used, should it be consolidated?
- Should the investor's interest be classified as non-controlling interest or debt?

- If the funding is via contractual arrangements, has the film company entered into a service contract and if so when should it recognise revenue, other income or a contra-expense?

Transactions are often complex and can include features such as embedded derivatives or other put and call arrangements that need to be evaluated. Such complexities are outside the scope of this paper, but companies should ensure that they have appropriate expertise in these areas of accounting and valuation, or otherwise seek guidance from auditors and advisors.

Financial executives can provide valuable input in the early stages of developing such structures by highlighting the potential financial statement impacts. This will include impacts on the film company's key performance indicators such as EBIT, net debt, return on investment, and so on.

## **How are film financing arrangements often structured?**

Many film financing arrangements are characterised by a low level of involvement by the financial investor in the film production process and the financial and operating policies of the investee. These 'passive investor' arrangement can be structured using either legal entities or contractual arrangements.

In a legal entity structure, the film company and the financial investor fund their respective ownership percentages in the newly established company (e.g. see Figure 2 in Example 1). This allows the film company to reduce its initial capital outlay by transferring to the financial investor some of the risk and rewards of film under/over-performance.

Some film financing arrangements may not involve use of a legal entity but are instead structured as a contractual arrangement between the film company and investor. The mechanics of the overall cash flows are similar to arrangements involving legal entities. However, in a contractual arrangement, a film company might also sell a portion of the film's copyright to the investor, as considered in this paper in example 3.

### What are the key accounting considerations?

Figure 1 sets out some of the key accounting considerations under 'entity' and 'contractual' film financing structures. This paper then goes on to illustrate these considerations using some specific examples.

### Are there any tax implications?

Like all MIAG publications this paper is concerned primarily with accounting, which should be consistent across companies reporting under IFRS, rather than tax, which will vary with each country's local laws and tax regulations.

Many countries have specific tax legislation relating to film production, such as 'film tax credits' to encourage domestic and international film producers to shoot and edit in that country. In such cases, the accounting treatment adopted for film financing arrangements should in theory be tax

neutral, since tax is governed by specific rules. But given the complexity of both tax rules and many film financing arrangements, we would always recommend consulting with a local tax expert to determine the possible tax consequences of such arrangements and the accounting for them.

**Figure 1: Film financing structures – simplified guide to accounting considerations**

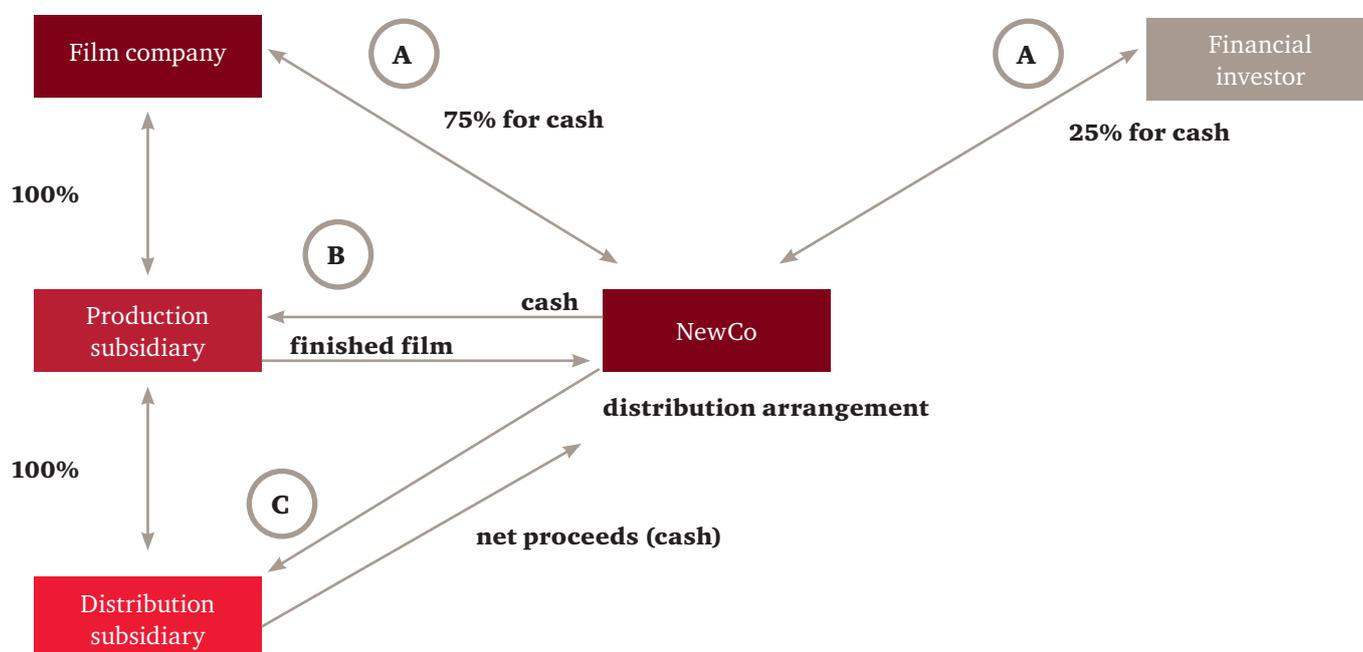


Note: This decision tree is illustrative and does not contemplate all possible film financing scenarios. The specific facts, circumstances, and structure must be analysed each time to determine an appropriate accounting treatment.

## Example 1: Should a funding vehicle be consolidated?

Figure 2 below illustrates a typical film financing arrangement using a legal entity structure.

Figure 2: Film financing arrangement – typical legal entity structure



A – Film company and financial investor fund their respective ownership percentages in NewCo through cash (capital investment)

B – NewCo acquires a completed film at cost from a wholly owned production subsidiary of the film company

C – Wholly owned distribution subsidiary of the film company has an agreement with NewCo to distribute the film; net proceeds are returned to NewCo: revenue less distribution fee, marketing, and participations and residuals (i.e. shares of results paid to talent)

### Consolidating NewCo – what is the relevant IFRS guidance?

Figure 2 illustrates a typical scenario. If the film company and financial investor held the same class of ordinary shares in NewCo, each with proportionate voting and dividend rights, then a 75% shareholding would be expected to give the film company control. The film

company would consolidate NewCo and the financial investor's stake would be classified as a non-controlling interest.

However, in many cases the key rights of each investor are set out in contractual arrangements rather than in the shareholders' agreement and as such, NewCo will be a 'structured entity'

defined in IFRS 12 *Disclosure of interests in other entities* as 'an entity that has been designed so that voting or similar rights are not the dominant factor in deciding who controls the entity, such as when any voting rights relate to administrative tasks only and the relevant activities are directed by means of contractual arrangements'.



The film company will control (and therefore consolidate) NewCo if it has power over its relevant activities and exposure to the variable returns that it creates. IFRS 10 sets out a framework of items to consider in making this assessment:

- Purpose and design of the investee;
- What the relevant activities are;
- How decisions about those relevant activities are made;
- Whether the rights of the investor give it the current ability to direct the relevant activities;
- Whether the investor is exposed, or has rights, to variable returns from the investee; and
- Whether the investor has the ability to use its power over the investee to affect the amount of the investor's returns.

So the film company might also control the NewCo by virtue of the production and distribution arrangements, which will typically ensure that the 'relevant activities' are directed by the film company. In many cases, the financial investor does not have any right, direct or indirect, to make decisions about any activity that may directly impact the success and returns from NewCo.

### **Scenario**

Film company FC enters into an arrangement with investor I. FC and I incorporate NewCo, which issues 60% of its share capital to I and 40% to FC. The funding will be provided in that ratio and proceeds will be distributed similarly. NewCo will not have any activities or employees of its own as it solely enters into outsourcing arrangements. FC leads the drafting of the contract to be signed by FC, I and NewCo.

FC and I can appoint directors in proportion to their shareholding and Board decisions are made by majority decision. NewCo is constituted to fund, develop and commercialise Film X, to which it will own all rights. The project plan and budget are agreed in advance.

NewCo is required to enter into contracts with FC's wholly owned subsidiaries, production company P and distribution company D. All production decisions (e.g. casting) are devolved to FC, as are all distribution decisions (e.g. where to focus advertising spend). These contracts are priced at arm's-length.

The agreement says the NewCo board is required to approve certain key decisions. However, approval cannot be withheld unless there is a material change to the agreed plan and budget e.g. the original idea for the film is scrapped or the budget is to be increased by > 25%.

### How does film company FC account for its 40% shareholding?

NewCo is an IFRS 10 structured entity because it is not controlled by voting rights but by the contractual arrangements. While I's 60% shareholding gives it the ability to control the board of directors, this has no substantive powers.

FC and I jointly set up NewCo, the purpose of which is to develop and commercialise film X. FC had the opportunity and expertise at inception to lead the drafting of the project plan

and budget, from which the board does not have the power to deviate. In addition, the key contracts and decisions over relevant activities (production and commercialisation) are devolved to FC.

FC is exposed to the variable returns of NewCo since it is entitled to receive 40% of any profits that the film generates, profits that will be affected by FC's power to make decisions over relevant activities. FC therefore controls NewCo.

So in this case FC consolidates NewCo since power is conferred by the contracts and not the equity stake.

The classification of I's 60% stake as non-controlling interest or liability would require careful consideration by FC, based on the contractual clauses in NewCo's shareholders' agreement that set out the ability or obligation to distribute profits. (Refer to example 2 below for an example.)

Assuming classification of I as non-controlling interest, FC's income statement might look like this:

Investor I pays \$60m for a 60% interest in NewCo, which uses P to produce a film costing €83m which generates revenues of €250m over five years:

| FC presents I as non-controlling interest/€m   | Year 1 | Year 2 | Year 3 | Year 4 | Year 5 |
|--|--------|--------|--------|--------|--------|
| Revenue (theatre, DVDs, licensing, etc.)       | 75.0   | 75.0   | 50.0   | 25.0   | 25.0   |
| Distribution costs                             | (7.5)  | (7.5)  | (5.0)  | (2.5)  | (2.5)  |
| Marketing costs                                | (50.0) | (25.0) | (10.0) | (10.0) | (10.0) |
| Amortisation of film costs (€83m over 5 years) | (25.0) | (25.0) | (16.7) | (8.3)  | (8.3)  |
| Operating (loss)/income                        | (7.5)  | 17.5   | 18.3   | 4.2    | 4.2    |
| Non-controlling interest (I's 60%)             | 4.5    | (10.5) | (11.0) | (2.5)  | (2.5)  |
| FC's net (loss)/income                         | (3.0)  | 7.0    | 7.3    | 1.7    | 1.7    |

### What might change the assessment?

FC might not control NewCo if its board's decision making powers were broader, e.g. if the NewCo board could decide to use another production or distribution company, or if key production and commercialisation decision required majority board approval, or if the board's veto rights were expanded to cover more substantive decisions.

Or, if FC's financial interest was less than 20% (including all other interests), it might conclude that it does not have sufficient exposure to variable returns and, as such, is acting as an agent for I.

If FC does not have control, it still needs to assess whether or not it has significant influence over NewCo i.e. whether it is an associate requiring equity accounting. Since it has a shareholding of more than 20% there is a rebuttable presumption that it does. If FC were to conclude that it neither controls nor has significant influence over NewCo, it would account for NewCo as a financial instrument (equity investment).

### What else might be tricky?

In some arrangements, the financial investor may have a 'put right' or the film company may have a 'call right' on the equity shares held by the financial investor. Such repurchase features can have varying and complex implications and should be considered carefully.



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## **Example 2: How is the investor's interest classified?**

In example 1 above, the film company FC will need to carefully assess whether the financial investor's interest is more appropriately classified as non-controlling interest or debt.

The critical factor in this assessment by the film company is whether NewCo has an unavoidable contractual obligation to make payments to I (in which case the investor's interest is debt) or whether it has discretion over making payments (in which case, the financial investor is most likely a non-controlling interest)

The specific facts and circumstances would need to be considered in each case to determine whether the film company should classify the financial investor's interest as non-controlling interest or debt.

### **How is film financing debt presented in the income statement?**

If the film company determines that the investor's interest should be classified as debt, it must then decide if the investor's share of the film's results should be presented as either interest (because the

investor represents a source of capital) or as an operating expense (because the use of such investors is a cost of making and distributing the film). In either case, the amount to be recorded would be the expected return to the investor based on the film's forecast results and an effective interest model.

Specific facts and circumstances will need to be carefully considered to determine which of the two options – interest expense or operating cost – most accurately reflects the underlying economics of the transactions. If this is a recurring scenario for a film company, the income statement presentation of such amounts is an accounting policy choice that should be disclosed and consistently applied.

### **What if the film underperforms?**

As described above, the amount recorded in the income statement is estimated based on the film's forecast results and an effective interest model, such that it accretes up to the actual amount due to be repaid.

If it becomes clear the film's performance will be disappointing, the debt liability might need to be decreted between one period and the next. The corresponding income statement credit will be reversed against the same income statement line item as the original cost i.e. as either interest income or an offset against operating expenses.

If a film's anticipated performance becomes so bad that no amounts are expected to be repaid to the investor, the entire debt obligation is written off as an income statement credit. In such a scenario, the film company should also carefully assess the film asset for potential impairment. The conduct of such impairment reviews is covered in a separate paper, *MIAG 10 Film cost capitalisation*.



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## Example 3: Contractual arrangements

### **For contractual arrangement involving an investor, what are the accounting considerations?**

In many contractual financing arrangements, the investor pays a fixed amount in exchange for a variable return, based on how a film performs.

For contractual arrangements the key consideration is whether or not the film company has a contractual liability to repay any funding (albeit, those repayments might only be made if the film is successful). This is more likely to be the case where the investor is a financial organisation rather than another media entity.

However, it might be the case that the substance of a transaction is of a sale of an interest that might be accounted for under IAS 18 *Revenue* (or IFRS 15 in the future). This might be more likely if the counterparty is another media entity.

With a non-financial investor, it is more likely that the substance might be of a collaborative agreement rather than a financing. These types of arrangements tend to require significant judgement to establish the best representation of substance and an appropriate income attribution model.

### **Scenario**

Film company FC and investor I agree to collaborate on the production and commercialisation of a film. No new legal entity is created. Investor I commits up to €50m of funding and receives a percentage of gross cinema receipts for two years after the film is first released. If the film is unsuccessful, investor I might receive back significantly less than it has advanced; conversely if the film is highly successful then investor I might receive back significantly more than its original investment.

Investor I has agreed the project plan and budget but does not participate in any of the ongoing production or commercialisation decisions. Film company FC must make best efforts to complete and market the film within budget.

### **How does film company FC account for this arrangement?**

The arrangement gives rise to a financial liability in the scope of IAS 32 *Financial instruments: Presentation*. It is not an executory contract as investor I does not have performance obligations. The amount and timing of payment is contingent on the occurrence of future events that are outside the direct control of either party. The cash received is recorded as a liability. The liability is subsequently remeasured at each reporting date under IAS 39 *Financial instruments: recognition and measurement*.

### **Do presale arrangements with other distributors and producers represent film financing arrangements with financial investors?**

In a presale arrangement, a film company licenses the rights for certain markets or territories to another entity that will exploit those rights in the licensed market or territory in exchange for a fixed up-front payment. In many cases, these arrangements should be accounted for under IAS 18 *Revenue* as deferred revenue pending actual delivery of the film. In some cases, particularly if there is collaboration or cost-sharing, the up-front payment might also be treated as a deduction in the film cost.

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## Conclusion

The costs of developing and producing films can be significant and the underlying financing structures to fund this investment can be very complex. Companies that are adept at navigating the intricate accounting and reporting practices can tell their story in a clear and compelling manner, building public trust in their performance with stakeholders such as investors, analysts, employees, suppliers, partners and audiences.

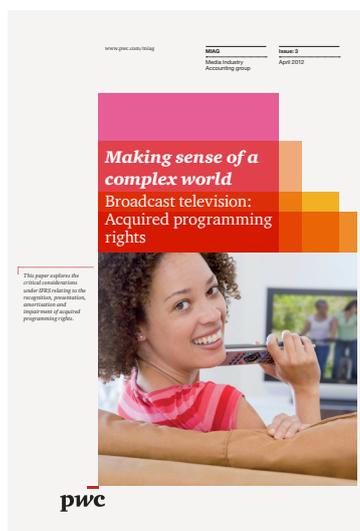
This paper has explored some of the key considerations under IFRS in accounting for film financing arrangements. The examples in our paper are clearly not designed to be exhaustive; but they will hopefully provide food for thought for film companies when considering how to account for their own film financing arrangements.

The answers 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.




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### MIAG Issue: 6

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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.




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### MIAG Issue: 7

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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.




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### MIAG Issue: 8

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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.




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### MIAG Issue: 9

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Media investments in technology companies

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




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### MIAG Issue: 10

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Film cost capitalisation, amortisation and impairment.

This paper explores some of the key considerations under IFRS for film cost capitalisation, amortisation and impairment.

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