When Ethel Merman belted out the famous refrain, “There’s no business like show business,” she wasn’t singing about the business of accounting in Hollywood. But she probably should have been. That’s because the accounting rules in Hollywood are like no other accounting rules in the world. According to critics, the rules make it difficult—if not impossible—for investors to determine the real financial condition of movie studios and their products.

Under existing rules, for example, studios can treat advertising costs as an asset (an economic resource) instead of an expense. This practice enables studios to inflate both assets and short-term profits. Studios can also choose to add to a film’s costs millions in studio “overhead” charges and millions more in start-up costs of unrelated failed projects. Like advertising costs, these costs can be treated as assets and depreciated over a given number of years from the studio’s balance sheet.

The following illustration (adapted from an article in Business Week) demonstrates how Hollywood’s accounting system works. Using the unique system suggested above, studios manipulate balance sheet entries to paint a rosy financial picture that leaves investors in the dark about expenses and profits.

1. Let’s say that Bigwig Pictures makes Violent Death, spending $50 million to acquire the story, hire actors, and film the movie.

2. The studio spends another $40 million to advertise and release Violent Death. This money is added to the movie’s reported cost. This cost, moreover, climbs when Bigwig adds another $10 million to cover expenses from other films that were never released—plus costs related to everything from Bigwig salaries to paper clips. The total cost of Violent Death now stands at $100 million.

3. Now let’s thicken the plot (albeit in a perfectly plausible way). Let’s say that Bigwig is facing a depressed stock price and investor pressure to raise the value of shares by improving its performance. Bigwig management thus decides to project that Violent Death will bring in $1 billion over the next 20 years. This revenue will come not only from the film’s theatrical release, but from its release to home video, to pay TV and regular TV, and to laser disks, not to mention licensing in foreign markets. Because the studio states that Violent Death will be making money for 20 years, Bigwig can take the full two decades to subtract the film’s bloated $100 million cost from its books.

4. Let’s now say that Violent Death does well, taking in $200 million in box office and video revenue in the first year of its release. After deducting $20 million—that year’s share of expenses—Bigwig shows an immediate profit of $180 million. Naturally, the studio’s earnings—and stock price—jump. What about the remaining $80 million that the studio spent on the film? That sum remains on Bigwig’s books for years—as an asset, not a liability.

Studios argue that this system makes sense. Because a movie has value that lasts long beyond the year in which it is made, it is reasonable to estimate profit margins over the lifetime of a movie. Profits, meanwhile, can be reported as such as soon as box office dollars begin rolling in. Why is this bookkeeping mechanism so important in the movie-making business? Studio executives point out that even a runaway hit has virtually no chance of making money during its first distribution year. In most cases, first-year box office receipts cannot cover the average $65 million cost required to make and market a Hollywood film. (For one thing, only 40 percent of the box office gross goes to the studio, with the remaining 60 percent going to theatres.)

However, this unique accounting system makes it extremely difficult for people with a so-called “net profit” interest in a movie to make any money from
that interest. *Net profits* are the revenues that big studios agree to distribute among writers, actors, and others *after expenses, including salaries and distribution fees, have been paid.* Net profit arrangements are typically negotiated as part of individual contracts. Interestingly, however, only 5 to 20 percent of all films pay any net profits. "For most films," charges Philip Hacker, a consultant to plaintiffs in lawsuits against studios, "net profit participants don't receive anything." Thus, even though the blockbuster *Forrest Gump* grossed approximately $650 million, it has paid no money to anyone with a net profit interest in the film. So, too, with such successful releases as *JFK, Coming to America,* and *Batman.*

The estate of Jim Garrison, the late New Orleans prosecutor whose book was the basis for the 1991 Warner Brothers movie *JFK,* has initiated a federal class-action suit over the net profit issue. Joining in the suit are thousands of people who signed net profits contracts with movie studios since 1988. All the studios involved, including Disney, Universal, Warner Brothers, Twentieth Century Fox, Paramount, Columbia-TriStar, and MGM-UA, use the same accounting practices. If successful, the Garrison *JFK* suit could force payments of more than $1 billion and redefine Hollywood’s approach to accounting.

A task force reporting to the Financial Accounting Standard Board (FASB) is now taking a close look at the way Hollywood studios determine their balance sheets. Its goal is to reform many of the unorthodox practices that give investors a distorted view of studio finances. The toughest practice to change involves the capitalizing of advertising costs (treating them as assets rather than expenses). The FASB, which determines the accounting rules by which U.S. companies must generally live, objects to this practice. The movie industry, however, is determined to maintain the status quo. “Most of us think that how we do the accounting makes sense,” says Peter Cyffka, a task

force member and the senior vice-president of finance at Twentieth Century Fox Film Corp.

Even if the task force succeeds in changing Hollywood’s accounting practices, its reforms will not affect the disbursement of net profits to those who help create movies. Any change in the studios’ net profit system must come from the studios themselves in the process of contracting with creative artists. Dreamworks, the production company founded by Steven Spielberg, Jeffrey Katzenberg, and David Geffen, was the first studio to initiate a change. Screenwriters, animators, and other artists working for Dreamworks now sign contracts guaranteeing that they will share in the success of the films they help create.

**CASE QUESTIONS**

1. In your opinion, are Hollywood’s current accounting practices fair to investors?
2. What changes would you suggest to make Hollywood’s accounting system fair to both studios and investors?
3. Why is the contractual agreement to share in a film’s net profits usually an empty agreement?
4. If you were a screenwriter, what accounting-related questions would you ask before agreeing to a movie deal?
5. Why is the Financial Accounting Standards Board involved in reforming Hollywood’s accounting practices?

[Twentieth Century Fox Film Corp.](www.box.com/white.html)

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