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REEL WORLD ACCOUNTING

Making the CFO a player in Hollywood.

By Lee Berton & Roy Harris

At the Academy Awards ceremony a year ago, Arnold Schwarzenegger tossed Titanic an accolade that may have dwarfed even the best-picture honor. "Some say its box office may grow so large," he intoned in the intimidating accent Hollywood has made globally recognizable, "that it will actually show a profit that no accountant can hide."

Finance and accounting within America's entertainment industry have almost always inspired mirth, or at least wonderment. After a court confirmed in 1992 that Art Buchwald deserved a net-profit share in the movie Coming to America, a huge hit that grossed $140 million, Paramount Pictures declared that the film had been written off as unprofitable for contract purposes. This despite an estimated cost of just $40 million to make the picture. (Industry contract-accounting allows studios to apply against revenues a range of charges seemingly unrelated to a picture.)

For Titanic itself, the joke was that its reputed 100 percent overrun of an original $110 million budget seemed a financial iceberg dead ahead--until adoring audiences lined up to buy a phenomenal $3.2 billion worth of tickets, videos, and soundtracks worldwide, and make legends out of "risk-sharing" partners Paramount and 20th Century Fox.

And, as always, any financial foibles in filmmaking command visibility far beyond the 0.38 percent of America's gross domestic product that entertainment represents, or its 3 percent of service-industry exports. How quickly, for example, do big-budget movies like Heaven's Gate and Ishtar become household names--for the wrong reasons--after falling monumentally short of box-office expectations.

$3 Billion in Write-Downs

Lately, the business has drawn the attention of accounting rulemakers intent on making Hollywood get serious about how it keeps its books.
The Accounting Standards Executive Committee (AcSec) of the 350,000-member American Institute of Certified Public Accountants (AICPA) last year drafted tighter new rules, which studios have had under review. The changes, which could take effect next year, are meant to prevent extremely liberal financial interpretations like those applied in the late 1980s by the now-defunct Cannon Films and Orion Pictures, among others. Some of their abuses involved estimating revenues far too aggressively, and capitalizing costs against the bloated estimates in an attempt to paint an unrealistically rosy picture of how the companies were doing.

Controls on cost amortization and revenue projections would be installed under the AcSec proposals, along with other restrictions on studios' ability to manage earnings. For example, the cost of abandoned scripts and projects—often a hefty consideration for deal-crazy studio executives—would have to be written off directly to the profit-and-loss statement, not amortized among future films as part of the overhead pool, as is commonly done now. And movies would be considered long-term assets, not inventories, meaning that money-losing films would be written down to net present value rather than net realizable value. Under current accounting, revenue estimates need not be discounted, so cost write-downs could be greater in the future, and interest income would be earned as the films pay off.

AcSec motion-pictures task force member David Londoner, a managing director and financial analyst at Schroder & Co., estimates that the changes will create one-time, noncash write-downs for movie companies exceeding $3 billion. Londoner, who calculated write-down amounts for each studio last fall, believes the rules will be especially important in helping studios face some tough new realities of movie making.

"Too many films are being released at too high an average cost, at a time when the drivers of recent business—foreign television and worldwide home video—are slowing their growth," he says. Capitalized film costs on the balance sheets of the six reporting industry members last year, including TV production, swelled nearly 20 percent, he figures, to a total of $17.5 billion. "And this doesn't include off-balance-sheet financing and commitments to purchase films when completed by independent producers." Londoner says cutbacks in production and cost efficiencies are needed for the industry to improve its profitability.

"Until recently, it's fair to say there was a lack of discipline at a lot of studios," he says. "One of the problems is that you budget a film at $100 million, then get halfway there and find you're at $80 million already. What do you do? You can't close it down. But everybody knows that at that level, the risk-reward equation goes negative." Helping avoid such scenarios, Londoner believes, is one important role for studio finance executives.
Setting the Scene
The accounting overhaul promises to help boost Hollywood's financial image. Still, some observers say the industry is already benefiting from the recruitment of better finance people, with a bit more clout reining in movie costs. As big outfits like The Walt Disney Co. and smaller ones like New Line Cinema Corp. earn reputations for reducing the risk on pictures, they can serve as finance incubators in the high-turnover industry. Meanwhile, some cost-conscious producers with great track records, such as Steven Spielberg, are giving fiscal management a good name for a change. And while greenlighting an expensive long shot may be as tempting as ever for studio chiefs with near-dictatorial control--such "creative" decisions are far outside the CFO's realm--the latest crop of powerful parent companies seems at least more willing to let finance people flash yellow lights during the budgeting and production processes.

Not surprisingly, the tendency is greatest at studios that seem down on their luck.

"The CFO helps you become aware early if the cost of a $50 million picture is swelling toward $70 million," says Jerry York, board member of investor Kirk Kerkorian's Metro-Goldwyn-Mayer Inc., and vice chairman of Kerkorian's Tracinda Corp. "While CFOs in this industry are usually not involved with high-level strategy, they are having a lot more attention paid to their advice." In recent months, under CFO Dan Taylor, "we've had a pretty good track record," York says of MGM. And going further back, "The last three years we're definitely within 5 percent of our budget for pictures." Some of that success involves finance personnel monitoring the production process--in some cases, right down to shooting on location, where finance gets involved with making day-to-day cost decisions.

The very presence of Jerry York in the industry should inspire some confidence. One of the most visible finance executives of the past decade, he played critical roles in both IBM Corp.'s and Chrysler Corp.'s dramatic turnarounds. But MGM's new owners are treading carefully because of the company's delicate condition. MGM, which itself was run into the ground earlier in the decade by Italian financier Giancarlo Parretti, until Kerkorian bought it from its banker-owners three years ago, is still a shadow of its former presence. And only The Man in the Iron Mask, among its 12 films last year, was one of the top 40 box-office performers.

Another studio trying to nurse itself back to health, and using finance in a key role, is Universal Studios Inc. As at most film companies, much of the top finance job at Universal has evolved into "hand-to-hand combat" over new sources of capital for film production, says Brian Mulligan, an
eight-year Universal veteran who recently left a corporate-development and strategic-planning post to become Universal's executive vice president, operations and finance. With the once-deep pool of Asian capital drying up, Mulligan has been working to win financing from Europe and other sources.

**Back Into Action**

But setting the right budget for a movie and then trying to hold costs to budgeted levels is never far from his mind. "Our finance people spend more time these days helping to estimate what a film can do--starting with domestic box office. [The analysis includes] such things as looking at the past record of directors, actors, and movie genres, plus looking at ancillary markets," he says. "They cost out the movie and help figure where it will be shot and how much money can be saved along the way."

Mulligan meets weekly with studio executives about "how our films are tracking," and whether spending is running over budget.

In the system at Universal, which is controlled by Montreal-based Joseph E. Seagram & Sons Inc., Mulligan reports to Ron Meyer, a former "superagent" who is now president and chief operating officer. Studio CFO Bahman Naraghi reports both to Mulligan and to motion-picture president Chris McGurk, once a Disney executive and known for cost-cutting efforts there.

Costs are currently under pressure at Universal because of Meyer's drive in recent years to sign big-name, big-contract talent, a movement symbolized several years ago by a three-picture deal with Sylvester Stallone reported to be worth $60 million. Meyer said at the time that the contract signaled "that Universal was now in the big-star action business."

It has not been a great business so far; Stallone's first picture flopped domestically. And 1998 overall was "a disappointing year for films," says Mulligan, a former Price Waterhouse entertainment specialist who now has finance reporting to him not only from the film business, but also from Universal's TV and theme-park operations. (Among its two unexpected letdowns last year: *Meet Joe Black* and *Babe: Pig in the City.*)

If Universal and other studios don't worry too much about skyrocketing star salaries, it reflects the knowledge that casting big-name talent is one of the few handles the industry has on securing an "opening"--the make-or-break first weekend, when drawing crowds and creating buzz are vital.

"Smaller films can open with word of mouth, but for the majors, stars are critical. People go because the star indicates the quality of the film," Mulligan says. Further, distributors often insist on star power when they decide the number of screens to assign to a new release. And even if things don't go well in the United States, stars can help assure a successful foreign box office. For example, that first Stallone picture in
the three-film deal, *Daylight*, made a strong showing in international release.

Mulligan won't comment on specific Universal star deals. But others in the industry note that the studio is working to contain talent costs--for instance, by reviewing terms with Stallone, and by signing Jim Carrey, a $20 million-a-picture star in comedies, to a substantially lower payout to play a dramatic role he badly wanted, as the late "Taxi" TV star Andy Kaufman, in the upcoming *Man on the Moon*. Another trend in lower-cost casting involves placing fewer high-priced stars on the same bill. In one such case several years ago, Universal cast the high-priced Tom Cruise in *Jerry Maguire*, but teamed him with then-relative unknowns Renee Zellweger and Cuba Gooding Jr.

**Smart and Smarter**

At Disney, says John Giesecke, who was vice president of corporate controllership there until last year, finance executives sometimes step into Hollywood's almost-sacred cost arena: contract negotiations with stars and directors. Indeed, "one of the jobs of the CFO was to help the studio executives, behind the scenes, obtain the best possible deal with the talent," he says. Disney has led the way in striking deals in which some immediate pay is replaced by remuneration "in such other venues as merchandising and theme parks. That's where finance can get involved in how a contract is structured."

The finance department at New Line Cinema, which has a great track record for profitable filmmaking, tries to set a tone of cost awareness. "We do a P&L for every film before it gets greenlit," says CFO Stephen Abramson, "and as the contracts get written, we're working within that context." Throughout most of its 32 years, New Line has concentrated on such lower-budget pictures as the *Nightmare on Elm Street* and *Teenage Mutant Ninja Turtles* series.

Lately, it has moved up a notch to the middle-budget films other studios were abandoning. Still, New Line continues to do well with pictures like *Rush Hour*, *The Wedding Singer*, and *Wag the Dog*.

But New Line is wary of saying no when its creative people seek more money for a film. The issue to be decided is whether the cost can be recovered at the box office. In one such decision, after Jim Carrey had turned *The Mask* into a hit for New Line, the studio had to decide whether to give a huge raise to the new star to make its next comedy, *Dumb and Dumber*, Abramson recalls. "Now, the amount of money involved looks small," he says, both because Carrey has become a $20 million man and because *Dumb and Dumber* hit pay dirt for New Line. "But at the time, it was a very difficult choice."
At New Line, now a subsidiary of Time Warner Inc., the final call on whether to incur additional costs is a creative decision, which Abramson maintains is how it must be in Hollywood. "You have to let creative work its magic--within a business context," he says. "The worst thing you can do is say, 'I don't want to spend extra money to reshoot the final scene'--if the scene doesn't work for the picture."

**Accounting for Accounting**

When it comes to the new AcSec accounting standards that studios may soon be using to amortize their costs, many studio finance people don't expect them to have much impact on the way the industry does business. "Over time, there's only one place the debits and credits are going to go, and it's going to equalize," says Universal's Mulligan. "We're still going to be making movies."

But Londoner predicts the new rules will force studios to make some changes--perhaps by asking for bigger shares of revenues from TV syndication, videos, and foreign deals, for example. "They will have to completely revamp their accounting systems to segregate certain costs, and will have to restate many of their revenue reports," he adds. Software will have to be designed "to look at each film and take portions of unamortized costs that relate to ads and prints, and then amortize them much sooner." Those costs are included in Londoner's write-down estimates for the industry and for individual companies.

Some Universal executives say that Londoner's estimate of a $110 million one-time write-down for their company is probably in the ballpark. But others are dubious about his numbers, or claim it's too early to estimate. An MGM executive says the estimate of a $150 million one-time write-down by MGM is "definitely on the high side." And a public relations executive at Paramount Pictures parent Viacom Inc. is much harsher in questioning Londoner's estimate of a $400 million Paramount write-down. "This analyst really doesn't know how our movie business will shake out in the future," the Viacom executive says. "He's just estimating from the top of his head, and has no concept of the underlying health of our business."

Sony Corp. recently became the only filmmaker to publicly estimate its own potential write-down. Its figure, $900 million, was twice what Londoner included in his table, leading the analyst to think that some of his other numbers also are low. Sony's accounting has been at the root of some reporting issues in recent years. The Japanese company, which owns Columbia/TriStar Pictures, last August paid a $1 million fine to settle Securities and Exchange Commission charges that it downplayed movie-making and merger-related losses. In settling the suit, Sony neither admitted nor denied the accusations. Sony had already paid $12.5 million to settle a shareholder class-action suit over other alleged financial-
reporting irregularities.

Rogues & Loopholes

It was in 1981 that the industry had its last accounting overhaul, with FASB Standard 53. "That rule attempted to match costs with revenues, but remember that there were then no home videos, no cable channels, and no pay-per-view movies on TV," notes John Giesecke, who since leaving Disney has become CFO of Realtor.com, a closely held Internet real-estate lister. "Also, the international market was relatively small, and the entire business has moved from movies in theatres and on TV to multiple forms of distribution."

While most studios did their best to estimate revenues properly under the 1981 standard, says Londoner, some "smaller, rogue movie-makers" took advantage of loopholes that allow extreme liberties in estimating and amortizing expenses. A studio spending $10 million to produce a movie, and estimating future revenues at $20 million, Londoner notes, deducts from profits 50 cents of each dollar spent over the three-to-six-year life of the movie. But by hiking estimates of future revenues to $25 million, a company expenses only 40 cents of each dollar. When the lower, $20 million revenue amount is actually realized, the extra shortfall must be expensed right away. Under the AcSec proposal, the estimating process becomes tighter.

Universal's Mulligan and MGM's York maintain there are grounds for spreading advertising expenses over the later video and syndication revenues, which often continue for seven years for an expensive movie. "More than $25 of every $50 we spend for a movie is in advertising," Mulligan says, "so you can see what a big burden this puts on financial results if we're required to expense these ad dollars immediately." Adds York, the initial movie-theater run for, say, a $50 million film with $40 million in marketing costs often can't come close to recovering that total investment. "We'd be lucky if we regain half the amount," he says. "The rest of the sales and profits would come from home videos, TV showings, and moving into international markets."

In the case of revenue recognition, Hollywood's proposed rule is consistent with broader efforts to tighten accounting in a range of businesses. SEC chairman Arthur Levitt has called for "immediate and coordinated action" among accounting rule makers--including the SEC, FASB, and AcSec--to improve the transparency of financial statements in general. He has criticized "accounting hocus-pocus" designed to boost earnings. And he has said the SEC staff will determine whether the recently published standards AcSec set for the software industry can be applied to other service companies.

"We've A Bomb on Our Hands"
Rapid escalation of movie costs in recent years—to an average close to $60 million a film, roughly half in marketing—has been spurring creative bookkeeping, say some industry critics. Abraham Ravid, a professor of finance and economics at Rutgers University in Newark, New Jersey, warns the investing public "not to trust Hollywood accounting, because much of it is as make-believe as the movies"—and allows studios "to move money around to serve their purposes." His 41-page study of film-industry profitability is being published in the *Journal of Business* this year. Of the accounting changes, Ravid says that "investors should be happy that Hollywood is being brought into line with most other industries."

Any extended increase in the power of finance executives, though, will require some major cultural transformation, especially in how accounting people relate to the powerful marketing side of Hollywood, and vice versa.

"The guys who have to do the estimates are the marketing people, and they don't want to tell you they've got a bomb on their hands," says Susan Beazley, a former Ernst & Young partner who specialized in entertainment clients. "The accounting people often will follow along, instead of bringing to the business the healthy skepticism they should. They are much stronger today, but they've never been the studio's strong arm."

Of course, as long as there's a *Titanic*, there will always be an excuse to suspend skepticism.

"Some people in Hollywood," says Londoner with a laugh, "think *Titanic* may have been the worst thing to ever happen to the industry."

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**Titanic, Indeed**

Studios generally don't disclose cost and revenue figures for individual pictures, leaving estimates to industry groups and the entertainment media. But Titanic's incredible success has created an unusual flurry of reports about what Paramount and Fox paid to make and market the epic.

**Costs:**

- Original budget: $110 million
- Actual production cost: $200 million
- Marketing and other costs: $150 million

**TOTAL: $350 MILLION**

**BREAK-EVEN POINT: $400 MILLION**
(after splitting box-office with cinemas)

**Revenues:**

- "Opening" (first-weekend box office): $27 million
- Total domestic: $600 million
- Foreign box office: $1.2 billion
- Domestic video sales: $500 million
- Foreign video: $495 million
- Soundtrack, domestic and foreign: $402 million
- Broadcast TV rights: $30 million

**TOTAL (to date): $3.23 BILLION**


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**Rewriting the Financial Script**

**Major changes in the proposed AcSec rule on motion-picture accounting**

1. Exploitation costs (prints and advertising) would no longer be capitalized and amortized against revenues for the entire film. They would instead be amortized against revenues from the applicable market (e.g., domestic theatrical, foreign by country), and fully amortized over a maximum of three months. Costs other than theatrical would be expensed as incurred. Since Disney and Universal already amortize costs under the proposed AcSec method, for example, their one-time write-downs would be less than the other companies'.

2. Total-revenue estimates from a film, against which production costs are amortized, would be based on collections over 10 years, compared with the current practice of spreading costs over revenues for up to 20 years. Prohibited from inclusion in such revenues would be profits from promotional items like toys.

3. Abandoned projects would be written off directly to the P&L statement and not to the overhead pool, which is amortized over several years among future films.
4. Films would be defined as long-term assets, not inventories, meaning their worth would be set using future revenue estimates discounted to present or fair-market value. Under current accounting rules, revenue estimates are not discounted. Thus, cost write-downs would be greater in the future, and interest income would be earned as these films pay off.

5. Syndication revenues would be recognized over the life of the contract, rather than at the first available pay date. -- L.B.