5
Financial accounting in movies and television

Happy trails to you, until we meet again. – Dale Evans[1]

This song is perhaps more appropriately sung by Hollywood accountants than by cowboys. But, as this chapter indicates, the issues that arise in accounting for motion picture and ancillary-market income are more often related to differing viewpoints and interpretations than to intended deceits.

5.1 Dollars and sense

Contract clout

No major actor, director, writer, or other participant in an entertainment project makes a deal without receiving some kind of high-powered help beforehand, be it from an agent, personal manager, lawyer, accountant, or tax expert. In some cases, platoons of advisors are consulted; in others, only one person or a few individuals may perform all functions. Thus, an image of naive, impressionable artists negotiating out of their league with large, powerful, and knowledgeable producer or distributor organizations is most often not accurate.

As in all loosely structured private-market negotiations, bargaining power (in the industry's jargon, "clout") is the only thing that matters. A new, unknown talent who happens on the scene will have little if any clout with anyone. Top stars, by definition, have enough clout to command the attention of just about everyone. In Hollywood as in other businesses, it has been observed, "you don't get what's fair; you get what you're able to negotiate."[2]

By hiring people with an already proven record of being able to attract large audiences, a producer can gain considerable financial advantage. It may be less risky to pay a star $2 million than to pay an unknown $100,000; the presence of the star may easily increase the value of the property by several times that $2 million salary through increased sales in theatrical and other markets, whereas the unknown may contribute nothing from the standpoint of return on investment. The star, in effect, becomes the product, the franchise, and the brand. Clout, it seems, is best measured on a logarithmic scale.[3]

Contracts are usually initially agreed on in outline (a *deal memo*, *letter of intent*, or *term sheet*), with the innumerable details presumably left for later structuring by professionals representing both sides. However, final contracts normally are complex documents and, if imprecisely drawn, are open to different interpretations and potential disputes. It is, of course, in the nature of this industry to attract a disproportionate amount of publicity when such disputes arise.

Orchestrating the numbers

Accounting principles provide a framework in which the financial operating performance of a business can be observed and compared with the performance of other businesses. But it was not until 1973 that the American Institute of Certified Public Accountants (AICPA) published a guide, *Accounting for Motion Picture Films*, that pragmatically resolved many (but far from all) controversial issues. Publication of that guide significantly diminished the number of interpretations used in describing film industry transactions and thus made comparisons of one company's statements with another's considerably easier and more meaningful than before.

The AICPA guide, however, has not prevented accountants from tailoring financial reports, starting with a set of base figures, to suit the needs and purposes of the users and providers of funds. Just as there are different angles from which to photograph an object to illustrate different facets, there are different perspectives from which to examine the data derived from the same base. In fact, given the complexity of many contracts, it is an absolute necessity to view financial performance from the angle that suits the needs of the viewer.

For example, outside shareholders generally need to know only the aggregate financial position of the company, not the intricate details of each participant's contract. Those participants, however, usually will care only about their own share statements, from which the aggregates are constructed. In the sections that follow, the two different accounting perspectives are more fully described.

5.2 Corporate overview

Because this is not strictly an accounting text, no attempt will be made to describe the full terminology used by CPAs. It will be useful, however, to note instances in which movie business definitions are different from those used in other industries.

Revenue-recognition factors

Industry practice with regard to recognition of revenues from theatrical exhibition is fairly straightforward. With either percentage or flat-rent contracts, revenues from exhibitors are accrued and recognized by distributors when receivable, which, because of cash intake at the box office, is almost immediately. Contrariwise, ancillary-market revenue recognition is potentially much more complex. Prior to the issuance of the aforementioned accounting guide, four methods existed:

1. Contract method: All revenue is recognized on contract execution.
2. Billing method: Revenue is recognized as installment payments become due.
3. Delivery method: Revenue is recognized on delivery to the licensee.
4. Deferral or apportionment method: Revenue is recognized evenly over the whole license period.

To place the entire industry on a uniform basis, the AICPA guide indicated that television license revenues for feature films should not be recognized until all the following conditions were met:

1. The license fee (sales price) for each film is known.
2. The cost of each film is known or reasonably determinable.
3. Collectability of the full license fee is reasonably ensured.
4. The licensee accepts the film in accordance with the conditions of the license agreement.
5. The film is available; that is, the right is deliverable by the licensor and exercisable by the licensee.

Although there are many further complicating elements – discounting the time value of money on long-term receivables or the possibly different methods used for tax-reporting purposes and for shareholder reports – for most analytical purposes, only a few points need be noted.

Availability (item 5) is most important with regard to television or other ancillary-market licenses. Even when contract-specified sequencing to downstream markets restricts a distributor from making films available at certain times, the distributor often retains great discretion as to when product is to be made available. For example, television networks interested in obtaining a movie may be totally indifferent as to whether the picture is available on September 30 or October 1. But to a distributor company trying to smooth its reported quarterly earnings results, the difference of one day could be substantial.

Another sensitive and potentially litigious area concerns fees allocated to films in a package of features that might be sold to a network.[4] Packages usually contain a dozen or so films, with, of course, some titles much stronger than others. Theoretically, each film is individually negotiated, but in practice, the package is offered as a whole. The problem is then to allocate the total-package revenues among all the films according to a proportional formula based on relative theatrical grosses, genres, and other criteria. It has been estimated that the strongest film in a package might be worth 2.5 times the value of the weakest, with strength being defined by box-office performance (and price per film typically equaling 12% to 15% of domestic box-office totals). Allocation procedures are further discussed in Section 5.4.

By and large, though, it is worldwide licensing of films – to cable networks, pay-per-view service providers, broadcast television, and streamers such as Amazon, Apple iTunes, and Netflix – that generates the vast majority (perhaps 85%+) of film company earnings. The profitability of this licensing is so exceptional because, aside from residual payments to actors and guild pension funds, virtually no additional advertising, print, or distribution costs are incurred.

Of further significance are "backlogs" – the accumulation of contracts from which future license fees will be derived. Important contracts for ancillary-market exhibition are often written far in advance, sometimes even before the film is produced or released in theaters. Such backlogs generally do not appear directly anywhere on the balance sheet as contra to inventories, except when amounts are received prior to revenue recognition. In those cases, the amounts are carried as advance payments and are included in current liabilities.

It has thus been argued with some justification that film company financial statements only partially reflect true corporate assets. However, companies ordinarily will indicate, in balance-sheet footnotes in annual reports and 10-K filings with the Securities and Exchange Commission, the extent to which backlogs have changed during the reporting period.

Inventories

Perhaps the greatest conceptual difference between the movie industry and other industries has been in the definition of inventory, which is normally taken to be a current asset (i.e., an asset that is used for production of goods or services in a single accounting period). Because the life cycles of filmed entertainment products (from beginning idea or property to final distribution) are measured in years, entertainment company inventories had

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been categorized, in balance sheets that are classified, into current-period and noncurrent-period components. Included in such assets are the costs of options, screenplays, and projects awaiting release in the preproduction, current-production, and postproduction phases.

More formally, according to the early accounting guide, inventories classified as current assets included the following:

1. For films in release, unamortized film costs allocated to the primary market
2. Film costs applicable to completed films not released, net of the portion allocable to secondary markets
3. Television films in production that are under contract of sale

Under the early AICPA guide, costs allocated to secondary markets and that are not expected to be realized within 12 months, and all other costs related to film production, are classified as noncurrent. Typically, a film company included the following captions:

Film productions:

Released, less amortization
Completed, not released
In process
Story rights and scenarios

Amortization of inventory

Inventories are matched in a "cost-of-goods-sold" sense against a *forecast* schedule of receipt of income. Although forecasts of film receipts are mostly best guesses, in the aggregate it is fairly certain that perhaps 85% of all theater-exhibition revenues will be generated in the first three months of release and almost all the remainder by the end of the second year.

Rather than using a cost-recovery theory, in which no gross profit is recognized until all costs and expenses have been recovered, the film industry's theoretical approach is based on a system in which costs are amortized in a pattern that parallels income flows. With this flow-of-income approach, gross profit is recognized as a standard portion of every dollar of gross revenue recorded.

Prior to implementation in 1981 of Statement 53 of the Financial Accounting Standards Board (FASB), which essentially formalized the aforementioned AICPA guidelines, two amortization approaches were generally applied. A company could either use separate estimates of gross revenue for each film or average tables (which are no longer practicable or permitted) based on the performance of groups of films.[5]

With costs in the industry now reported at the lower of unamortized cost or net realizable value on a film-by-film basis (i.e., on an individual rather than group average), accountants' procedures require that estimates be reviewed periodically (at least quarterly and at the end of each year) to be sure that the best available data are being used (Table 5.1). In the absence of any changes in the revenue estimates for an individual film, costs are amortized and participation costs are accrued (expensed) in a manner that thus yields a constant rate of profit over the estimation period.

If there are material revisions in gross-revenue estimates, however, amortization schedules must be recomputed. For this reason, films performing poorly in early release are quickly written down. Moreover, a write-down before release will be required in the rare situations in which the cost of a production obviously exceeds expected gross revenues.[6]

This methodology also presumes that properties are to be reviewed periodically and that, if story rights have been held for three years and the property has not been set for production, or if it is determined that the property will not be adapted for film projects, those story costs will be charged to production overhead in the current period.

Unamortized residuals

Before the days of pay cable, home video, and the Internet, most of a film's income was derived from movie theaters (and also to a much lesser extent from free television broadcasts).[7] That was indeed the situation in 1981, when FASB Statement No. 53 was adopted. However, although FASB 53 has been rescinded and replaced by SOP 00–2 (with differences discussed later), the basic architecture of FASB Statement 53 remains in place and still provides a useful framework for discussion of film accounting concepts and controversies. Among the most important of these are unamortized residuals.

By the early 1980s, an ever-larger stream of film revenues was being derived from nontheatrical sources of distribution and it became increasingly important to match revenues and costs more closely. A portion of a production's cost known as an *unamortized residual* was therefore set aside to be written down against expected future income from television.[8] For a major feature in the 1970s, an unamortized residual of $750,000 or so was typical.

As income "ultimates" (revenues ultimately receivable from pay cable, DVDs, syndication, etc.) have grown proportionally more significant in comparison with those derived from theatrical exhibition, unamortized residuals have also been set aside, pro rata, to be matched against these additional estimated ancillary-market revenues. Such residuals have become much larger than in the past and it would not be unusual now for the bulk of a picture's cost to be written down against future revenues from nontheatrical sources.[9]

Thus the rate at which capitalized costs are amortized – that is, moved from the balance sheet through to the income statement – always plays a critical role in determinating reported period profits. All other things being equal, a relatively large unamortized (remaining) inventory suggests that profits in future periods will be lower and vice versa.

Table 5.1. *Amortization computation using forecast for individual film: an example*

Assumptions	
Film cost	\$10,000,000
Actual gross revenues:	
First year	12,000,000
Second year	3,000,000
Third year	1,000,000
Anticipated total gross revenues:	
At end of first year	24,000,000
At end of second and third years	20,000,000
Amount of amortization	

Amortization

First-year amortization

$$\frac{\$12{,}000{,}000}{\$24{,}000{,}000} \times \$10{,}000{,}000 = \$5{,}000{,}000$$

Second-year amortization (anticipated total gross revenues reduced from \$24,000,000 to \$20,000,000)[a]

$$\frac{\$3{,}000{,}000}{\$8{,}000{,}000^{b}} \times \$5{,}000{,}000^{c} = \$1{,}875{,}000$$

Third-year amortization

$$\frac{\$1{,}000{,}000}{\$8{,}000{,}000^{d}} \times \$5{,}000{,}000^{d} = \$625{,}000$$

[a] If there were no change in anticipated gross revenues, the second-year amortization would be as follows:

$$\frac{\$3{,}000{,}000}{\$24{,}000{,}000} \times \$10{,}000{,}000 = \$1{,}250{,}000.$$

[b] \$20,000,000 minus \$12,000,000 or anticipated total gross revenues from beginning of period.

[c] \$10,000,000 minus \$5,000,000 or cost less accumulated amortization at beginning of period.

[d] The \$8,000,000 and \$5,000,000 need not be reduced by the second-year gross revenue (\$3,000,000) and second-year amortization (\$1,875,000), respectively, because anticipated gross revenues did not change from the second to the third year. If such a reduction were made, the amount of amortization would be as follows:

$$\frac{\$1{,}000{,}000}{\$5{,}000{,}000} \times \$3{,}125{,}000 = \$625{,}000$$

Source: Appendix to FASB Statement 53. © Financial Accounting Standards Board, High Ridge Park, Stamford, CT 06905, USA. Reprinted with permission. Copies of the complete document are available from the FASB.

Interest expense and other costs

As average production budgets have soared, interest expense has also become a more noticeable component of feature filmmaking. Until 1980, when FASB Statement 34 concerning treatment (capitalization) of interest was issued, such costs had been written off as incurred. Under this new standard, interest costs are capitalized and then charged as part of the negative cost.

Although studio period outlays, including those for rents and salaries, fall into a normal-expense category, studios also incur other costs of distribution (exploitation) that are capitalized. These may include, but are not limited to, prints and advertising and payments of subdistribution fees. For example, prior to the use of digital projectors and satellite feeds, prints would typically cost over $2,000 each (for five reels), and because simultaneous saturation booking is now common and often requires that well over 1,000 copies be made, this had amounted to a substantial investment. Such print costs were, under FASB Statement 53, usually amortized according to a formula similar to that used for amortization of the negative.

According to FASB Statement 53, all exploitation costs (for prints, advertising, rents, salaries, and other distribution expenses) that are clearly to benefit future periods should be capitalized as film-cost inventory and amortized over the period in which the major portion of gross revenue from the picture is recorded. This method especially pertains to national advertising, in which expenses before release can be considerable. Local and cooperative advertising expenditures, however, are generally closely related to local grosses and are normally expensed as incurred, because they usually do not provide any benefits in future periods.

Calculation controversies

Accounting rules and procedures as well as theories related to economic, financial, and legal concepts and principles are normally developed in all industries, and media and entertainment accounting is *not* exceptional in this regard.[10] FASB Statement 53 certainly contributed to a basis for comparison of film and television company financial data that was much improved over the relatively amorphous conditions that had prevailed prior to its issuance. But in looking at the FASB's accounting rules, it is first important to recognize that they ought not be confused with *contractual accounting* – the definitions that are specified in contracts that are crafted between representatives of participants, producers, and distributors and that reflect the relative bargaining powers of each party at the time of signing (as described later in this chapter).

Yet the FASB's Statement 53 had nevertheless drawn criticism for allowing considerable discretionary variation in the treatment of marketing and inventory cost amortizations in particular. With marketing costs often amounting to more than 35% of inventory, and overhead for another 10%, the recoupment of such costs is proportionately far more important to earnings reports in films and television programming than in other industries, such as manufactured products. In most other industries, such cost amortizations constitute a relatively smaller percentage of total expenses and are much more closely related to the projected useful lives of assets based on prior experiences with other similar assets.

According to the rules for movies and television productions, the rate of amortization instead depends on *management's* projections (market by market and medium by medium) of often-uncertain *revenue* streams that are expected sometime in the possibly distant future. Moreover, because income recognition is generally unrelated to cash collections, it is entirely possible to report earnings and yet be insolvent at the same time. It was thus often argued that the accounting picture rendered by application of FASB Statement 53 did not accurately reflect the true earnings power, cash flow potential, or asset value of a company.

Using FASB Statement 53, for example, some companies might have assumed that all advertising costs incurred during theatrical release create values in the ancillary markets. As such, they would have capitalized some of the costs despite the fact that local advertising in Tampa would ordinarily have no effect on video-market sales in Toronto or Tanzania. In addition, some companies would have amortized prints over estimated revenues from all markets rather than against revenues generated in specific markets; for instance, domestic versus foreign.

Other companies might have assumed long lives for their films and television series and thus included second- or third-cycle syndication sales, even though precise timing or pricing of such syndication sale events may not have been known. And still others might have differed on how long, or through what means, development-project costs from in-house independent producers were to be capitalized and then written off as studio overhead. In general, the costs of abandoned properties should be amortized as soon as it is clear that the properties will not be produced, but it is not unusual for many projects to be lost in creative limbo for relatively long periods.[11]

Under FASB Statement 53, even receivables presented problems: Receivables, according to these rules, were shown on the balance sheet as *discounted* to present value, while estimates of far more uncertain revenue ultimates, made largely on the basis of a film's genre and the star power of its actors at the time of initial release, were not. The effect of this was to lower the amount of cost to be amortized in the current year (which boosts reported earnings) and to raise (via capitalization of costs) the asset values carried on the balance sheet.[12]

Under FASB Statement 53, there was thus ample room for substantial variations in earnings reporting practices to appear.[13] In many instances, analysts could only compare specific company results against industry standards for financial statement ratios such as those presented in Table 5.2.

Table 5.2. *Accounting ratio benchmarks for major film studio-distributors, 1985–2013*

	Film cost amortization as % of			Unamortized costs of released films as % of inventories	Additions to film costs as % of film cost amortization[a]
	Revenues	Inventories	Operating cash flow		
2013	40.7	146.0	169.7	47.4	77.2
2010	43.9	125.4	84.2	59.0	77.8
2005	47.8	108.4	104.5	44.4	87.3
2000	40.7	NM[b]	57.4	47.2	60.4
1995	51.9	80.9	92.3	64.0	63.2
1990	41.8	69.0	70.0	50.0	104.9
1985	52.6	80.9	88.8	65.4	128.3
Mean[c]	44.4	85.4	97.5	56.5	87.2

[a] Based on a smaller sample since 1996. *Source*: Company reports.
[b] Not meaningful.
[c] Averaged over all years, 1985 to 2013.

Statement of Position 00–2

The variations and controversies that appeared in the applications of FASB Statement 53 finally led to a request by the FASB in 1995 for the AICPA to develop new guidelines in the form of a Statement of Position (SOP) that would tighten the reporting requirements for producers or distributors of films, television specials, television series, or similar products that are sold, licensed, or exhibited. SOP 00–2 took effect as of the year 2000, and a new FASB Statement (139) rescinded the previous FASB Statement 53.

Disney's 2010 explanation of accounting policies is illustrative:

> The company expenses "film and television production, participation and residual costs over the applicable product life cycle based upon the ratio of the current period's revenues to the estimated remaining total revenues (Ultimate Revenues) for each production. If our estimate of Ultimate Revenues decreases, amortization of film and television costs may be accelerated. Conversely, if estimates of Ultimate Revenues increase, film and television cost amortization may be slowed. For film productions, Ultimate Revenues include revenues from all sources that will be earned within ten years from the date of the initial theatrical release. For television series, Ultimate Revenues include revenues that will be earned within ten years from delivery of the first episode, or if still in production, five years from delivery of the most recent episode, if later."

In all, the tighter rules require, among other things, that:

- Exploitation costs are to follow SOP 93–7 (*Reporting on Advertising Costs*), which requires that all marketing and exploitation costs should, for the most part, be expensed as incurred (or the first time that the advertising takes place), with the cost of film prints charged to expense over the period benefited. Previously, such costs had often been capitalized and then amortized over a film's full distribution lifetime.

- Total film revenue estimates against which production costs are amortized are based on estimates over a period not to exceed 10 years following the date of the film's initial release, with some limited exceptions. Previously, this period might have been as long as 20 years.[14]
- For episodic television series, ultimate revenue should include estimates of revenue over a period not to exceed ten years from the date of delivery of the first episode or, if still in production, five years from the date of delivery of the most recent episode. Ultimate revenues should include estimates of secondary market revenue for produced episodes only if an entity can demonstrate that *firm* commitments exist and that the episodes can be successfully licensed in the secondary market. Previously, the episodic revenue assumptions had been largely open-ended.
- Syndication revenues for television series episodes are to be recognized over the life of the contract rather than at the first available playdate if certain revenue-recognition criteria are not met. Those criteria include the completion, delivery, and immediate availability of the series for exploitation by the licensee and the establishment of a fixed or determinable fee that is reasonably assured of being collectable. For some syndicated series, the effect is to spread the one-period earnings bump previously seen under FASB Statement 53 over more earnings periods.
- Ultimate revenue should include estimates of the portion of wholesale or retail revenue from an entity's sale of items such as toys and apparel and other merchandise only if the entity can demonstrate a history of earning such revenue from that form of exploitation in similar kinds of films.
- Abandoned-project development costs and certain indirect overhead costs are to be charged directly to the income statement and are thus no longer part of total negative costs – that is, included in a studio's overhead pool.[15]
- Films are to be defined as long-term assets (i.e., as film cost assets), not inventory. This means that their worth is to be based on future cash flow estimates discounted to present or fair value as compared with the previous condition, in which revenue estimates were not discounted. Interest income would be earned as the films played off.
- If the percentage of unamortized film costs for released films (excluding acquired film libraries) expected to be amortized within three years from the date of the balance sheet is less than 80%, additional information regarding the period required to reach an amortization level of 80% must be provided.

Although SOP 00–2 does not fully resolve all controversies, it goes a long way toward standardizing applications of the individual film-forecast method, which has long served as the conceptual foundation of movie industry accounting.

Beyond this core, however, there remain many thorny issues that arise from the differing assumptions made by studio corporations and by individuals. Among the most important of these differences concerns the timing of receipts and the subsequent disbursements to participants. For example, distributors would normally use accrual accounting methods (booking income when *billed*) for their own financial-statement reporting purposes and cash accounting methods (based on revenues when *collected* and out-of-pocket expenses when incurred) for tracking disbursements to producers and others.[16]

Indeed, all levels of the industry are extremely sensitive to cash flow considerations, and delays of payments tend to compound rapidly on the way to downstream recipients. Although the financial performance of a film company can sometimes be disguised by accounting treatments, the true condition becomes evident once the flow of new investment stops.

And mergers cannot forever hide true conditions.[17] The important thing to remember is that film and television program assets are, by nature, intangibles, that valuations are often highly subjective, and that all accounting methods contain elements of both art and science.[18]

5.3 Big-picture accounting

Financial overview

Preceding sections have described how financial statements appear from the corporate angle. But accounting statements for individual participants are properly viewed from a different perspective. This section illustrates the results for typical production, distribution, and exhibition contracts in terms of profit-and-loss statements for individual projects.

For the producer, the legal heart of most such projects is the production-financing-distribution (PFD) agreement, which may broadly contain one or more of the following four sometimes overlapping financial attributes or elements:

1. *Step deals*, in which the financing proceeds in steps that allow the financing entity to advance additional funds or to terminate involvement depending on whether various predetermined conditions (e.g., approvals of screenplay drafts and casting choices) are met.
2. *Packages/negative pickups*, in which a producer, or an agent, assembles the key elements of a project and then attempts to interest a studio in financing that project. A bank will lend against such a studio promise as long as the producer has obtained a completion guarantee bond. The studio will then "pick up" the negative upon its completion.
3. *Presales*, in which the producer has financed all or part of a picture by selling off various exhibition or distribution rights to the completed picture prior to its being produced. Such sales of what are, in effect, licenses

to distribute normally involve home video and foreign distribution entities that provide promissory notes discountable at banks. However, no more than 60% of the negative cost can usually be financed in this way.

4. *Private funding*, in which the producer, usually only of a low-budget picture, taps into private sources of funds through arrangement of a limited partnership.

Each of these financing options provides the producer with different trade-offs in terms of creative controls and profits. In step deals, for instance, a relatively large degree of creative control and of potential share of producer profit may be relinquished in favor of speed and efficiency. At the opposite end of the spectrum, private financing may allow unrestricted creative control, but may also severely limit the time and money available for actual production.

More generally, however, the production section of a PFD concerns the development process of making a feature (and, as such, does not usually apply to small-budget productions). It specifies the essential ingredients of a feature project: screenplay, director, producer, principal cast, and budget. It then further spells out who will be responsible for which steps in bringing the film to completion, who gets paid when, and under what conditions the studio financier can place the project in "turnaround" (i.e., abandon the project and attempt to establish it elsewhere).

A significant structural distinction here is that each film is essentially set up as a stand-alone financial entity (corporation or partnership) that separately accumulates revenues and costs apart and different from those of the studio. This suggests that a film's company might generate losses even when the studio's generates gains. Also, of course, the financial section of a PFD describes financing arrangements and stipulates completion-guarantee details and costs (which would normally average about 6% of the total budget before rebates).[19]

Ultimately, though, it is the distribution-agreement section that is of greatest importance in the allocation of revenue streams. Included here are definitions of distribution fees (in effect, sales commissions or service charges for soliciting playdates, booking films, collecting rentals, and negotiating with other distribution outlets) and specifications concerning audit and ownership rights, accounting-statement preparation (frequency, details included, and time allowed), and advertising and marketing commitments.

The matrix of Table 5.3 illustrates the various ways in which the five basic financing, production, and distribution options described by Cones (1997, p. 29) can be combined. These options are as follows:

1. *In-house production/distribution*, wherein the studio/distributor funds development and distribution of the project. Here, an independent

Table 5.3. *Basic film-financing matrix*

	In-house Production/ distribution	Production financing/ distribution	Negative pickup arrangement	Acquisition deal	Rent-a-distributor
Source of production funds	Studio/ distributor	Studio/ distributor	Lender	Third party	Third party
Source of p&a funds	Distributor	Distributor	Distributor	Distributor	Nondistributor
Time of agreement	Prior to production	Prior to production	Before film completed	After film completed	After film completed

Source: Cones (1997, p. 30). Reproduced by permission.

producer attached to a project is considered an employee of the studio (which broadly funds the affiliated producer's overhead in the development period).

2. *PFD agreements*, in which a project is brought to the studio/distributor by an independent producer as a fairly complete package and the studio provides production and distribution funding.
3. *Negative pickup arrangements*, in which the distributor commits to distribution and to payment of production costs (i.e., to *buying* the original negative along with the rights to distribute) pending suitable delivery of the completed project.[20]
4. *Acquisition deals*, in which the distributor funds distribution but the film's production cost is already financed by other parties.
5. *Rent-a-distributor* deals, in which virtually all the funding for production and distribution has already been provided by others and the completed film is ready for distribution. (Because of the low fees and limited upside potential, studios are not likely to place priority on the marketing of rent-a-system films.)

An overview of revenue flows for a typical theatrical release would then follow as in Table 5.4. In looking at this, however, it helps to keep in mind that the exhibitor's objective is to minimize rentals, whereas the distributor's objective is to maximize them. Also, what participants see as their gross is the distributor's rental, not box-office gross as usually reported in the trade papers. For reasons previously discussed, the box-office gross can be much larger than the distributor's gross (i.e., rentals).

A convenient illustration of PFD concepts has been provided by Leedy (1980, p. 1), from which the following descriptions are drawn. Leedy's

Table 5.4. *Flowchart for theatrical motion picture revenue: box-office receipts*

Distributor's gross receipts less
  1. Distribution fees
  2. Distribution costs
  3. Third-party gross participations
↓
Producer's gross proceeds less
  1. Negative cost
    (a) Direct cost
    (b) Overhead
    (c) Interest on loans
2. Contingent deferments
First net profits
↓
Breakeven
↓
Third-party net-profit participations (100% of net profits of picture)
↓
Producer's share of net profits of picture

Source: Breglio and Schwartz (1980). Courtesy of John F. Breglio.

illustration (Table 5.5) for a major successful picture is particularly useful because it well illustrates the typical deferred payments to the writer and director, profit participations by the leading actors, and contingent compensations to the financier and producer. It further shows how a $14 million (negative cost) picture earning $100 million in distributor's rentals might generate $16 million of profit for the financier and the producer before participations and $8.1 million after adjustment for participations and deferments.

Although this model does not provide detailed revenue specifications for all new-media sources, it nevertheless properly portrays typical domestic theatrical-distribution fees (i.e., U.S. and Canadian) at about 30%, foreign distribution and television syndication fees at 40%, and other distribution fees at 15%.[21] Such distribution charges are, by long-standing industry practice, largely nonnegotiable. But because the charges are unrelated to actual costs, they will, on relatively rare occasions, be adjusted to retain the services of important producers. In those cases, use is made of a sliding-fee scale down to a predetermined minimum, with perhaps a 5% reduction for every $20 million of theatrical rentals generated.

Table 5.5 can also provide an indication of how sensitive profits are to changes in the cost of capital. For example, an assumption of interest rates of 20% for this type of project brings interest cost on the production closer to $3 million than to the $2 million that is shown. If so, $1 million of additional

Table 5.5. *Revenues and costs for a major theatrical release, circa 1992*

Gross revenue		
Subject to a 30% distribution fee		
Theatrical film rental (United States and Canada)		$50,000,000
Nontheatrical film rental		1,000,000
Royalty on home video		5,000,000
U.S. network television		4,000,000
Total		60,000,000
Subject to a 40% distribution fee		
Foreign film rental		20,000,000
Foreign television license fees		5,000,000
Royalty on foreign home video		5,000,000
Television, pay, and syndication		9,000,000
Total		39,000,000
Subject to a 15% distribution fee		
Merchandise royalties		950,000
Advertising sales		50,000
Total		1,000,000
Total gross revenue		$100,000,000
Distribution fee		
30% × $60,000,000		$18,000,000
40% × $39,000,000		15,600,000
15% × $1,000,000		150,000
Total distribution fee		(33,750,000)
Balance		$66,250,000
Distribution expenses		
Cooperative advertising		$20,000,000
Other advertising and publicity		5,000,000
Release prints, etc.		3,000,000
Taxes		2,000,000
Trade-association fees and other		1,500,000
Bad debts		1,000,000
All other expenses		1,750,000
Total distribution expenses		(34,250,000)
Balance		$32,000,000
Production cost	14,000,000	
Interest thereon	2,000,000	(16,000,000)
Net profit before participations		$16,000,000
Deferments paid		(125,000)
Participations in gross and net		(7,775,000)
Total		(7,900,000)
Net profit to be split 50:50		$8,100,000

Source: Leedy (1980, pp. 1–3 and unpublished updates).

Table 5.6. *Fee splits, deferments, and participations for a major motion picture release: an example based on the results in Table 5.5*

Writer		
Fee	$250,000	
Deferment	50,000	$300,000
Director		
Fee	525,000	
Deferment	75,000	600,000
Major lead actor		
Fee	2,000,000	
Participation[a]	6,875,000	8,875,000
Major lead actress		
Fee	500,000	
Participation[b]	900,000	1,400,000
Producer		
Fee	500,000	
Contingency compensation	4,050,000	4,550,000
Financier		
Interest income	1,000,000	
Contingency compensation	4,050,000	5,050,000
Distributor		
Fee		33,750,000
Net profit before participations	16,000,000	
Deferments paid	125,000	
Participation in gross	6,875,000	
Total	7,000,000	
Net profit after participations	$9,000,000	
Participation rate	10%	
Participation	$900,000	

[a] Actor participation based on $2 million against a participation of 10% of gross revenue, less cooperative advertising and taxes before breakeven, and an additional 2.5% participation rate on this basis after breakeven.
[b] Actress participation based on 10% of net profits contractually defined as after the deferments and after the participation in gross.
Source: Leedy (1980, p. 3 and unpublished updates).

interest cost would reduce investors' profits by about 12%, from $8.1 million to $7.1 million.[22]

Table 5.6 summarizes how other participants might have fared in Leedy's example of a picture bringing rentals of $100 million. Here it is important to remember that, in contrast to the financiers and distributors, the potential profit participants, including the director and lead actors, are at no risk of loss. ~~They~~ generally do not have equity capital invested in a project and their profit participations, if any, should thus be appropriately characterized as contractually defined salary bonuses.

Participation deals

From a major studio's standpoint, risk is reduced if a production schedule contains a balanced mix of project-source financings. For instance, a studio might plan to release 24 films a year, of which perhaps 4 might be fully financed and produced in-house, another 14 might be financed using PFD arrangements with affiliated production entities, and the remainder financed with pickups and acquisitions.

No matter what the financing sources, however, revenue and profit participations are always the central issues. Participation arrangements are limited only by the imagination and bargaining abilities of the individuals who negotiate them. Important equity fund contributors to a project might sometimes be able to carve out discrete gross revenue "corridors" from which they would be entitled to receive a cut. But only talents in great demand can command significant participations in addition to fees or salaries. In most situations, the filmmaker's trade-off for major studio funding includes ceding ownership of the film and control of the project to the studio, which then also shares substantially in the film's financial returns (if any).

Pickups. Of the several major variants of participation agreements, perhaps the simplest is a "pickup" – a completed or partially completed project presented to studio financiers or distributors for further funding and support.[23] From the distributor's point of view, pickups are somewhat less risky than other early-stage projects, in which it may be especially difficult to evaluate how all in-process artistic elements may fit together. For this reason, independent filmmakers often find that their best opportunity to distribute through a major is via such pickup agreements.[24] Deals with independents may also vary widely.[25]

If it is further assumed that the producer is able to fully fund prints and advertising (p&a) for the film through other sources – such as through private funds specializing in this type of financing – and deliver a completed (or nearly completed) film, a "rent-a-studio" deal can often be made in which access to a major's domestic theatrical distribution organization and collection system can be obtained for relatively low fees (usually ranging between 12.5% and 17.5%).[26] Distribution arrangements for the second cluster of George Lucas-financed *Star Wars* films that began to be released in 1999 provide a prominent example of this type of deal (wherein the distribution fee earned by Fox was 6%).

Coproduction-distribution. Distributor-financiers often make coproduction deals with one or more parties for one or more territories in order to share risks. For instance, domestic and foreign distributors, in a "split-rights" arrangement, might each contribute half of a picture's production cost and each be entitled to distribution fees earned in their respective territories. Because distribution costs and box-office appeal often vary significantly in different markets, however, a picture might be profitable for one distributor and unprofitable for another. Also, the results for all distributors may be aggregated, with profits or losses split according to aggregate performance rather than territorial performance.

In practice, there is thus no standard formula for dividing a project's benefits pro rata according to the share invested; the share of whatever a project ultimately generates may differ considerably from the share that is funded because other considerations, such as distribution rights and creative collaborations, might be part of the deal. Otherwise, coproductions are normally governed by treaties between countries, and include Europe's Council Convention on Cinematographic Coproduction, which became effective (also in the United Kingdom) in 1994.

Talent participations and breakeven. Participation in net profits or in gross receipts (often described in "Exhibit A" contract definitions) is contingent on a film's making enough money to break even. Participations are thus a form of contingent compensation and, as such, may never be payable. Moreover, so-called *at-source* provisions require that royalties and participations tied to gross receipts be calculated at contractually defined links in the distribution chain; for example, film rentals in theatrical release and wholesale prices charged to retailers in video release.

Yet because participations are essentially negotiated risk-sharing arrangements (with the studio and/or producer), the pool of money that the film generates will always be compartmentalized into specifically defined (ordered and prioritized) revenue, cost recoupment, and deductible categories. For this reason, contracts use terminology that says that the talent is entitled to *X*% of 100% (or perhaps some other percentage) of *Y*, the defined pool. All of this adds enormously to accounting complexity because definitions are, despite some standardizations, tailored to each individual and applied to different domestic and international markets and product categories (DVDs, toys, games, TV shows, etc.).

Writers, directors, or actors may become financial participants if their agents have been able to negotiate for gross "points," which can be defined on a number of different grosses. Distributors' grosses are what have been called rentals and participation points defined on this basis are obviously valuable because a picture does not have to be profitable for such points to be earned. Participations of this kind are thus rare and are assigned to only the strongest box-office draws.

Nevertheless, as studios have attempted to contain the costs of production, they have offered gross participation deals that can generally be categorized into three basic types, ranked from rarest to most common: first-dollar, adjusted gross, and gross after breakeven/breakeven.[27] Such *contingent* compensations are apart from and in addition to *fixed* compensation – essentially upfront salary payments to gross and net players no matter what happens to the movie – and are defined as follows:

- *First-dollar gross*. First-dollar ("dollar-one") gross participations after certain limited expenses (trade dues and other "off-the-tops" totaling perhaps 3% of revenues) have been deducted to reach what is known as distributor's adjusted gross. Cash compensation goes *against* a percentage of defined first-dollar receipts.[28]
- *Adjusted gross.* Gross after cash breakeven, in which a participant receives a share of gross receipts after the studio has recouped its negative and p&a (and perhaps some other imputed) costs and taken a somewhat reduced distribution fee, ranging between 12% and 25%. Compensation is not against receipts but is an addition (bonus) contingent on attaining cash breakeven, the definition of which varies not only from film to film but also often for different participants in the same film.
- *Gross after breakeven/breakeven.* Gross after actual breakeven, in which a participant receives a share of gross receipts after the studio has recouped all its costs and taken standard (i.e., full) distribution fees (of as much as 40%), or, alternatively, gross after rolling breakeven (described later), in which the studio continues to deduct distribution expenses in relation to a distribution fee even after the picture has achieved net profits. In a more recent variation, known as the "pool," the top creative talent foregoes (waives) significant upfront payments and allows the studio to lower its risk through relatively early recoupment of expenses and fees, but is then entitled to a much larger than usual share of backend receipts.[29]

In practice, no one, not even top first-dollar players, can ever command payments on the true full gross; the only true first-dollar participant will always only be the studio via its off-the-top distribution fee. The most routine participation would instead be based on a designated actual or artificially set breakeven level. For example, some talent participants might receive a percentage of distributor's gross after the first $40 million had been generated. In other instances, participation might begin after breakeven – defined as distributor's gross minus distribution fees and distribution costs, which might include collection and currency conversion costs, duties, trade dues, licenses, taxes, and other charges known as *off-the-tops*. Additional points might then be earned after, say, rentals reach 3.5 times the production cost. As may be imagined, the variations on these concepts are infinite.

Recent pressures on studio profits have begun, however, to shape star talent deals away from gross dollar participations and toward those in which the participants waive gross points, accept a greatly discounted salary, and instead receive a percentage of revenues, sometimes including a large portion of DVD revenues, after a picture breaks even – that is, after recoupment of budget, interest charges, p&a, and usually relatively low distribution fees. In effect, this increases production efficiencies and, more generally, aligns the interests of all parties involved by turning participants into project owners and financiers.[30]

Nevertheless, the more gross players attached to a project, the less likely that a project will go into a net profit position.[31] This means that often the greater potential for conflict may not be with the participant against the studio but instead with the participant against all the *other* participants!

Also, net profit is itself not a static concept, because additional distribution fees and expenses will routinely be incurred even after attaining breakeven. With multiple-talent participations, the accounting complexities are merely compounded: What usually begins as a simple agreement between an agent and a studio attorney or business-affairs representative often ends as a complicated financial-accounting document replete with the potential for widely divergent interpretations.

Is star *A*'s participation deducted before that of star *B*? Is participation based only on domestic rentals or on both foreign and domestic? Which distribution costs are subtracted before artificial breakeven? Are both television advertising and national-magazine advertising included or excluded? And perhaps more fundamentally, by what method are subdistributor and other ancillary revenues represented in "gross receipts"? Those are some of the subjects on which opinions may differ, especially within the context of the tens of thousands of transaction entries that are typically generated in the course of bringing a major feature to the screen. No wonder, then, that even in the best of circumstances, in which contract terms are sharply defined, it is time-consuming and expensive to follow an audit trail.

Moreover, with the concept of a *rolling breakeven* – defined as the point at which revenues are equal to production costs plus distribution fees and expenses on a continuing (cumulative) basis – still further complications are introduced. For instance, once gross participations kick in, they become deferred production costs that are retroactively added to the film's budget. Even in the same film, different participants will have different cash breakeven contingency compensation definitions in their contracts. Equity financing partners may also be able to carve out geographic market entitlements or "corridors" that siphon revenues from a specific territory before others are allowed to participate.

Also, with a picture approaching profitability, a distributor's decision to spend more on advertising will delay or defer breaking even, thereby adversely affecting talent participants entitled to receive points in the picture's "net" profits. Yet some participants higher up the food chain could hardly object to their careers and compensation being enhanced in this way from the increased exposures and grosses that additional advertising usually brings.

As shown in the following formula, the amount of rentals required for a new breakeven ("rolling break" in industry jargon) is found by dividing total expenses exclusive of the distribution fee (i.e., p&a plus negative costs) by 1 minus the distribution-fee percentage. Let a = required rentals, b = total expenses, and $r =$ distribution-fee percentage. Then

$$a = \frac{b}{1-r}.$$

For instance, if $r = 30\%$ and $b = \$7$ million, then $a = \$10$ million. But if another \$1 million is spent on advertising, then $b = \$8$ million and $a = \$11.43$ million. In this situation, every \$1 million of additional expenditure requires an additional \$1.43 million of rentals to be generated to remain at breakeven.

Because the studio views the cost of financing a film as a loan, breakeven is also greatly affected by studio deductions for interest charged (normally at 125% of the bank prime rate) on the unrecouped production cost of the picture. In such calculations, studio overhead and surcharges for use of facilities and equipment (usually in the range of 12.5% to 17.5% of the cost of the picture) are often included. But as Goodell (1998, p. 14) notes, the studio is paying *itself* with so-called soft-dollar budget items. These charges are paid back to the studio before any money is shared with participants: interest is being charged on overhead and sometimes, alternatively, overhead being charged on interest (which is chargeable on unrecouped production costs).

Similarly, for downstream participants, the decision as to whether an expense item is to be categorized as belonging to production cost or to distribution expenses may be important and dependent on timing.[32] In a PFD arrangement, the distributor will generally prefer to characterize as much expense as possible as production cost because the studio will derive more income from interest and overhead charges if the production cost base is larger. But for pickups or acquisitions, the studios' preference may often be to bulk up distribution expenses instead: In pickup, acquisition, or rent-a-studio deals, the use of production facilities on which overhead can be charged and profit earned may be minimal.

Some of the quirkiest contractual ambiguities often also hinge on how various tax credits and remittances, advertising and film lab rebates, guild fees, licensing costs, subdistributor fee overrides, and blocked currency effects are treated in the film's accounting. Rebates or tax credits might, for instance, be counted in the distributor's definition of gross receipts. If so, the inference is that the studio's 30% distribution fee is applicable, thereby leaving that much less available for participants to share.

As a result of such complications and the aforementioned sequencing of deductions for fees and costs, potential profit participants often find that the "net" profits of a picture are elusive and subject to widely varying accounting definitions and interpretations (especially in relation to earlier upstream claims made by participants in the "adjusted-gross" receipts). Profit calculations are not, moreover, even fixed in time, being instead continually subject to recalculations in each accounting period as film revenues and costs accrue. A star's deferred backend payment taken in lieu of a larger upfront compensation might, for example, be one such element (with an advance against the deferment also affecting other participants because it adds to production cost, overhead charges, and time to recoupment).

Revenues, as Daniels, Leedy, and Sills (1998, 2006) suggest, do not necessarily represent *all* dollars generated by the picture, production cost is not necessarily what it costs to shoot the film but rather what the participant contract says are the costs that may be reported as production cost, and breakeven comes in many flavors (e.g., cash, actual, rolling, and artificial – i.e., a negotiated multiple of certain receipts). When it comes to profit participation agreements, it is thus crucial to understand that *all contract terms and accountings are specifically defined for each film* (and also for each participant). As Baumgarten, Farber, and Fleischer (1992, p. 3) have noted, terms such as "gross receipts" and "net profits" have no intrinsic meaning. "The words mean whatever the participants decide they mean."[33]

Producers' participations and cross-collateralizations. Producers are responsible for a film's production costs and they often have contractual incentives to keep project expenses down. When costs exceed approved budgets by certain percentages, producers' shares may be penalized by several times the percentage overage. However, the share of profit, if any, that the producer will receive (in addition to earned production-services fees) can be structured to provide a floor or minimum payment (i.e., a *hard floor*) that has priority over other (third-party) participations, which are borne by the distributor. Were it not for this hard floor (as opposed to a *soft floor*), the presence of several third-party participations – each at perhaps 10% of total net profit (equal to a 20% slice out of the producer's half of total net profit) – would severely diminish the producer's potential income (from a project that the producer may have long nurtured and promoted well before any other participants had been signed).[34]

Producers are also affected if the financial fate of one picture is tied to that of another, or if the box-office performance of a single picture in one territory is linked to its performance in another. Such *cross-collateralizations* of producers' shares, done on either or both the production and distribution ends, may imply that the profits of one picture must exceed the losses of another for there to be anything to share. It is especially frustrating for potential profit participants when profitable picture *A* is cross-collateralized with picture *B* that has perhaps yet to be produced, distributed, or show a profit. In these situations, none of the profit on picture *A* will be credited to participants until picture *B* recovers most of its costs. In the case of independently financed films, important equity investors who have put up cash may also be entitled to early recoupment via specially defined *revenue corridors*.

Video participations. Because the system for distribution of DVDs (and earlier, tapes) developed from hybrid roots in the distribution of recorded music (see Chapter 6) and book products, a different – and controversial –

Table 5.7. *Film rental calculations: examples contrasting floor minimums versus percentages of net box-office receipts*

	Case 1	Case 2
Box-office receipts	$10,000	$8,000
Less: Deductions for second feature	(2,500)	(2,000)
Net box-office receipts	7,500	6,000
Minimum film rental at 70% of net	5,250	4,200
Less: Contractual theater overhead (nut)	1,500	1,500
Net box-office receipts after nut	6,000	4,500
Maximum film rental at 90% of net after nut	$5,400	$4,050

basis for participation accounting has evolved. Rather than distribution fees and expenses being subtracted directly from defined gross receipts, as has already been described, video participants are instead entitled to royalties that are normally set (but subject to bargaining power) at 20% of the unit's wholesale price for units to be marketed as rentals and 10% for those as sell-throughs. As a result, studios will usually include at most only 20% of total video unit sales royalties in participants' gross-receipt calculations and retain, except for residuals, the remaining 80% to cover the relatively modest costs of manufacturing, advertising, and duplication. The studio then still subjects the participant's video gross receipts to distribution and other fees, which reduce the participant's net royalty to perhaps only 10% to 12%.[35]

With the bulk of primarily DVD revenue thus accordingly shunted aside (to the studio's wholly owned manufacturing/wholesaling subsidiary) and taken out of the participants' calculation of a particular film's gross-receipts performance, the arithmetic for a studio's profitability on home-video distribution is persuasive. It is therefore easy to see why home video had become such a boon for the filmed entertainment industry and such an acute issue for the participants to negotiate. Indeed, from a corporate standpoint, it might reasonably be argued that home video (i.e., DVDs) had at its peak become the primary source of studio profits.[36] However, given the shift toward electronic sell-through (EST) via Internet streaming and download services, a change in this fee structure in favor of participants is probable.[37]

Distributor–exhibitor computations

As already indicated, rentals are the portion of box-office receipts owed to the distributor. Table 5.7 shows an example in which the exhibitor's nut for fixed overhead is negotiated or set at $1,500 and there is a 90:10 split (90% for distributor, 10% for exhibitor) of box-office receipts after the nut (but not less than the previously agreed 70% of total box-office receipts to the distributor).

Table 5.8. *Exhibitor operating revenues and expenses: an example*

Box-office (BO) weekly gross	$3,000
Concession sales (at 15%)	450
Total weekly gross	3,450
Deduct:	
Distributor's share at 50% of BO	1,500
Advertising (10% of BO)	300
Payroll (10% of BO)	300
Food cost (23% of sales)	104
Rent and real estate taxes at 15% of BO	450
Utilities at $150/week	150
Management fee at 10% of total weekly gross	345
Insurance and employee benefits	100
Repairs and maintenance	100
Miscellaneous (tickets, etc.)	100
Total average weekly expenses	$3,449

Source: Lowe (1983, p. 346).

In Case 1, the distributor will be owed $5,400, whereas in Case 2 the distributor will be entitled to $4,200. In neither case will the distributor share in the theater's concession income from candy, beverages, popcorn, and video games (see Section 4.4). As can be inferred from Table 5.8, such concession sales are a significant profit-swing factor for exhibitors.[38]

Rentals usually are accounted for on a cash basis when collected by the distributor, and expenses are recorded as incurred. In fact, this reporting method – reflecting the normally slow collection of cash and the delayed billing of period expenses such as co-op advertising – is reasonably equitable from the viewpoints of all participants.

Co-op advertising is normally calculated on gross receipts and allocated according to the distributor–exhibitor percentage revenue split in effect at the time the advertising appears. The following example indicates the true net percentage:

Box-office gross	$20,000
less house expenses	4,000
Net	$16,000

Ninety percent, or $14,400 (90:10 split), goes to the distributor, and the true distributor co-op percentage here is 72% (14.4:20.0), not 90%.

In analyzing the corporate accounting statements of exhibition companies, it should also be noted that the mix of owned versus leased real estate and the methods of accounting for real-estate transactions and leasehold

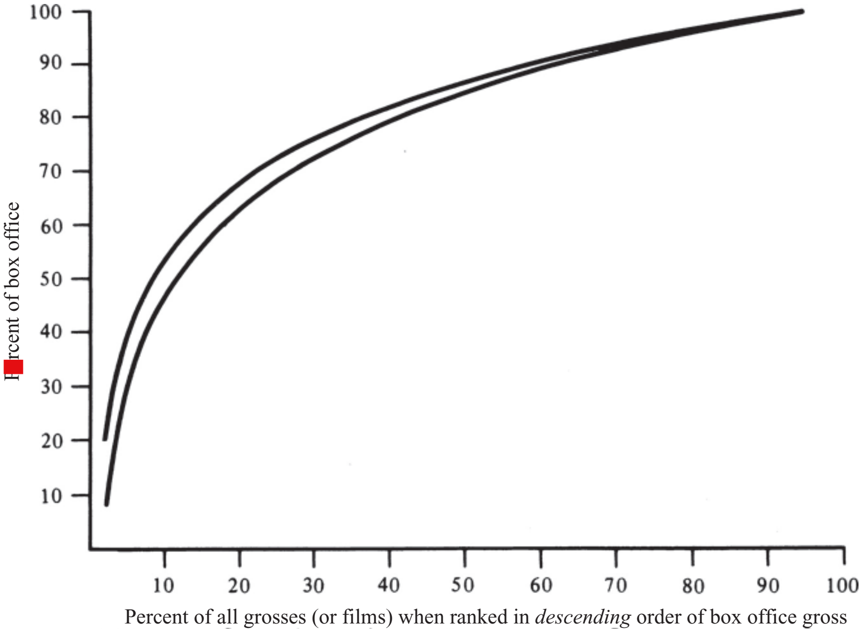

Figure 5.1. Ten percent of films generate 50 percent of the box office. When film box-office figures are ranked (either by individual weekly grosses or by individual films in order of their box-office grosses), the results fall in the range shown by the plotted curves. *Source*: *Daily Variety*, July 31, 1984. Copyright 1984 by A. D. Murphy.

improvements can vary significantly from one company to another, thereby limiting financial comparability.[39] In all, it might be said that exhibitors are actually engaged in four distinct business operations: movie exhibition, concession stands, on-screen advertising, and real estate.

Distributor deals and expenses

The previous hypothetical example of a film generating $100 million in rentals (Table 5.5) showed a distributor fee, or service charge for the sales organization, of $33.75 million (∼34%). Although much of the fee may be regarded here as profit, it is this very distribution profit on a hit that would be expected to more than offset losses sustained on other releases; 10% of the films released generate 50% of the total box-office receipts (Figure 5.1). Indeed, for the industry as a whole, actually incurred distribution expenses are estimated to average perhaps no more than 8% to 10% of distribution revenues, and even somewhat less for blockbuster releases.

Simplistically, then, it is distribution profit – perhaps for a major distributor averaging over time one-third or more of total distribution fees – that would normally provide the positive cash flow for investment in new films. And it is this profit, derived by subtracting from distribution fees all office overhead costs, compensation for sales personnel, and various other publicity and promotion expenses *not* recouped through other charges, that keeps the distributor in business despite the high probability that many pictures will lose money in toto when *all* input factor costs and expenses are tallied.

Still, even with all the contractual advantages that studios typically hold, this remains a relatively risky business; there have been many instances and many years when studios have not earned enough to cover their weighted average costs of debt and equity capital (WACC). Modern finance teaches that, for companies in any industry to survive, the cost of capital must be earned.

The distribution fee itself is a prior claim on a film's cash flows. But it is perhaps best conceptualized as being an access charge or a toll paid to a distribution organization for the use of the established turnpikes and bridges that allow direct access to large audiences. As with all such major access routes or pipelines, there can only be a few, and the upfront capital investment required to establish them is sizable.[40] The tolls or rents charged by distributors for such access are thus not especially sensitive to bargaining pressures and are, by nature, quasi-monopolistic and unrelated to direct costs.

Within this structure, many, if not most, pictures operate under a "net deal," in which the distributor charges a fixed or graduated percentage of rentals (e.g., 30% in domestic theatrical markets) as a distribution fee and then advances the funds for other distribution costs, including those for prints, trailers, and national advertising. In addition, there may be charges related to publicity and personal-appearance tours, co-op advertising with exhibitors, taxes (based on rentals) by countries and localities, trade-association and guild fees in the form of residuals (for exhibitions in ancillary markets), and bad debts. The distributor normally recovers these expenses before making any payments to the producer and, as shown in Table 5.4, would normally, before arriving at a definition of "net profit," prioritize recoupment by taking distribution fees and expenses (prints, ads, publicity, etc.) first, then interest on negative costs, then negative costs (here including all gross participations), and finally deferments and various other participations.

Although the aforementioned net deal predominates, there is also a so-called gross deal, wherein the distributor (usually of low-budget, independently made and independently distributed films) is not separately reimbursed for distribution expenses but instead retains a distribution fee (e.g., 50% to 70%) that is considerably higher than normal. Distribution expenses are then recouped out of this higher fee, while the producer receives the remaining unencumbered portion of the gross rentals.[41]

For a picture performing poorly at the box office, the producer with a gross deal will have an advantage because overall distribution costs (which can be quite high on a percentage-of-revenue basis) are not chargeable. Contrariwise, for a picture doing well at the box office, a producer might prefer a net deal because marketing costs as a percentage of revenues then diminish rapidly and specific marketing charges become more bearable. A structure in which gross-deal and net-deal characteristics are combined as certain performance criteria are met may also be arranged.

In the negotiation of such formulations, the potential advantages to be derived from the control of ancillary-market revenues have inspired many independent producers to attempt to strip from domestic theatrical-distribution contracts, and thus to retain for themselves, the rights to exploit cable, home video, and other sources of income. Studios are, however, ordinarily reluctant to allow these rights to be taken away ("fractionalized") through so-called split-rights deals unless there is compensation through participations or through some other means. Clearly, the larger the total upfront studio fee, the less there is available for recoupment of production costs – and, ultimately, for profit to the independent filmmaker.

In brief, studio profits are centered on distribution activities, where fees may range to over 30% of gross receipts, while out-of-pocket expenses might be covered by at most 15% to 25% of gross receipts. This cushion of profit is earned, in part, for taking the risk that a picture will not earn its releasing costs and also to compensate for the sizable capital invested in maintaining the studio's global distribution infrastructure.

As opposed to licensing to video, pay cable, syndication, and network markets, *theatrical release is the only area where there is the possibility of a negative cash flow* (i.e., where releasing costs can exceed income). But the fee-driven cushion also, in effect, pays for maintenance and extension of the distribution pipeline; when a picture is doing well at the box office, distribution profits soar. Meanwhile, the initial performance in theaters still largely determines, through direct arithmetical links (in sometimes complex formulas), the prices that the film will be able to command in all the markets that follow the theatrical.[42]

The existence of relatively large and highly profitable aftermarkets explains why the film business has – beyond the hype and frenetic interest about first-weekend box-office grosses – instead essentially become a video and television licensing operation.[43]

As broadband distribution of films via the Internet expands, fee formulas will most likely evolve along the lines of the pay-per-view cable or the video 20% royalty models in which gross receipts defined for purposes of participations are bounded. Yet, because manufacturing and distribution costs are nominal as compared with those of traditional physical carrier formats (film reels, tapes, DVDs), prices for Internet viewings are below those for DVDs. The prominent issues here will continue to involve ownership of Internet distribution rights, sequencing of exhibition, and territoriality.

Studio overhead and other production costs

The inclusion of talent participations as part of production costs and not as distribution expenses allows interest and overhead fees to be charged on the participations. From the participants' view, large proportions of production costs are thus often seen as studio overhead charges, which are calculated by applying a contract-stipulated rate to all direct production costs. Such overhead charges may or may not, however, have any close relationship to the actual costs of, for example, renting sound stages or buying props and signs outside the studio's shops and mills.

Because it would almost always be less expensive to buy or lease items on a direct-cost basis, participants may question what services and materials are actually covered by the studio rate. If agreements are not clearly written, and are thus open to different interpretations, disputes may arise with regard to contractual overhead charges for everything from cameras and sound equipment to secretarial services. Probably the most important question, however, is whether full rates are applicable to location shooting. How these matters are resolved – before, during, or (hopefully not) after production – as always, depends on the relative bargaining strength of the parties involved.

Producers are motivated to obtain independent financing to avoid or reduce the effects of these charges, which can add between 15% and 25% to a picture's budget (plus 10% applied to direct ad and publicity costs) and thereby significantly raise the breakeven point required to activate net-profit participants' share payments.[44] Sometimes it is worthwhile and feasible for an independent producer with outside financing to minimize studio overhead charges by offering the film for pickup in an advanced stage of production.[45] In other instances it is less time-consuming and, in the long run, less expensive to go with the studio.

In brief, although overhead rates generally are not negotiable, the things to which those rates apply (offices, vehicles, etc.) may be, and hence it is important for producers to have a full understanding of what their contracts specify. If a studio wants a project badly enough, the items excluded from the standard rule will be more numerous.

Once production begins, cost accounting follows a job-order cost procedure wherein time and materials are "charged against" a job or charge number. This is where careful control by the producer, who has final responsibility during the production phase, is essential. Costs can easily get out of hand because everyone from painters and electricians to cameramen and editors may have at least some authority to charge against the picture's number for materials and services. Detailed budgets for a major feature film shoot lasting ten weeks can easily run to 80 pages and cover several hundred item expense categories.

Budgets high and low

A synopsis of what usually happens to a dollar that flows from the box office will help clarify the processing thus far described.[46] If it is assumed that house expenses are 10%, there remains 90 cents of every dollar to which

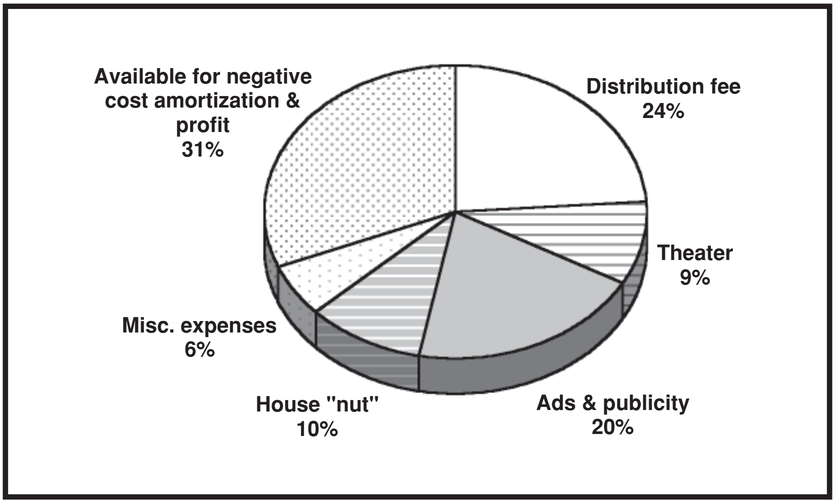

Figure 5.2. Splitting the box-office dollar for a major film.

(for an important release by a major) a 90:10 split in favor of the distributor may be applied for the first two weeks. That, in turn, leaves a distributor's gross ("rentals") of around 81 cents.

In the United States and Canada, a 30% distribution fee totaling 24 cents is then subtracted, leaving 57 cents. Advertising and publicity costs, which are generally at least 20% to 25% of rentals, require deduction of another, say, 20 cents. The remainder is now 37 cents, out of which about 6 cents more is required for miscellaneous distribution expenses, including prints, taxes, MPAA seal, and transportation.

Before the usually substantial negative cost of the picture is even considered, there is thus a residual pool of only 31 cents of the original dollar. Should there also be gross participations, say 10% (of rentals) to a major actor, there would then be 8 cents less with which to recoup the negative cost. And if the picture is studio financed, half of any profit after recoupment would ordinarily be owed to the studio, with the other half split among other participants (Figure 5.2).[47] Including the cost of the negative, the whole box-office dollar (and usually more) has already been spent and the picture is in financial deficit, a loss.

Full cost recovery now generally requires more than theater exhibition alone; for any further recoupment of costs and for profitability to be attained, a picture relies on ancillary-market revenues (DVDs, cable and network TV sales, etc.) that, incidentally, also happen to be circularly tied to box-office performance. So, normally, the worse your picture initially does, the worse it does, and vice versa. It is no wonder then that so many firms have found production to be more difficult and less profitable than they had at first thought.[48]

The partial list of high-budget theatrical flops shown in Table 5.9 illustrates that box-office failure is usually congenital: No matter how large ancillary markets grow, they cannot a golden goose of a turkey make. And there truly is little, if any, correlation between the cost of a picture and the returns it might generate (Table 5.10).

Although lawsuits concerning ostensibly onerous and deceitful "Hollywood accounting" treatments are often based on examples like the one for *Harry Potter* shown in Table 5.11 ("What? It did $1 billion and still 'lost' money?"), it ought to be evident from the preceding explanations that such suits are typically ill-advised and do not usually reflect the true relative economics and bargaining positions of the participants. There is no doubt that studios/distributors have distinct relative bargaining advantages – among them the ability to round numbers up and to employ a wide variety of contractual elements (e.g., those involving interest payments, overhead charges, and advertising expenses) in their favor.

But despite such advantages, studio/distributors are also exposed to risk and sometimes experience periods of low or no profitability. Studios have over many years invested significant permanent capital in difficult-to-replicate distribution, filmmaking, financing, and marketing operations and have long-developed expertise in these areas. For the system to be sustained and to be readily available for relatively fleeting and impermanent single film projects (that occupy scarce, time-perishable distribution slots that might easily be filled with many other potentially worthy competing projects), there must be a significant return on capital (via the large fees charged).

Note, too, that everyone signed to a major studio's release is represented by knowledgeable not-at-all deceived legal advisors, has always had negotiated salaries fully paid (with no bounced checks), and seen future career prospects enhanced from publicity and participation in a major-supported film. For participants, option values on their next project rise, even though their "net" deals – that is, provisions for contingent compensation – are highly unlikely to ever be paid because there are gross participants above them and the picture "lost" money.

5.4 Television-programming accounting

Television was initially thought to threaten the very survival of movies. The tube's mesmerizing influence and its nearly ubiquitous presence indeed contributed to the reduction of annual theater admissions from the all-time peak of about 4 billion in 1946 to about 1 billion in the early 1960s. Yet television eventually became the film industry's first major ancillary market and, in the process, probably its savior. It was a long time before the value of the television market was fully understood by moviemakers.

Studios today engage in three distinct television-related activities: licensing of features to networks; syndication of features, series, and other

Table 5.9. *Selected theatrical winners and losers*

Title	Distributor	Year of first release	Est. neg. cost ($ millions)	Est. domestic rentals ($ millions)
Winners (high and low budget)				
Jaws	Universal	1975	8	130
Star Wars	Lucasfilm/Fox	1977	11	225
Kramer vs. Kramer	Columbia	1979	7	60
Airplane	Paramount	1980	3	41
Raiders of the Lost Ark	Lucasfilm/Fox	1981	22	116
E.T. The Extraterrestrial	Universal	1982	12	228
Return of the Jedi	Lucasfilm/Fox	1983	33	168
Beverly Hills Cop	Paramount	1984	14	80
Batman	Warner	1989	41	151
Home Alone	Fox	1990	18	140
Jurassic Park	Universal	1993	70	212
The Lion King	Disney	1994	65	173
Four Weddings & A Funeral	PolyGram	1994	7	25
Independence Day	Fox	1996	65	171
Titanic	Fox/Paramount	1997	200	1,214
Blair Witch Project	Artisan	1999	<1	141
Spider-Man	Sony	2002	175	406
My Big Fat Greek Wedding	IFL Films	2002	5	241
Paranorm Activity	Paramount	2009	<1	108
TS: New Moon	Summit	2009	50	297
Iron Man	Paramount	2008	140	590
Avatar	Fox	2009	240	750
The King's Speech	TWC	2011	15	140
Losers (high budget)				
Heaven's Gate	UA	1980	44	2
Reds	Paramount	1981	52	21
Howard the Duck	Universal	1986	37	10
Ishtar	Columbia	1987	45	8
Hudson Hawk	TriStar	1991	55	6
Last Action Hero	Columbia	1993	75	28
Town & Country	New Line	2001	105	7
Adventures of Pluto Nash	Warner	2002	100	4
Treasure Planet	Disney	2002	140	38
The Green Zone	Universal	2010	120	35
John Carter	Disney	2012	250	72
Battleship	Universal	2012	209	64
The Lone Ranger	Disney	2013	250	90

Sources: *Variety*, Anniversary and Cannes issues, Imdb.com, Box Office Mojo.

Table 5.10. *Real reel numbers, selected examples, big and small*[a]

Title	*Who Framed Roger Rabbit*	*Commando*
Domestic release date	June 1988	October 1985
Distributor	Walt Disney Co.	20th Century Fox
Period end	12/31/90	2/29/92
Gross receipts		
Domestic theatrical	$80,763	$17,941
Foreign theatrical	80,102	24,022
Pay television	9,680	8,005
Home video	26,573	6,045
Nontheatrical	2,316	
Television		8,507
Consumer products and other	5,686	725
Total	$205,119	$65,245
less		
Distribution fees and costs		
Distribution fees	$68,259	$22,122
Advertising and publicity	48,333	11,529
Checking, collections, etc.	655	194
Other version	1,076	156
Residuals	3,415	3,135
Trade dues	843	371
Taxes, insurance	2,949	1,608
Prints	5,746	3,387
Transportation	951	431
Miscellaneous	166	140
Total	$132,394	$43,073
less		
Negative costs		
Production cost	$50,579	$15,946
Production overhead	7,587	
Interest	17,105	3,129
Gross participation deferments	17,054	396
Total	$92,325	$19,471
Net profit (loss)	($19,600)	$2,701

[a] Data in $000s.
Source: Adapted from *The Hollywood Reporter*, August 17 and September 14, 1992, with permission.

programs; and production of made-for-television movies, series, and programs. The television market itself, however, breaks down into four primary segments – pay-per-view, premium cable, network, and local station syndication – with Internet streaming, that is, digital service provider syndication, emerging as a fifth segment. Many small firms are also active in these areas.

Table 5.11. Harry Potter and the Order of the Phoenix, *profit and loss statement, condensed summary in $ millions. Released July 2007.*

	% Fee	Cumulative $ to date	% of total
DEFINED GROSS			
Domestic			
Theatrical	30	162.113	26.5
Non-Theatrical	30	2.133	0.3
Television	25/25/40	0	
Foreign			
Theatrical/Non-Theatrical	15/25/40	298.059	48.7
Television	40	2.371	0.4
Pay TV	30/35/40	42.875	7.0
Videocassette	30/35/41	87.988	14.4
Miscellaneous/Other	[a]	16.725	2.7
TOTAL DEFINED GROSS		612.264	100.0
TOTAL DEFINED GROSS AFTER ACCOUNTS RECEIVABLE		609.913	
DISTRIBUTION FEE		211.800	
DEFINED GROSS AFTER DISTRIBUTION FEE		398.113	
EXPENSES			
Prints		29.211	15.2
Preprint, dubbing subtitles, editing, etc.		5.634	2.9
Advertising & publicity (incl. 10% override)		131.127	68.3
Taxes, duties, customs, & fees		6.096	3.2
Guild, union & residual payments		10.196	5.3
Other (e.g.,freight, insurance, trade assoc., collection cost)		9.616	5.0
TOTAL EXPENSES		191.881	100.0
DEFINED GROSS (LOSS) AFTER DISTRIB. FEE & EXPENSES		206.232	
INVESTMENT & OTHER, TOTAL		**373.529**	
Negative Cost and/or Advance[b]		315.892	
Interest		57.637	
DEFINED PROCEEDS (DEFICIT)		**(167.298)**	

[a] Various from 0% up to 40%.

[b] Includes payments to author and gross players. Direct production cost estimated at $150–$180 million.

But easy this business is not. In comparison with the situation in feature films, the full earnings potential of a program or series is normally quite limited and the uncertainty of sale or of eventual price in aftermarkets is high.[49] Moreover, potential participant accounting problems (delay and minimization of income recognition and applications of numerous deductions) are often similar to those found in feature-film accounting.

Feature licensing

The peak demand for network feature-film licenses occurred in the late 1970s, when pay cable was still in its infancy and when the American Broadcasting Corporation, flush with ratings victories and cash, had the wherewithal to bid aggressively for rights to exhibit recent theatrical hits. Many of the major licenses at the time permitted up to five runs for fees that (with escalator clauses based on box-office performance) frequently were in the neighborhood of $20 million.

Bidding fervor cooled, however, when it became apparent that pay cable was siphoning off the potential for high network ratings with early showings of uncut movies without commercial interruptions.[50] The ratings of all but the biggest box-office hits also diminished relative to those of made-for-television movies. But, in spite of this, films making their first network appearance in the early 1980s could command an average of perhaps $5 million for two runs. That price reflected expected ratings for the film, the number of weekly hours the networks allotted to feature-movie programming, and the cost of producing comparable programming in terms of running time and content.

Out of any television-license fees, residual payments to participants have to be made, and other distribution costs (including high-priced legal talent and, on a rainy day, taxi fare up New York's Sixth Avenue) must be deducted. A feature film licensed to network television might thus generate for the studio-distributor a profit margin in the range of 40% to 65%.

An important accounting dilemma, nevertheless, appears in the situation in which a package of several features is licensed by a single vendor to one purchaser. According to trade-paper reports, for example, United Artists had followed an allocation formula that

- divided the package price by the number of pictures in the package to determine average price per picture,
- assigned a value of 1.5 times the average price to the feature with the highest theatrical rentals,
- assigned a value of 0.5 times the average price to the feature with the lowest theatrical rentals, and
- ranked the remaining features by rentals earned and assigned a value between 1.5 and 0.5 times the average price.[51]

Similar formulas had been used by other distributors with the rationale that, over the years, "it has been determined that the ratings of the most successful pictures on television, in both domestic and foreign markets, receive no more than three times the rating of the least successful pictures."[52]

However, such formulas were legally challenged because they seemed to produce unfair results for some participants. Thus, under current practices, prices for features in a package are supposed to be negotiated separately for each title even though questions concerning the basis for arriving at a specific price may still arise.

For outside participants, probably the easiest way to account for income from television-license fees is on a cash basis as of telecast date. Nevertheless, there can be many variations, which are to some extent configured by relative negotiating power. As already noted, for purposes of financial reporting, the studio-distributor will recognize revenues at the time the pictures are made available for exhibition. However, actual contract terms might stipulate cash payments of 20% on signing, 50% on availability, and 30% on subsequent runs (in cable network deals, sometimes defined as exhibition days), with down payments on older features being even smaller.

Problems as to the timing of cash receipts, allocations, and different reporting requirements also frequently arise in situations involving licensing of syndication, pay cable, and other ancillary-market rights (novelizations, games and toys, character merchandise, and music).

Program production and distribution

Development and financing processes. Production of original programming for network television is generally in the form of made-for-television movies ("made-fors") or regularly scheduled series and miniseries such as *War and Remembrance* or *Roots*.[53] Each of these program forms may receive somewhat specialized cost-accounting treatment, with the procedures and methods applied to made-fors being similar to those used in making feature films.

Financing for made-fors and series, however, is provided by the networks on a piecemeal basis. About a year ahead of anticipated playdates, networks and program producers, including the television arms of the major film studios and many large independent producers, sift through hundreds (up to 500) of concepts to select those with the potential to become two-hour movies, miniseries (usually 8 to 12 hours in length), or one-hour or half-hour series. No more than two or three dozen of these concepts will then be provided with funds for scripting, and of these, no more than around 20 will be developed into a "pilot" production that will introduce the major themes and characters. At the end, perhaps only two or three might then sustain audience ratings high enough to justify carriage beyond one season and eventually into lucrative syndication (especially to cable).

Pilots allow network advertisers to sense how well the elements in a proposed program will work together on the screen. However, in an attempt to stimulate the buyers, who make their judgments based largely on first impressions, pilots are often loaded with costly production values.[54]

Of 120 or so comedy and drama pilots that have traditionally been produced to compete for vacant scheduling slots (on ABC, CBS, NBC, Fox, and the CW), perhaps only 30 or so might be ordered for the start of the television season, of which no more than half are likely to be immediately placed as regularly scheduled series programming. Acceptance by a network is usually accompanied by a funding commitment to produce 13 episodes initially and by an option contract for additional episodes (usually 9 to 11 more) if the program attracts relatively large audiences. For each episode, the network may pay one-third upon commencement of filming or taping, another third upon completion, and the last third upon delivery and clearance (by network censors and others). The percentages at the various steps of a deal occasionally vary, however, and there may be an additional payment of 10% or so on a rerun of an episode (even though, since the late 1990s, the ratings performance of reruns, and thus their economic value, has fallen sharply).

There are two reasons that producers do not generally profit immediately or directly from series or made-fors developed by the process just described. First, network funding via license fees (normally for two runs) does not typically cover all out-of-pocket cash expenditures incurred by the program producer. In fact, on average, such production costs may be only 80% to 85% recouped from the network license fee, with the remainder expected to be eventually covered by revenues generated through licensing in foreign markets.[55] Under these circumstances, even a relatively efficient producer would have difficulty coming out ahead on a cash basis of accounting.[56]

But a financial deficit is also virtually assured using the accrual method of accounting, in which noncash accruals for studio overhead expenses (at 10% or more of the budget) are included. It is thus common for program producers to "deficit finance" their series and made-fors while trusting that the network ratings will be strong enough to carry the show into the potentially more lucrative off-network syndication aftermarket at some future time.[57]

Network option clauses are another reason that producers or performers might not immediately profit from a successful series introduction. Option clauses for series usually allow the network to order (i.e., "pick up") programs for four or more (six is now not unusual) additional broadcast seasons, with episode fees increasing at least 3% to 5% and more likely 7% to 8% each year. The contracts also provide for first right of refusal for extensions beyond the initial period. This means that even if another network or perhaps cable channels were to offer the production company more money for a program, the offer could not be accepted immediately.[58] Option clauses thus enable a network to retain a show at a cost below the current market rate in compensation for taking the early original risk of placing the show in a timeslot-scarce schedule before the willingness of an audience to watch it has been demonstrated.[59]

Nevertheless, with a network contract in hand, a studio or, more likely, an independent producer can obtain additional financial support by borrowing from a bank, another lending institution, or investor groups. Cash can also be obtained by selling a program's anticipated syndication rights in advance

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to distributors, who are generally in need of programs to fill their already established pipelines. Distributors will often obtain rights from a producer by guaranteeing a certain level of program sales and they may also include cash advances as part of the guarantee. Such advances are then recouped by the distributor from the producer's initial share of program sales, with the distributor taking the risk that program sales will be sufficient to cover the outlay.

After the initial run (and, presumably, rerun), the production company ends up owning the program and can do with it whatever it pleases. The real payoff, if any, however, comes if the series can sustain competitive network ratings for at least three full seasons (and probably four seasons), so that more than 60 episodes (typically 22 per season in broadcast and usually 13 per season in cable) can be completed.

Yet the probability of this occurring is relatively low: At best, about one in five new series survives the ratings wars for that long.[60] Consolidation of station ownership has, moreover, resulted in only six large station-group owners – Fox, Tribune, and Sinclair predominantly but also ABC, NBC, and CBS – becoming the major decision-makers in the scheduling and buying of blocks of off-network and also off-cable fare (e.g., *Sex and the City* and *The Sopranos*) for the lucrative slots in prime-time-access and late-fringe times.[61]

As for movies-of-the-week, first-run syndicated productions (i.e., programming designed for a nonnetwork initial run), prime-time-access shows, and made-for-cable programs, financing is available from large television-program distribution companies (including the television divisions of all major movie studios). For exclusive rights to such productions, a distributor will typically contribute part of the funding in return for profit participations and the opportunity to earn distribution fees.

Syndication agreements. Should a series last three seasons on a network (now increasingly unlikely as audiences continue to shift viewing habits to newer Internet-based viewing platforms), it begins to have significant value for the syndication (used-film) market: Local television stations and cable systems can then obtain enough episodes to "strip" the program into scheduled daily runs over a period of at least several months.[62] Syndication-market licenses, which go to the highest local station or cable network bidder, are conventionally for six consecutive runs of a series in a period of not more than five years and are now commonly for no longer than three years.[63] For long-running series, Internet downloads and DVD sales directed to consumers have also evolved into an important new source of additional revenues.[64]

A typical broadcast syndication agreement will provide that, out of the gross revenues collected, the syndication company will first deduct syndication fees, then deduct out-of-pocket expenses (including costs for shipping,

Table 5.12. *Barter-syndication revenue estimate: an example*

Assume:	• 100 million TV households
	• average ratings of 5.0; i.e., 5 million homes viewing
	• percentage of viewers in target demographic of 60%
	• a cost per thousand, or CPM, of $9.00 for a 30-second spot
Then:	The estimated number of targeted viewers = 3 million (i.e., 5 million times 0.60)
	Revenues per spot = $27,000 (i.e., 3,000 times $9.00)
	Net revenues after deducting a 15% agency commission = $22,950
	Barter revenue for 10 spots a week = $229,500
	Cash license fee per week = $100,000
	Total revenue per week = $329,500
	Total syndicator revenues for 52 weeks = $17.65 million[a]
Costs:	Production of 39 weeks at $125,000 a week = $4.9 million
	Local marketing = $2.5 million
	Distribution fees = 30% of revenues = $5.3 million
Profits:	$7.45 million

[a] Available to be shared with producers and any other "backend" participants.

advertising, and prints), and then recoup advances made to producers. Fees for syndication services (i.e., distribution fees) as a proportion of gross income are generally 15% to 20% for net stripping sales, 30% to 35% for domestic syndication, and 40% to 50% for foreign syndication.

Syndication examples typical of a major movie studio appear in Table 5.12, where the profit potential for a distributor and the similarity in structure to the aforementioned gross deal used in theatrical distribution of features can be seen. Operating margins for distributors of shows produced by others would normally average 30%, and for long-running, self-produced programs around 40%.[65]

Television networks have historically relied on various shows and series to fill most of their prime-time hours. But since the early 1980s, *first-run* syndication has developed into an important means of obtaining programming for independent (i.e., nonnetwork-affiliated) local television stations as well as network affiliates seeking to fill their prime-time access hours (i.e., the hours just before the network's evening schedule begins). First-run syndication, primarily of game, talk, or tabloid news shows, provides television stations with a relatively low-cost, disposable form of programming that is immediately topical and does not depend on, or require, a lengthy network run: The programming skips the network entirely and is syndicated to local stations from its first broadcast appearance.

Although an infinite number of variations can be devised to finance and distribute first-run programming, the primary requirement in launching a first-run program series is to have commitments from enough stations so that at least 65% to 70% of the national viewing audience can see the show. These commitments are normally made on the basis of pilots that are much less elaborately produced than those for network series proposals. And unless a production is a proven ratings winner, it is unlikely that a station would make a syndication agreement that spanned more than one year.[66]

Producers and distributors will generally prefer that stations pay cash for the right to air the programs. But more often than not, the stations instead prefer to swap, or to barter, some of their advertising time slots in return for broadcast rights. Such *barter syndication* arrangements, as discussed in more detail in Chapter 7, have grown rapidly since the late 1970s into a $5 billion-a-year business that, on the margin, reduces revenues available to the networks.[67] The sensitivity of the syndicator's profits to relatively small changes in ratings and the notable degree of risk thus assumed by the syndicator are apparent from the example given in Table 5.12.

The key accounting issue in barter syndication concerns the time at which barter revenues ought to be recognized. According to rulings by an FASB task force, such revenues should be recognized to the extent that they are covered by noncancelable contracts (less an estimated value for "make-good" spots; i.e., adjustments for less-than-expected ratings) and at the point when a program is available for first telecast.[68]

Costs of production. Networks attempt to keep their costs under control through tough negotiations on production contracts. The producer's problem is then to live within the budget constraints imposed by those contracts. That is often difficult, given the limited production time and the sharp union-mandated pay escalations for overtime work related to frequent rewriting and rehearsal.

As of the early 2000s, a prime-time one-hour network show (52-page script) required, on average, up to eight days to shoot (several more to edit) and around $2.0 million to produce, although less popular shows with lower-paid performers might be made for perhaps 70% to 80% of that amount (and half-hour sitcoms for $1.6 million).[69]

For a long-running series, however, the fixed costs for sets, props, and general story concept decrease on a unit basis as more episodes are produced. Everything else then being equal, a series will, over time, become more profitable to make. But the way in which this is reflected in cost accounting depends on several additional factors.

First and foremost is the inclination of performers on a highly rated series to begin demanding much higher compensation per episode under threat of resignation. Per-episode compensation for the main star can easily exceed $125,000 (e.g., up to $1 million in *Seinfeld*, $1.6 million in *Frasier*, $2 million for *Two and A Half Men*, and around $1.8 million in *Everybody Loves Raymond*). And although most of the extra production costs can be passed on to the network through a higher license fee, there have been instances (e.g., *Three's Company*) in which performers' demands have been rejected.[70] Original cable series can normally be produced for around 15% less per hour and in seven instead of the usual eight days per episode.

Another important determinant of reported profitability is the rate at which production costs are amortized. This depends, to an extent, on the number of exhibition windows through which a program can be exploited. Generally, the more windows there are, the higher the production budget that can be afforded.[71]

The theory plays out in practice whenever a producer-distributor begins to see series-syndication potential. At that point, the rate of cost amortization is reduced (i.e., amortization is stretched out over time) so that a portion of expenses can be charged against anticipated future syndication revenues. This treatment of amortization is consistent with that used in accounting for unamortized feature-film residuals, as discussed in Section 5.2.

In contrast, however, first-run production and syndication are relatively attractive to show producers and syndicators because the production costs of such shows are normally much below those of network series and because the returns from syndication of a successful first-run series materialize much sooner than with syndicated off-network programs. Whereas it might cost well over a million dollars to produce a typical half-hour network comedy series, a first-run half hour might cost two-thirds as much. And a week's worth of half-hour game shows (five) can be produced for not much more than a quarter million dollars.[72]

As for what are known as made-for-television movies ("made-fors"), or equivalently, movies-of-the-week (MOWs), the production cost considerations more resemble those of a standard filmed television series episode than those of a full-blown theatrical feature. As of 2014, for instance, most two-hour MOWs were being produced at a cost of approximately $5 million. With network license fees for two runs covering perhaps up to 85% of the cost, and with foreign sales and syndication bringing additional revenues, MOW productions can often turn an immediate though modest profit for the producer.[73] (The network will cover its outlay by selling 45 or more 30-second spots for each run at a price to advertisers of at least $60,000 a spot.)

Costs and problems of distribution. Distribution costs for television programming include sales-office overhead, travel, and the important variable of participant residual payments. Differences in residual payment schedules for broadcast as compared with cable network syndication also often dictate syndication marketing decisions.[74] But, in addition, there may also be expenses for retitling episodes, for possible dubbing into other languages, and for printmaking, which taken together can become significant.[75]

The syndication market has evolved substantially as both independent and network-affiliated stations have come to depend on programming provided by syndication companies through combinations of cash and time-barter arrangements. In fact, syndicated programming accounts for more weekly shows (around 140) and more hours per week than are distributed by the major broadcast networks combined. This includes movie packages, specials, and original first-run programming produced specifically for this market. Inevitably, the same types of arrangements will also become quite common as European, Asian, and Latin American commercial television markets develop.

Nevertheless, in the 1990s, the greatest changes in program distribution relationships in the United States stemmed from elimination of the government's so-called financial interest and syndication ("fin-syn") rules. These rules had barred television networks from owning any syndication interests in shows that they had broadcast and had placed limits on the number of program hours that a network might self-produce.[76] The expiration of fin-syn restrictions in 1995 then opened the way for networks to obtain a significant second source of income through sales of self-produced entertainment programming.[77] More importantly, however, the end of fin-syn made it possible for studios and broadcast networks to be merged.[78]

The financial consequence of owning *both* the production/syndication rights and a major broadcast network is illustrated by the following example, which assumes that a 30-second prime-time spot yields an average $200,000 and that there are 14 such spots per half hour and 22 new episodes per season.

Network license fee: $1.5 million per episode × 22 episodes =	$33 million
Domestic syndication: $1.5 million per episode × 22 episodes =	33 million
International syndication: $2 million per episode × 22 episodes =	44 million
Total	$110 million
Less: Studio production cost: $3 million per episode × 22 episodes =	(66 million)
Studio profit =	$44 million
Plus: Net network ad revenue: $3 million per half hour × 22 episodes =	66 million
Combined annual profit =	$110 million

Given that many such successful series can be produced for at least seven to ten years and go into several syndication cycles, the total franchise value can thus exceed $1 billion!

Although the former dominance of the networks has, in the meantime, been eroded by collectively severe competition (from cable, independent television stations, and other home-viewing options), television-program development, production, and distribution have become largely consolidated into the hands of the major movie studios and other media companies with deep pockets. Small independent companies have not been able to thrive, given the sizable risks and capital investments now required to launch, market, and distribute prime-time television series.

Timing troubles. Whenever a distributor owns a program series, revenues and earnings are recognized when the series is made available to stations – a practice identical with that established for feature-film licenses.[79] But for series in which only distribution services are being rendered, distribution fees would normally be recognized as being earned period by period as the episodes are played out and as cash payments are accordingly received.[80]

Producers, distributor-syndicators, and individual profit participants all have different claims on the television-license income stream and individuals or corporations may simultaneously function in one or in several of these roles. Also, much as on the theatrical side, differences in perspective may often lead to great controversies and to audits. Disputes may occur because the timing of the disbursements and the profits recognized by one participant in a series project may be vastly different from the timing and profits received by another.

Illustrative cases, as discussed in a segment of the CBS show *60 Minutes* (December 7, 1980) and in a *TV Guide* story (Swertlow 1982), have involved actors Fess Parker of the *Daniel Boone* series, produced by Twentieth Century Fox, and James Garner of the Universal series *Rockford Files*. These stars, who had contracted for deferred profit-participation points in addition to, or in lieu of, greater immediate salary, asserted that the distributors had earned substantial profits totaling many millions of dollars, whereas they had yet to receive any profit on participants' shares.

Parker sued Fox for $48 million, claiming that the one-hour series that ran in prime time for six years on NBC moved into successful syndication and grossed $40 million. Garner claimed that his long-running network series grossed over $52 million from both domestic and foreign sales. How, they asked, is it possible for these series to be reported as unprofitable?

The answer lies in the definition of "profits" used in the contracts. Just as in feature-film participations, a few rare talents may bargain for and be powerful enough to command high fees plus a percentage of gross revenues. Some others may bargain for a high salary and be entitled to only a small (or no) percentage of narrowly defined "profits." And most others are not participants at all; they are fortunate simply to get a job at minimum scale.

Take, for example, a hypothetical situation described by Robert Leeper, a former executive at Universal and Fox, in the *TV Guide* story:

> A studio claims a production cost of $10 million for the first year of a one-hour series. . . . 70 percent of those are hard, or actual costs for such items as sets, lights and film – but the remaining 30 percent includes studio charges for overhead such as the studio's parking lots and offices.
>
> If the network carrying the $10 million show pays $8 million for the series the first year, then the series has lost $2 million for the year. If the series is a hit and runs for five years on that basis, it means that on the book, technically, the hit series has lost

Table 5.13. *Summary profit accounting for the television series participant: an example*

Studio's self-produced series (over five years)	
Revenues ($ millions)	
Network payments for production	50.0
10% selling fee (program to network)	5.0
40% syndication distribution fee (125 episodes at $200,000 each)	10.0
40% foreign-sales distribution fee	5.0
Interest and other	3.0
Total	73.0
Expenses ($ millions)	
Production costs (including overhead)	65.0
Direct distribution costs	2.0
Residuals and other	6.0
Total	73.0
Studio profit before taxes	0.0

$10 million in production costs alone. There are other charges too. The studio also gives itself 10 percent as a commission for "selling" the series to the network. That's $800,000 a year – an additional $4 million in costs over five years, plunging the series $14 million in the hole on the books. The studio then charges the show interest on these losses. Say that, over the five years, with a fluctuating prime rate, the interest has amounted to $2.2 million. The series is now $16.2 million in the red.

. . . [N]ow, the 125 episodes produced over the five years are sold for a total of $100,000 per episode – a grand total of $12.5 million. The profit participant may think that the series' deficit has now been reduced to $3.7 million, and that he is on the verge of turning a profit. Wrong. Forty percent of the syndication revenue is lost to the distribution fee – the money the studio gives itself for selling the show to stations buying the reruns. In this case, that's $5 million. The remaining $7.5 million is then deducted, leaving the series $8.7 million in the red. The studio then charges the series what are called "actual costs" for distributing the series to syndication. They include costs for editing, making prints and negatives, costs for shipping the series to stations buying the reruns. These "actual costs" may amount to another $1.3 million. So our one-hour series is still $10 million in the red. (Reprinted with permission from *TV Guide* magazine, copyright 1982 by Triangle Publications, Inc., Radnor, Pennsylvania)

Despite the deficit reported to participants, does the studio make a profit? The answer, in the case of a long-running series, is a qualified yes if it is indeed assumed that "soft" costs (which help to absorb the general overhead costs of running a studio) are embedded in the total production-cost figure, if it is understood that the studio is in business to make a profit out of renting its distribution capability (and thus make a profit on the distribution fees charged), and if it is recognized that the studio tends to receive its cash payments a lot faster than the participants, who might see only a summary accounting such as that shown in Table 5.13.[81]

Studios do not deny that production and distribution of series can be profitable for them even while the statements of individual participants indicate losses. But again, as in feature films, the difference is that the studio places substantial operating capital at risk with its investments in plant and equipment, sales offices, and other assets required to run the business over the long term. In contrast, participants are normally paid handsome salaries for their services, and they do not incur such risks.

5.5 Weakest links

Well-publicized financial-accounting disputes in movies and television support an impression that dishonesty and cheating are rampant in entertainment industries. Keen news-media coverage catering to the high level of public interest in industry affairs also tends to magnify whatever problems exist. But just as in other segments of the economy, the great majority of individuals and companies in entertainment conduct their businesses ethically. Indeed, because creation of entertainment products is such a people-intensive, collaborative process, success may depend as much on esteem and trust as on ability.

To guard against improper conduct, however, it is necessary to know where "leakages" in the revenue stream are most likely to occur and to consider how and where people might cheat.[82]

Exhibitors: The beginning and the end

Customers' cash payments at the box office represent both the beginning of a chain of remittances and the end of a long creative manufacturing process – with a single, simple idea for a movie eventually generating hundreds of pounds of legal paperwork and hundreds of thousands of feet of processed film (and/or computer hard drives filled with trillions of digits).

Because the precise terms of distributor–exhibitor contracts are seldom made known to anyone not party to the agreements, both exhibitors and distributors can, for publicity purposes, sometimes distort the true size of the box-office gross.[83] In this way, a small picture can, for a brief while, be made to look like a modest hit, and a modest hit may be proclaimed practically a blockbuster.

On the next level of the cash stream's cascade, the exhibitor's house expense (nut) is a negotiated item that can be inflated to ensure a profit to the exhibitor. In fact, a given theater may simultaneously have different house-expense understandings with different distributors. The degree of this inflation can be the result of long-standing tacit agreements, or it may be subject to momentary relative bargaining strength. Either way, though, the size of the nut ultimately affects the grosses (rentals) received by the distributor and thus the incomes of other parties downstream. The incomes of those parties would, of course, also be reduced if theater owners paid their bills slowly or if there were significant "adjustments" to the allowances for co-op advertising or for "settlements."[84] After all, a distributor's relationship with exhibitors is usually more important than that with gross or net participants.[85]

Ticket-pricing policies, however, may generally have the greatest effect on what the downstream participants might ultimately receive. Pricing is subject to local competitive conditions, moviegoer-demand schedules, and the exhibitor's interest in making as much as possible from concession sales. Exhibitors who attempt to promote concession sales by setting low admission prices are in effect diverting and thereby diminishing monies available for downstream disbursements. To prevent abuses in this area, distributors occasionally write contracts specifying minimum per capita ticket prices (see Section 4.4).

Playing the "float" (i.e., the time value of money) is another endemic industry problem. This is somewhat surprising because box-office income is almost always in cash and, in theory, exhibitors should have absolutely no difficulty in paying rentals immediately due. Moreover, because theater owners normally have an interest in playing a distributor's next film, large distributors have important leverage to encourage prompt remittances. Nevertheless, in practice, playing the float appears at all levels of the industry and eventually has a cumulative adverse effect on profit participants.[86]

Outright fraud occurs if exhibitors and distributors cooperate to falsely claim national advertising when the advertising is characteristically local. In such situations, national advertising is charged to the producer's share, leaving the exhibitor and distributor a larger profit. It is also sometimes possible for an unscrupulous exhibitor to obtain false invoices for more local advertising (paid on a co-op basis by the distributor) than is actually placed in local papers. Exhibitors might also conveniently forget to inform distributors that, after a certain amount of newspaper linage is placed, a quantity rebate is obtained.

In addition, distributor–exhibitor *settlements*, which are renegotiations of terms for pictures that do not perform according to expectations or that reflect shifting bargaining leverage, might be abused.[87] In this case, distributors join with exhibitors in actions that deprive producers and other participants of income that would otherwise be theirs.[88]

Distributor–producer problems

As has been seen, the income of profit participants is affected by charges for studio overhead, by publicity and other marketing fees charged for in-house departments, and by deductibles from the producer's share, which may include dubbing, editing, checking distributor receipts, copyrighting, screenings, censorship clearances, trailer preparation, insurance, tariffs, trade-association dues, print examinations, and print junking costs. If participant contracts are not carefully negotiated, the extent to which these charges are applied in any project is sometimes a source of dispute.

Major profit participants, such as leading performers, can also adversely affect the interests of other participants. For instance, this occurs when special antique furnishings, wardrobes, houses, or cars originally bought for a film are given to performers for personal use after production is completed.

Another version of this occurs when films are being shot in countries (e.g., Hungary and India) that have blocked currency remittances because of foreign-exchange controls. In these instances, it is not unusual for family and friends of important actors to receive free trips to exotic film locales. Blocked currency earned within a country must be spent within the country of origin.[89]

As already indicated, there is inordinate potential for controversy in allocations of television-license fees, cross-collateralization deals, and studios' accounting for foreign taxes, which may be charged to a picture even though the parent company later receives a credit against U.S. taxes. Also, accounting for remittances from foreign-based sources may be especially difficult because auditing privileges may be contractually restricted to books based in the United States, foreign-exchange rates may be rounded off in favor of the distributor, and foreign collections may be unusually slow.

Producers may attempt to avoid entanglement in these issues by making their own arrangements for independent foreign distribution. This is often done most efficiently by contracting with experienced overseas foreign sales companies whose service fees are generally in the range of 10% to 15% of revenues collected (and are subject to the right of recoupment of direct-sales costs if the film's gross is insufficient).[90]

5.6 Concluding remarks

The essential strength of the major film studios has been derived from their ability to control and to command fees for distribution and other services from the early financing stages to the timing of theatrical release. And developments in technology are always presenting new challenges as well as opportunities for industry participants.

Such opportunities will allow many smaller companies to carve out profitable niches for themselves. Yet the enormous amount of capital required to operate film and television-program production and distribution facilities on a global basis ultimately presents a significant barrier to entry and reinforces the trend toward vertical integration of the industry. Because the costs of production are what financial economists call *sunk costs* (i.e., most of the expenditure to create a product is invested up front and incremental expenditures are thereafter relatively modest), it makes sense for a production to be exposed in as many windows of exhibition as possible. For products such as films, in which variable and marginal costs are relatively small as compared with large fixed and sunk costs, market size is the key to viability.[91]

Emergence of new media markets does not, however, necessarily reduce or eliminate risk, changes in production and distribution technologies will continue to be disruptive, and new product-appeal cycles have not disappeared. These elements are a part of this business, just as they are for any other.

Although industry consolidation appears to be largely completed, the financial-economic structure of the movie and television production and distribution industry is becoming ever more complex and, as such, is providing a more interesting and selectively more profitable arena for investors.

Notes

1. Copyright 1951 and 1952 by Paramount–Roy Rogers Music Co., Inc. Copyright renewed 1979 and 1980 and assigned to Paramount–Roy Rogers Music Co., Inc.

2. Bart and Guber (2002, p. 155).

3. Rosen (1981) was the first to apply rigorous economic analysis to the "superstar" phenomenon. Subsequent papers on the same subject include those by Adler (1985), MacDonald (1988), and Hamlen (1991). See also Frank and Cook (1995) and especially Elberse (2013, Chapter 3).

4. Litigation concerning *Bad News Bears*, which was licensed to ABC by Paramount for \$6.75 million as part of an \$18.5 million package, helped set legal precedent in a 1979 lawsuit. Details are in *Variety*, January 21, 1981, and July 2, 1980.

5. Companies using amortization tables periodically tested their continuing validity based on actual experience, with most tables amortizing total production costs allocated to theatrical exhibition over a 104-week period by charges to income equal to about 65% of such costs in the first 26 weeks of release and 90% in 52 weeks.

MCA Inc., for example, had amortized according to tables prior to FASB Statement 53 but found that such estimates were not consistent with those on an individual-picture basis. To restore consistency, in 1981 the company adjusted its inventories on films already released by taking a "write-down" of about \$50 million against previous years' retained earnings.

6. A writedown before release is a relatively rare event because, if the correct low-performance box-office estimates were available early in the production process, the film wouldn't ever be financed, made, or distributed. An example of SOP 00–2 rules requiring restatement of a previously announced quarter was seen in December 2002, when Disney adjusted downward by 2 cents per share (\$74 million pretax and \$47 million after tax) its already announced fourth-quarter 2002 earnings per share results immediately after the disappointing first (five-day Thanksgiving) weekend box-office take (\$16.6 million) of the animated *Treasure Planet*, which had an estimated cost of \$140 million.

7. There were also some 16-mm screenings at educational and penal institutions.

8. Growth in television revenues is illustrated by the following: In 1956, MGM received about \$250,000 for a network showing of *Gone with the Wind*; in 1979, based on a \$35 million face-value 20-year contract with CBS, the average per run was more than \$1 million.

More recently, networks had been paying record amounts for top films. For example, in a 1994 agreement, NBC paid MCA $50 million for pre-cable rights (four runs) of *Jurassic Park*. And, in 1996, ABC acquired the rights to two runs (after pay-per-view and pay cable) of *Mission: Impossible* for $18 million to $22 million, depending on box-office performance. Other important deals include the Fox network agreement in 1997 to pay $80 million for early broadcast rights to *Lost World*, Fox's $80 million television rights deal for *Star Wars Episode I: The Phantom Menace*, and Disney's acquisition of the broadcast and basic-cable television rights to *Harry Potter and the Sorcerer's Stone* in 2001 for about $70 million (plus rights to the sequel for an additional $60 million). Most pictures would likely receive 20% to 25% of theatrical box office gross for two prime-time network runs.

9. In the early 1980s, the AICPA appointed a task force to recommend disclosures that would better explain cost-recoverability methods without unduly burdening the industry. The result is that companies now disclose information about their assumed revenue cycles, the composition of their film costs, and the expected timing of future amortization of the unamortized costs of released films. According to SOP 00–2, if the percentage of costs expected to be amortized within three years from the date of the balance sheet is less than 80%, additional information is required.

Also, in October 2012, the FASB issued Accounting Standards Update (ASU) No. 2012–07, Topic 926. This update requires that "if evidence of a possible need for a write-down of unamortized film costs occurs after the date of the balance sheet but before the financial statements are issued, a rebuttable presumption exists that the conditions leading to the writeoff existed at the balance sheet date." This has the effect of reducing a company's ability to smooth earnings from one year to the next. Note that International Financial Reporting Standards (IFRS) do "not contain industry-specific guidance on the impairment assessment of unamortized film costs."

10. On the conceptual framework for accounting, see Watts and Zimmerman (1990) and Dopuch and Sunder (1980). Schilit and Perler (2010) provide a guide on detecting accounting gimmicks and frauds in financial reports.

11. In 2004, the IRS provided guidance as to how abandoned projects ought to be treated for tax purposes. Revenue Ruling 2004–58 indicated that unless taxpayers (studios) have formally established an intention to abandon the creative property, they cannot claim a loss deduction for the capitalized costs of acquiring and developing the property. Also, should the property become worthless, the taxpayer can only take the related deduction if there is a closed and completed transaction fixed by an identifiable event establishing the worthlessness of the property. See also Revenue Procedure 2004–36 and www.irs.gov/newsroom.

12. The current year's amortization equals unamortized costs times current year's gross income divided by remaining estimated gross income (including the current year's), which means that any increase in the denominator decreases the amount currently expensed; hence, higher earnings are reported.

13. For instance, when Lorimar-Telepictures was acquired by Warner Communications in early 1989, more than $450 million of its equity was eliminated through adoption of Warner's more conservative accounting practices. Another example of accounting distortion occurred when Viacom, parent of Paramount, booked $1 billion of revenue for a ten-year pay-TV output deal with German television mogul Leo Kirch (Kirch Group). About halfway through the ten years, Kirch was unable to pay license fees.

The sensitivity of reported earnings to relatively small changes in early-period revenue estimates is also substantial. For instance, a 10% increase in total estimated revenues could normally be expected to at least double profit margins in such early periods. Companies with high inventory-to-sales ratios will generally correlate with optimistic projections of income ultimates, and vice versa.

14. For instance, according to the Time Warner 2008 10-K, "management bases its estimates of ultimate revenues for each film on factors such as the historical performance of similar films, the star power of the lead actors and actresses, the rating and genre of the film, pre-release market research (including test market screenings) and the expected number of theaters in which the film will be released." A more recent amendment to FASB standards also occurred in 2012, with respect to timing of recognition of film cost impairments. Previously, for films released near the end of a quarter but impaired prior to filing statements, any impairment recognition would have been recorded for the previous quarter. Now impairment is limited to information available at quarter's end, which pushes impairment recognition forward to after the balance sheet date and onto the next quarter's report. Disney applied this rule to its loss on the 2013 release of *The Lone Ranger*. The loss would have previously fallen into fiscal 2013 Q3 but was recognized in fiscal Q4. See also note 9 on ASU number 2012-07.

15. This is the reason for the downward adjustment in Table 4.2 of average negative costs for MPAA companies beginning with the year 2000.

16. Leedy (1980, p. 9) expresses the view that accrual accounting would be to the detriment of outside participants. Daniels, Leedy, and Sills (2006, pp. 45–8) note that the industry is unique in using a mix of both accrual and cash accounting methods, primarily because the cash flow patterns coming from various exhibition license windows are much different from and better suited to accrual than those for participants, where it makes sense for studios to use cash methods and thus not have to possibly bill participants later for refunds. Under Generally Accepted Accounting Principles (GAAP), cash basis accounting is not used in reporting public company statements. Only accrual basis, which recognizes revenue when earned and expenses when incurred, is allowed.

17. Until 2001, merger and acquisition accounting followed either a pooling-of-interest or a purchase methodology, neither of which were unique to the media industries. As described by Accounting Principles Board Opinion 16, the "purchase" method accounts for business combinations such as the acquisition of one company by another, with the acquiring corporation recording as its cost the assets less liabilities assumed. Under this method, goodwill is the difference between the cost of an acquired company and the sum of the fair values of tangible and identifiable intangible assets less liabilities. Prior to 2001, when purchase accounting was conditionally allowed, goodwill had been amortized over a period not exceeding 40 years.

According to new FASB Statement No. 142, effective 2001, however, in business combinations companies no longer have to amortize the value of intangible assets for which they can identify cash flows and show that the assets have indefinite lives. Under the new rules, goodwill need not be amortized unless the related asset values are impaired. If impaired, the assets must be written down to their estimated fair value. See the *New York Times* and *Wall Street Journal*, December 7, 2000.

In contrast, a business combination using "pooling of interests" is viewed as "the uniting of the ownership interests of two or more companies by exchange of equity securities. No acquisition is recognized because the combination is accomplished without disbursing resources of the constituents. Ownership interests continue and the former bases of accounting are retained."

18. The quasi-reorganization of Filmways Corporation in 1982 illustrates this point well. A spate of expensive box-office failures had led Filmways into financial difficulties. It was only through injection of fresh capital and reorganization that the company was saved from probable bankruptcy.

As applied here, the "quasi" is a form of purchase accounting in which the film library is assessed on a picture-by-picture basis, with some pictures written up and some written down. New amortization rates are then established for recent releases and in-process productions, and a fair market valuation of the company's distribution system is made. In the case of Filmways, an immediate cash infusion of $26 million (in exchange for issuance of debt and equity securities) combined with the sale of assets and various accounting adjustments gave the company a new lease on life under the name Orion Pictures. Although tax credits previously accumulated from the Filmways net operating losses had to be abandoned, the film library (composed of more than 600 theatrical and television motion pictures) was written up by $18.2 million. In addition, the distribution system, which had not been on the balance sheet as such, was assigned an estimated fair market value of $14 million (out of the eliminated $22.2 million in goodwill carried on the prior company's books).

Welles (1983) discusses Orion's quasi-reorganization and overhead-amortization accounting policies in a generally critical vein. Note, however, that the reorganization was done in consultation with various regulatory agencies and under the guidance of auditors from Arthur Young & Co. Filmways' auditor had been Arthur Andersen & Co.

MGM's acquisition of United Artists Corporation from Transamerica Corporation in 1981 provides another example of applied purchase-method accounting. The $380 million purchase price was allocated to the assets and liabilities of United Artists based on independent appraisals of those assets and liabilities. That portion of the acquisition cost not allocated to specific assets – in other words, goodwill – and the appraised value of the worldwide distribution organization acquired in the purchase of United Artists were to be amortized on a straight-line basis over a 40-year period. But MGM's assigned distribution-system value of $190 million is being amortized over 40 years, whereas Orion's distribution system is being amortized on a straight-line basis over only 25 years. A higher amortization rate places a greater burden on current reported income.

19. If a picture is completed on time, and is within 10% of budget, as much as half the premium may be refunded. See also Chapter 4, note 28.

20. A pickup arrangement should not be confused with the rare situation in which a distributor would actually agree to guarantee a bank loan instead of just promising distribution. In directly guaranteeing a bank loan, a contingent liability must be immediately recorded on the studio's balance sheet. In contrast, distribution guarantees and pickups do not appear on the balance sheet until the picture is delivered.

21. A notable exception to the standard 30% theatrical rate existed in the 1970s when United Artists distributed MGM's products for 22.5% of gross. In addition, limited financing partnerships such as those discussed in Chapter 4 have more recently been able to obtain agreements for below-average rates.

22. Return on investment in this example is, simplistically, 54% (i.e., $8.1 million/$15 million). However, many other factors, including length of time needed to make the movie and taxes,would need to be known in order to make useful comparisons.

23. However, as Cones (1998, p. 46) notes, "when a film is independently financed and presented to a distributor for pick-up, that transaction is more accurately referred to as an *acquisition*." The term *negative pickup* should be more properly reserved to describe lender-financed transactions.

24. After seeing what is in most cases the equivalent of a rough draft of the movie, an interested distributor will attempt to forecast expected minimum rentals and then offer an advance toward further production and postproduction costs based on the forecast. Knowing, for example, that distribution expenses for release in, say, the 450 theaters sought by the producer will be $6 million, and taking a standard distribution fee of 30%, the distributor will break even on film rentals of $20 million.

Minimum distribution expense/fee = distributor's breakeven point.
$6,000,000/30% = $20,000,000.

Given these circumstances, the distributor could extend a maximum advance of $14 million to the producer or promoter.

The amount of the advance actually offered by the distributor may, however, be only half that indicated because (a) the distributor requires a cushion against the risk that the rentals forecast may turn out to be too optimistic; (b) the distributor is in business to do better than break even; (c) not all distribution expenses are included in the minimum figure; (d) this variable-cost example does not reflect the large fixed costs of maintaining a major distribution organization, nor does it reflect studio operating expenses; and (e) studio distribution slot availabilities are time-perishable. See also Bluem and Squire (1972), Curran (1986), and Baumgarten, Farber, and Fleischer (1992).

25. Deals with independent producers, as noted in Berney (2004, p. 382), range from a fairly standard distribution advanced in return for distribution rights and fees to "rent-a-system" deals in which producers hire distributors for specific tasks (i.e., finding theaters, planning marketing, etc., as, for instance, in *My Big Fat Greek Wedding*), and on to "costs off-the-top" deals in which the distributor first recoups advances for prints and advertising (p&a) from the first dollar of rental and thereafter splits 50/50 with the producer.

26. Private funds specializing in p&a financing are relatively safe investments because the funds are repaid before or immediately after the distributor is paid and repayments are collateralized by income from video and other ancillary-market sales. In this situation, the distributor is less at risk and is therefore willing to accept a lower fee. Revolution Studios, founded in 2000 by former Disney head Joe Roth, for example, was structured on a similar concept; Sony owns equity in Revolution and paid 40% of each film's cost plus all marketing expenses. Sony got theatrical and video rights (except for Germany and Japan) and charges only 12.5% as a distribution fee. See *BusinessWeek*, March 5, 2001. The second Disney/Pixar deal that covered *Finding Nemo*, for another example, called for an even sharing of profits and a 12.5% distribution fee. Pixar was acquired by Disney in 2006. After the 2008 success of *Iron Man*, producer Marvel Entertainment struck a new 8% distribution fee agreement for four pictures with Paramount (versus around 10% previously). See "Paramount to Distribute Marvel Studios Movies," *Wall Street Journal*, September 30, 2008. In the separation of DreamWorks from Paramount in 2008, new worldwide distributor Universal (except for India) receives an 8% fee for releasing about six films a year. See "Universal Pictures to Distribute DreamWorks Films," *Los Angeles Times*, October 14, 2008.

27. The effect of gross participations on studio profits is discussed in Holson (2002). For instance, the film cost for producing and marketing *Men in Black II* was estimated to be $200 million, and at least 40% of the gross was earmarked for actors Will Smith and Tommy Lee Jones, director Barry Sonnenfeld, and others. The actors were paid a salary in advance but agreed to stop collecting their share of the film's revenue when the box-office gross reached $200 million, thereby allowing the studio to recoup its investment. Once that is achieved, what is known as the hiatus period ends and the stars again begin to collect their checks. As noted in *Variety* of November 25, 2002, however, studios had by late 2002 begun to limit first-dollar gross deals with even major stars to no more than 25% (instead of 30% or higher). To compensate for the higher-percentage deals, studios had used a distorted economic model in which as much cost as possible was packed into negative costs. The old "studio system" of the 1930s, in which performers were contractually tied for seven years, ended in 1944 when a California court ruled against Warner Bros. in an extension clause dispute. After this, negotiating power shifted from the studios to the stars, as performers could be employed for individual projects.

Gross participations of the lesser kind began to be offered more frequently in the late 1990s. In 1999, Columbia Pictures offered the first gross participation to writers. A writer with sole credit for a movie will receive 2%, and a coauthor 1%, of gross profits, defined as any sums left after the studio recoups the costs of producing, distributing, and marketing the film but before the studio pays itself a distribution fee. This means that if a film cost $50 million to make and another $30 million to market and the studio received $120 million in revenues from theatrical, television, and home-video distribution, a sole credit writer would receive an additional $800,000 over and above the Writers Guild minimum. See also *Variety*, February 8, 1999. The modern era of "profit" participations for talent began in the 1950s with Jimmy Stewart's deal for *Winchester '73*, which was negotiated by MCA's agent-president Lew Wasserman at a time when the studio was short of funds. The deal, as recounted in Bruck (2003, p. 114), also significantly reduced Stewart's tax liabilities. Another such Jimmy Stewart participation was for the movie *Harvey*. Earlier participations, however, go back to the days of Irving Thalberg at MGM in the 1930s. The first profit participation contract is believed to have been drawn in 1934 with the Marx Brothers for the MGM movies *A Day At The Races* and *A Night At The Opera*. The contracts were simple in that the brothers were to net 15% of all the money the studio received. See also Thompson (2008) for a brief historical review of star compensation practices.

28. First-dollar deals finally began to be trimmed or eliminated in 2006, when studios faced slower growth of box-office and DVD sales. Under the reworked deals – which are called cash breakeven – studios keep 100% of revenues until recoupment of production, marketing, and distribution costs. Some such deals may also require that studios count all of a film's video revenue toward its recoupment instead of the typical 20%. Among the films first affected were *Da Vinci Code*, *Mission: Impossible III*, *Holiday*, and two *Pirates of the Caribbean* sequels. The trend away from such deals then accelerated after the 2008 writers' strike. As Cieply (2010b) notes, compensation for major stars has increasingly shifted away from first-dollar gross to backend compensation. Some actors are even working for SAG schedule F minimums of $65,000.

An example recounted in Fleming (2008a) was Jim Carrey's deal for *Yes Man*, in which he waived $25 million in return for 33% of all revenue after defined breakeven and one-third of 100% of DVD revenues. Clint Eastwood also reportedly received 30% of first-dollar gross after the studio recouped its costs for *Gran Torino*.

Even so – as indicated in a *Hollywood Reporter* story of March 7, 2014 about Sandra Bullock's compensation for her role in *Gravity* ($110 million production cost) – first-dollar gross deals haven't entirely disappeared. Bullock earned $20 million upfront against 15% of first-dollar gross. So once the advance was covered, she was entitled to collect 15% of film rentals, which might have been 45% of a worldwide box-office gross that exceeded $750 million for Warner Bros. Bullock would thus make at least $50 million in addition to the advance. But theatrical is only around one-third of the total, with another third coming from DVDs and then a final third from pay and free TV. See also Holson (2006a), Kelly and Marr (2006), and Schuker (2009c). An example based on Horn (2006c) follows.

First-dollar gross method		*Cash breakeven method*	
Gross revenue to studio	$200.0 million	Gross revenue to studio	$200.0 million
Profit shared with filmmakers and cast at 25% of that revenue	−$50.0 million	Studio payback for cost of making the movie	−$160.0 million
Studio gross revenue	+$150.0 million	Net revenue for filmmakers, cast, and studio	+$40.0 million
Total cost of making the movie	−$160.0 million		
Studio bottom line	−$10.0 million	Payments to filmmakers and cast at 50% of net revenue	−$20.0 million
		Studio bottom line	+$20.0 million

Epstein (2006) further explains how first-dollar gross is modified. Top gross players receive both fixed and contingent compensation. "The fixed part is the upfront money that gross players are paid whatever happens to the movie. The contingent part is the percentage of a pool called the 'distributor's adjusted gross'. . . . The pool is 'filled, with the money that the studio's distribution arm collects or, in the case of DVDs, gets credited with. . . . The standard DVD royalty is 20 percent of the wholesale price." For TV licensing, the contribution to the pool is license fees minus residuals paid to actors, directors, and others. (So-called 100% accounting, usually only for corporate partners such as Pixar, credits the pool with DVD proceeds less manufacturing and packaging costs.) Gross players are entitled to a share of the pool only after certain conditions are met. Those conditions normally include the film earning back the fixed compensation and reaching contractually defined cash breakeven. Epstein shows that Arnold Schwarzenegger's contract for *Terminator 3* included a DVD royalty contribution to the pool of an unusually high 35%, which meant that the star was entitled to 7% (20% of 35%) of the studio's DVD sales receipts. Off-the-top deductions leading to what's known as distributor's adjusted gross commonly include deductions for, as Epstein (2010, p. 92) lists, "checking, collection conversion costs, quota costs, trade association fees, residuals, and taxes."

29. As described in Eller (2008), in *Indiana Jones and the Kingdom of the Crystal Skull*, George Lucas, Steven Spielberg, and Harrison Ford participated in such a so-called breakeven deal. In this rather atypical arrangement, an important difference is that Lucas, who created the story, owns the Indiana Jones copyright. Paramount's production cost was around $185 million, and it spent perhaps $150 million in worldwide marketing. The studio distribution fee is 12.5% of all revenues generated from theaters, DVD, and television sales. Only after Paramount receipts go above $400 million or so and therefore cover its funding and distribution fee do the participants begin to collect their shares. But at that point Paramount only receives 12.5 cents from every additional dollar, whereas the participants earn 87.5 cents. A failure at the box office would, however, result in little gain to either the studio or the talent.

The pooling concept, according to Brodesser-Akner (2011), originated with Disney's 2001 release of *Pearl Harbor*, which had an extremely expensive gross-participating combination of star, director, and producer. With DVDs in decline, use of pooling increased. Here, all parties agree to allow the direct physical costs of the production to be recouped, after which percentages of the pool are allocated according to the work performed. The pool can enhance studio profitability because it never exceeds 25% of the gross.

Tyler Perry, creator and star of the highly profitable *Madea* series of films, was also able to command first-dollar gross from distributor Lions Gate. According to Block (2009), "the indie studio pays him up to $15 million upfront plus 15% of first-dollar gross for his major projects. He also gets final cut and owns the copyright on his movies and TV shows, and he receives an unprecedented 50% of the gross on the backend for home video, pay TV and other post-theatrical rights."

Some participants might also receive a *cash breakeven zero* deal, which means that once the defined breakeven point is reached, no further (i.e., zero) distribution fees are included in the calculation.

30. Relativity Media, run by Ryan Kavanaugh, has been at the forefront of such risk-sharing deals, with pictures distributed through his Rogue production arm (formerly Universal's horror imprint), or through Lions Gate. See Fleming (2009), Jones (2009), and Garrahan (2011a).

31. The bigger the budget, the more costly the advertising campaign, and the more gross players are involved, the less likelihood that the net-profit point will be reached. Gross participants' payments, for example, are cycled back into the negative cost. As a rough approximation, net profits are achieved when the studio's revenues are about 1.5 times the studio's costs of production and promotion, including the salaries of the stars. According to Robb (1992), net profits of $155 million were paid to 94 participants on Paramount releases between the years 1974 and 1987.

32. The cost of a film trailer, for example, might arguably be classified as either, although it is usually taken as a distribution item.

33. Philip Hacker, one of the leading forensic movie accountants (at Hacker, Douglas & Co.), said (in Hennessee 1978), "The Warner Brothers definition of net runs on for five single-spaced pages; of gross receipts, four pages. One makes or loses money by the definitions. Participants don't have either net or gross. All they really have is an arrangement to receive a contingent sum of money that is based on an arithmetic calculation spelled out in the agreement." Contingent compensation is discussed in Weinstein (1998, 2005) and in Nochimson and Brachman (2003), where it is shown that the court's findings in this case were misguided. Garrahan (2011b) also correctly observes that "with the talent often so anxious to get their movie made that they're ready to agree to almost any terms, the studios often have the advantage." The most important accounting disputes are often with regard to DVDs. See also Horn (2005b), Vogel (2005), and Turman (2006, p. 154), who writes, "Creative accounting practices in Hollywood do exist, but much, much less so than popular opinion would have it. The studios don't need to cheat. Contracts . . . so favor the studio in every way."

Note that current studio agreements tend to use phrases such as "defined proceeds" or "adjusted gross receipts" instead of "net profits." This comes in the wake of a well-publicized dispute over the definition of "profits" developed in a 1990 case in which writer Art Buchwald won credit in a state court for developing the concept behind Paramount's *Coming to America*, one of the highest-grossing films of 1988. The issue then fought in Los Angeles Superior Court concerned the definition of such profits. Studios would generally argue that they deserve to take a large part of their profits upfront to compensate for the risk of investing their money in flops that never show any return on investment. Buchwald, however, argued that such upfront studio profits should not come at the expense of net-profit participants and that the studios unfairly manipulate such net profit contracts. Overviews of this case are presented in Stevenson (1990), Robb (1990a, 1990b), Weinstein

(1998), and Appleton and Yankelevits (2002), with the Buchwald side fully described in O'Donnell and McDougal (1992). The accountings for this picture (in $ millions) by Paramount and by Buchwald's attorney were as follows:

Paramount	
Gross receipts	125
less distribution fee	(42)
	83
less distribution expenses	(36)
	47
less Murphy, Landis gross participations	(11)
	36
less interest	(5 to 6)
	30 to 31
less negative costs, including direct production costs and studio overhead	(48)
net deficit	(17 to 18)
Buchwald's Interpretation	
Income	151
less distribution fee	(53)
	98
less distribution expenses	(40)
	58
less negative costs, including direct production costs, studio overhead, and gross participations	(63)
deficit	(5)
less interest	(6.2)
net deficit	(11.2)

The accounting for one of Warner's largest box-office hits, *Batman*, has also been revealed, and it suggests that net-profit participants will probably not be compensated. McDougal (1991) shows that, as of 1991, the film had grossed $253.4 million from all sources, but from that amount the distribution fee of 32% or $80 million was, as usual, taken out first. Then expenses (in $millions) included the following:

Advertising and publicity	62.4
Prints	9.0
Editing and dubbing	1.1
Taxes, duties, and customs	4.7
Trade association fees	2.1
Freight, handling, and insurance	1.4
Checking, collection, etc.	1.6
Guild and union residuals	1.6

These expenses, however, do not include the film's actual production cost, at $53.5 million, interest charges, and gross-profit participations. Through September 1990, interest on the entire production cost was $10.8 million. Yet it was gross participations, especially that of star actor Jack Nicholson (who played The Joker), that truly rolled the breakeven point upward. In addition to an "upfront" fee advance of $6 million, the actor also reportedly negotiated to receive 15% of the gross, with an escalator clause that ultimately brought his total percentage of the gross close to 20%. Other participants had similar advances-against-gross embedded in the film's production cost but at much lower adjusted gross levels. In all, the gross-profit participants took about $60 million of the film's income and left net-profit participants with nothing.

Other examples of profit participation statements, for example, *Who Framed Roger Rabbit*, *Three Men and a Baby*, and *Beverly Hills Cop*, are shown in Robb (1992), and that for *Harry Potter and The Order of the Phoenix* is shown in Fleming (2010). *Phoenix* took in defined gross of $612 million, which turned into $398 million in defined gross after distribution fees. Expenses, including $131 million of advertising, further reduced defined gross to $206 million, after which deduction of negative costs of $316 million and interest charges of $58 million made the defined *deficit* $167 million. That is, a more than $600 million gross from theatrical, video, television, and other worldwide sources resulted in no net profits for participants. See Table 5.11.

The effect of gross participations can also be seen in the case of *Last Action Hero*, wherein production, overhead, and p&a costs of $150 million were almost fully recouped from all markets until gross participation talent and interest costs ate up another $15 million. See *Variety*, September 13, 1993, and also *Daily Variety*, November 20, 1995. A suit concerning net-profit contracts for the film *JFK* moved through the courts in the late 1990s. In 2003, there was an accounting lawsuit concerning *My Big Fat Greek Wedding* filed at Los Angeles Superior Court. In 2005, director Peter Jackson, triumphantly coming off his *Lord of the Rings* trilogy ($281 million cost, $4 billion total revenues), sued distributor New Line for alleged underpayment of $100 millon of net-profit participation. Details are in Johnson (2005a). And in 2007, the $160 million film *Sahara*, which lost at least $78 million, was involved in a lengthy trial, from which detailed budget items were revealed in Bunting (2007).

34. Producers have since the late 1990s also experienced a steep decline in financial support for their previously large number of on-the-lot *first-look development* deals in which their purpose was to find and nurture promising projects for the affiliated studio. See Fritz (2014c).

35. Breimer (1995, p. 76) writes that studios also receive benefit from any nonreturnable advances for sale of cable or home-video rights and that such advances are not included in the calculation of participants' grosses until they are *earned*. Here, again, there are different definitions for the studio and for the participant. However, as noted in *Variety* of April 1, 2002, major star participants have begun to command larger percentages of the home-video royalties. The important deal point in figuring residuals and payments to gross players with regard to DVD revenues is what is known as the *video-to-gross* (VTG) ratio. Most participants would only share in 20% of home-video revenues, with 80% allocated for the studio. Yet even those few who are major participants will never see a VTG ratio greater than 50%.

See also Lubove (2004), Horn (2005b), and Snyder (2005). A brief history of the 20% royalty arrangement is in Daniels, Leedy, and Sills (2006, pp. 59–64).

36. Cones (1997, p. 58) notes that there are four problems in the majors' treatment of home-video revenues: (a) royalties are taken on a royalty rather than on a subdistribution-fee basis; (b) the royalty paid to the distributor is only 20% of the wholesale price; (c) because studios own the home-video distribution arm, they participate twice in the video revenue stream by also taking a distribution fee on the royalties; and (d) expenses for marketing the videos are deducted by the distributor in figuring profit participations.

A simple example makes the point. If, for instance, half a million cassettes are sold at $50 a unit ($25 million in total), $5 million might be credited to gross receipts of the participant, out of which a distribution fee is taken. The studio then retains $20 million out of total revenues. And after deduction of expenses of perhaps $6 a unit for manufacturing, sales, and advertising, and perhaps another $2 a unit to cover overhead, the studio-distributor still has a gross profit of $16 million ($20 million minus $8 times 500,000) before adding back the distribution fee earned out of the participant's gross receipts.

37. Just as DVDs displaced tapes, streaming is rapidly displacing DVDs, and so in recognition of the much reduced studio packaging and distribution costs of streaming and the fact that streaming is much more akin to television broadcast program licensing than royalty sales of books and records, a changeover to the licensing model is inevitable. See Johnson (2013).

38. A study sponsored by the National Association of Concessionaires and Coca-Cola indicated that, in dollar terms, about 40% of refreshment-stand sales come from popcorn, 40% from soft drinks, and 20% from food items and candy. A 1990 study further indicated that, at some theaters, concession sales might account for 90% of profits. The reason is that a soft drink priced at $2.50 may cost the owner less than 25 cents.

39. For instance, in its 1988 annual report, Cineplex Odeon shows a significant operating income figure; however, if profits from real estate transactions are excluded, it can be seen that the company's basic theater business operated at a loss. See also Wechsler (1989).

40. The cost of operating a major domestic-distribution organization is estimated to be $100 million annually circa 2014. If an average fee of 33% is assumed, this $100 million nut, which covers sales expenses, is earned after the first $300 million of theatrical rentals. But as A. D. Murphy notes in Squire (1992, p. 286), earnings in excess of that figure should not be called profits "in the sense of free-and-clear money available for dividends and such." The excess is instead first used largely to recover other out-of-pocket unrecouped marketing and production costs and is also recycled into new film productions. See also Wechsler (1990).

41. Donahue (1987, p. 183) provides a good example: ". . . a picture earns $10 million in film rental while the marketing costs amount to $5 million. In the distribution fee deal, the distributor takes $3 million and costs are recouped out of the $7 million, with $2 million left for the producer. In the gross percentage deal, the independent producer receives $3 million, costs are recouped out of the $7 million, leaving $2 million for the distributor."

42. For instance, pay-television license fees are often benchmarked at $7 million for films that generate $50 million in domestic box-office receipts and at $10 million if the box office exceeds $75 million. A scaled agreement might also state that films grossing less than $5 million at the domestic box office (dbo) are to have a pay-TV license fee of 50% of the dbo, those in the $60 million to $100 million range a base fee of $11 million plus 5% of the revenue over $60 million, and those over $200 million dbo capped at a fee of $15 million. In the future, as the proportion of total revenues derived from theatrical release diminishes, it is likely that such arithmetic links to box-office performance will also be weakened. For cable networks, on average, roughly 12% of a film's domestic gross, capped at a certain level, is the going rate. Thus, a film such as *Avatar*, which had a domestic gross of more than $760 million, would likely go to a cable network for more than $30 million.

43. After initial release, a film that grosses $100 million at the domestic box office and $140 million internationally might over the subsequent ten years be typically expected to domestically generate at least another $75 million in home video, $15 million from domestic pay TV, and a further $16 million from all other television (including broadcast, cable, and pay cable). And internationally, an additional $50 million from home video, $16 million from pay TV, and $18 million from other free-to-air sources might be collected, for a ten-year nontheatrical total amounting to nearly $200 million. See also Abrams (2012a), in which these estimates appear. And $25 million from all free TV ($10 million domestic and $15 million foreign).

44. Major studios, however, no longer include overhead in the budgets of their own productions. They instead budget actual cash costs, but will still generally charge a 15% overhead fee on the negative cost for the purpose of figuring participant payouts.

45. In the 1990s, completion bond companies began to provide "gap financing" to independent producers. The "gap" refers to the funding that producers need to make the film and what they have already arranged for using expected revenues from unsold territories as collateral. Gap loans are a form of mezzanine debt that is normally collateralized by the estimated value of unsold foreign rights. Recoupment with gap loans comes after senior production loans. When a gap loan extends to more than 15% of the production loan, it is called a supergap loan. At the peak of popularity, the gap had often been as high as 50% to 60% of production costs, but lenders have become more cautious in recent years as the risk of nonrecoupment has risen. See also Martin (2009, p. 106), who sees gap financing as being a relatively high-priced bridge loan for budget shortfalls that are not entirely covered by overseas presales. Grantham (2012) covers the history of such financing, writing that by the 2000s, the basic model had evolved from "bank financing against minimum guarantees to minimum guarantee plus gap financing to minimum guarantee plus gap plus soft-money financing." Soft-money includes tax rebates and credits and direct subsidies, as Chapter 3 notes. In all such financings, determinations of the collection priority sequencing of creditors in the case of project bankruptcy and foreclosure are known as "intercreditor" issues.

Finney (2010, p. 43) notes: "All film finance banks demand a 'market test' in the form of hard presales to significant territories" before committing to gap loans. For independent films, potential sales for each territory in the world are estimated and then presented in the form of Take-Ask (or in stock market terminology, bid-ask) data. The Ask estimates are generally ignored by banks and financiers, with lenders focusing on the accuracy of the lower Take number. In practice, banks will not gap finance unless some major presales have already been completed. A collection account manager would also normally be needed to assure that the funds received are properly allocated.

46. This follows Garey (1983, p. 104).

47. The traditional estimate is that the box-office gross must be two or three times the negative cost to reach breakeven. However, for major-event pictures, this ratio might actually be nearer to two times.

48. The following is a partial list of companies that, since the early 1970s, have attempted to enter production and either have failed totally or have substantially withdrawn from the field: ABC Pictures (ABC's first venture, distributed by Cinerama in the early 1970s), Associated Communications, Avco-Embassy, Cannon Group, Cinema Center Films (CBS's first venture, distributed by National General in the early 1970s), De Laurentiis Entertainment Group, Filmways (reconstituted as Orion), General Cinema Corp., and Time-Life Films. Some of these production entities had considerable financial backing and experience and yet couldn't buck the odds. As one industry CEO said, "You put $200 million in and make a movie no one likes and everyone has been paid off except the people who financed it" (*Daily Variety*, November 25, 2002).

49. A good real-world example of this is discussed in Eberts and Ilott (1990, p. 109).

50. In response, networks sometimes had a strategic interest in "warehousing" their best feature films by delaying their appearance on competing pay-cable networks.

51. See *Daily Variety*, October 24, 1979.

52. Quoted from *Daily Variety*, October 24, 1979. Litman, in Kindem (1982), discusses pricing of series and movies from the perspective of the 1970s. Since the late 1990s, it has been common in the industry that, for an "A" title, studios get $1.5 million for each $10 million of domestic box-office gross up to $150 million.

53. *War and Remembrance* was noted not only for its high-quality production values but also for its huge cost and the more than $20 million in losses that the ABC network sustained on its original broadcast of the 32-episode, $110 million miniseries, which was shown in the fall of 1988 and the spring of 1989. See Kneale (1988). In 2001, HBO produced a similar epic at a cost of $125 million for ten episodes of *Band of Brothers*. And in 2010, HBO spent at least $20 million for the debut episode of *Boardwalk Empire*, a gangster series of 12 episodes that is expected to recoup expenses through attraction of more HBO subscribers, DVD sales, and international distribution to more than 160 countries. See also Carter (2001a) and Chozick (2010d).

54. The high costs and generally unrepresentative nature of pilots, and the high probability that most will not be extended into full series, have led many in the television industry to question the wisdom of using this massive and wasteful spending system for program-development purposes. In "put pilot" deals, the network might pay a penalty fee of $250,000 to $500,000 if the script doesn't go to pilot. The penalty rises to $750,000 to $1 million if an unfulfilled pilot production commitment has been made. Unfortunately, satisfactory alternatives have yet to be discovered. Bunn (2002) states that in 2002 an hour-long pilot cost $2.5 million or more and the cost was $1.8 million for a 26-minute "presentation" (minipilot). Barnes (2004b) notes that pilots are not reliable in predicting success. *Seinfeld* and *The A-Team* tested poorly yet became hits, whereas other programs tested well but later failed to perform. See also Barnes (2011a), who relates that the pilot for the 2011 ABC series *Pan Am* cost $10 million, and Chozick (2011b, c). The 2012 pilot for the series *Smash* cost $7.5 million. See Sharma (2013, 2014) and Stelter (2013d) on how pilots are now migrating to Web services. Both Amazon and Netflix mine their giant streaming databases to select pilots for production. Littleton (2014) explains how each of the big four networks spends $80 million to $100 million a year on pilots and how their approach is changing.

55. Prior to the phasing out of investment tax credits in 1986, 6 2/3% of production costs had qualified as tax credits – a factor that had considerably eased the production deficit problem. The history of their implementation is covered in Bruck (2003, pp. 289–91).

56. Because it is so difficult to generate positive cash flows in the start-up phase of production, many production companies have encountered financial difficulties and have been forced to coventure or to merge with larger organizations or studios.

57. The issue of deficit financing was at the heart of the financial interest and syndication rule debate that had raged since the early 1980s. In return for paying higher license fees for original programming, the networks have long felt entitled to participation in some of the so-called backend syndication profits, which, at least through 1990, they had been barred from sharing. Deficits had risen from an average of around $64,000 a half-hour show in 1982–3 to more than $170,000 by 1986–7. For hour-long shows, the deficits are estimated to have risen from $198,000 to more than $370,000 in the same period. And in the 1989–90 season, the Alliance of Motion Picture & Television Producers indicated that deficits averaged $300,000 for one-hour series and $258,000 for half-hour series.

As Steinberg (2006) illustrates with the Fox show *24* as an example, DVDs became an important swing factor in offsetting such deficits. Previously, international sales alone filled the profit gap. The 120 episodes of the series *24* cost just under $2.5 million each, or $300 million total, to make. Network license fees covered $1.3 million an episode, and another $1 million came from international sales – thus contributing $276 million toward covering the cost but still leaving a deficit of $24 million. Total DVD sales of more than $200 million turned the production profitable. Munoz (2006) notes that Lions Gate has been able to avoid deficits in making series for cable. The company does this by collecting license fees, income from international sales, and state and local tax rebates and subsidies. Carter (2013c) indicates that the 2013 CBS summer drama *Under the Dome* did not experience any deficits because of foreign sales and Amazon's preliminary commitment of $750,000 per episode.

58. Such "talent-holding" deals in return for the network's (or in sports a team's) investment in developing shows, properties, and performers to the point at which there is potential for great fame and fortune to later be harvested are now common in the entertainment business. Deals of this type, for instance involving NBC's long-running weekly *Saturday Night Live*, are covered in Elberse (2013, pp. 105–8).

59. Owen and Wildman (1992, p. 184) suggest that the probability of renewal increases markedly for series that have been renewed at least once. The longest-running TV series through the 1992–3 season were *Gunsmoke* with 402 episodes, *Dallas* with 356, *Knots Landing* with 344, *Bonanza* with 318, and *The Love Boat* with 255. Through 2013, the longest-running prime-time series have been *60 Minutes* (45 years, beginning in 1968), *20/20* (34 years), *Cops* (25 years, 850 episodes, starting in 1989), *The Ed Sullivan Show* (24 years, 1948–71), *Gunsmoke* (20 years, 1955–75), *Law and Order* (original, 20 years, ending 2010, 456 episodes), and *The Red Skelton Show* (21 years, 1951–71). Though not in primetime, *Saturday Night Live* has been running on NBC since October 1975. As of 2014, *The Simpsons*, with 25 seasons completed, had far surpassed *Ozzie & Harriet* (14 seasons) as the longest-running sitcom. The longest-running program in worldwide broadcasting history is NBC's *Meet the Press*, which debuted November 6, 1947.

60. In the late 1960s and early 1970s, the probability of making a syndicatable, highly profitable series was higher than in the late 1970s and early 1980s. By the 1980s, viewers had become increasingly discriminating in their choices. Because of disruptions by strikes and other factors, the start of the TV season had become irregular, and cable, videocassette, and movie-of-the-week viewing alternatives had become more numerous.

61. The cable hit show *Anger Management* clearly demonstrated that off-cable shows also have significant syndication potential. After the show completed its ten-episode summer run on the FX network as the highest-rated new comedy series on cable (4.53 million total viewers and 2.5 million in the key 18–49 demographic), the series was picked up for production of 90 episodes in an unusual deal that was tied to exceeding a first-season ratings threshold. The reruns were then syndicated to nine Fox stations. The show is produced by Lions Gate Television and distributed by Debmar-Mercury in a cash and barter deal.

62. *Variety* of January 13, 1997 notes that the Katz TV Group has formulated three criteria for predicting the syndication success of an off-network sitcom: (a) at least 18% of viewers of a comedy during its prime-time network run should be men 18 to 49 years old; (b) if a show substantially benefits from a network hit-comedy lead-in, its syndication performance will probably be disappointing; and (c) throughout its four-year network prime-time run, a comedy series should have a Nielsen rating 20% above the average sitcom rating for adults 25 to 54 years old.

63. The increasing competitive influence of pay TV implies that producers now may be less willing to tie up their best properties for long periods, whereas networks will seek longer option periods. The relative values of syndicated half-hour and hour series episodes, as well as typical contract terms, are thus in a state of flux.

64. Jurgensen (2012) discusses how binge viewing of serialized programs via streaming and DVRs are changing the syndication business, as serials are more difficult to schedule and sell. Streaming is increasingly replacing relatively bulky and inconvenient DVD box sets. Sporich (2003) recounts that in 1999 Paramount was the first studio to put a television series (*Star Trek*) on DVD, and Fox was the first to have a huge hit (*The Simpsons*). Fox then followed up with several other popular series (e.g., *X-Files*, *Buffy the Vampire Slayer*, *24*) and by 2003 had captured a 42% share of the TV-to-DVD market. HBO Home Video (along with sister company Warner Home Video) also did well, with high DVD sales of *Friends, The Sopranos*, and *Sex and the City*. TV-to-DVD sales were around $3.0 billion in 2006. In 2005, the top-selling *Seinfeld* (seasons I&II) generated $90 million. See also Barnes (2005b) and Collins (2005). Steinberg (2006) indicates that DVD sales of $200 million between 2002 and 2006 for the Fox series *24* made the show profitable for the producers. DVD sales also figure in the profitability calculus of made-for-cable series, which, in comparison to broadcast network series, are generally ordered in batches of 10 to 13 episodes instead of 22, are shot in seven days instead of eight, and cost between $1.6 and $2.2 million per hour, or half to two-thirds the cost of broadcast network series.

65. For a show with the potential to last at least three years on a network, program-distribution companies may be willing to guarantee, in installments, say, at least $50,000 per episode against a percentage of anticipated syndication profits. Here producers may sacrifice some percentage of ownership in return for immediate cash, and distributors may obtain long-term project commitments on which they can rely to keep pipelines filled. The risk to the distributor is that the program will be canceled or that the show will lose its audience appeal. According to a Warner Bros. study cited in Flint (2004), for example, of 436 comedies launched between 1990 and 2002, only 54 lasted at least four years, and of those, only nine, or 2% became big rerun hits. Should the producer enter into such an agreement, an important issue for negotiations is which party will pay what percentage of talent residuals and royalties.

As in features, however, residuals would normally be expected to come out of the producers' side. For top producers, the percentage of the backend can be quite high. Witt Thomas Harris, producers of *The Golden Girls*, which is distributed by Disney and is estimated to have earned about $1.5 million for each of its 150 episodes, might have received as much as a 25% cut out of the backend profits. The milestone Carsey-Werner deal for *The Cosby Show* is believed to have been for a 33% cut.

66. An important exception has been the distributor King World (now owned by CBS Corporation), which had signed stations to three-year contracts on the basis of the ratings strength of its shows *Wheel of Fortune*, *The Oprah Winfrey Show*, and *Jeopardy!*. But because of shifting viewer demographics and technology, such contracts are now more likely to be only for a year. See Schuker (2011). Among the longest-running shows in syndication as of 2009 are *Soul Train* (33 years) and *Entertainment Tonight* (28 years).

67. Barter prices naturally ride on the back of network cost per thousand (CPM) prices and are usually 80% of what a network might charge. Barter, however, shifts the financial burden from the station to the syndicator, who must arrange to aggregate and sell the time to national advertisers.

68. Because barter contracts are not negotiated until fairly close to the actual time of telecast, the carrying value of such bartered shows cannot be accurately assessed and therefore be subsumed as part of a production-distribution company's long-term license-fee "backlog." The effect is that barter-program licenses tend to generate earnings that, for the distributor, are much more dispersed over time and that are of smaller relative magnitude than is the case with cash-licensed, off-network program syndication fees (which are recognized in large clusters at the time of first availability). See also Accounting for Advertising Barter Transactions (EITF 99–17).

69. The costs of network prime-time productions are estimated to have risen at a 14.4% compound annual rate during the 1970s. Although comparable data are not available for the 1980s, it seems fair to assume that the cost of production probably continued to rise by an average of 10% a year between 1980 and 1990, and by at least 5% a year beginning in the late 1990s. See also Chozick (2010a, c).

70. The squeeze from higher star salaries comes mostly out of network profits and always arrives at the point when the program has already been proven successful and the principal talent has maximum bargaining power. For instance, in *Seinfeld* (one of the most expensive regular series in television history and costing $4 million per ninth-season episode), NBC sold nine 30-second spots for about $500,000 each, or $4.5 million. With a rerun, the gross is $9 million, and less agency commissions, the total for the year might approach $8 million per episode. If 25 episodes per season were assumed, NBC would take in $200 million in revenues. But with the series stars receiving as much as $1 million each under proposed new contracts, the cost of the show might rise to $5 million an episode, up from perhaps $2 million in the early years of the program. The $3 million difference would thus reduce NBC profits from $150 million to $75 million. In addition, as of 1998, NBC agreed to pay a record $13 million per episode for *E.R.* – equivalent to $850 million over three years. Of the total, Warner would retain an estimated $330 million, with the remainder going to producers, creators, and agency fees. See also *BusinessWeek*, June 2, 1997, and the *Los Angeles Times*, January 16, 1998.

Carter (2006) notes with regard to NBC's tenth season of *Friends* that Warner Bros. was not an eager supplier unless the per-episode license fee was very high, on the order of $10 million. After negotiations it turned out to be $10 million for 17 new episodes. The reason for Warner's lack of enthusiasm is that after a show plays on the network for eight or nine seasons, there are generally 175 to 200 episodes, enough to fill out (i.e., strip) local station schedules during the year. Thus the tenth season has little or no value (Carter, 2006, pp. 213–14) in syndication. As popular shows approach their tenth year on the network, they typically price themselves out of the market because production costs for talent salaries (and sometimes backend participations) soar and the series is so much more valuable in syndication. After a decade, *CSI: Crime Scene Investigation* was costing CBS $3.7 million an episode, but was replaced by the successful *Elementary*, with a first-year cost of $1.8 million an episode – a significant cost saving of around $50 million a season. By 2014, more than 725 one-hour episodes in the entire *CSI* (fourteenth season) franchise had been made and, as noted by Cieply and Carter (2013), the original *CSI* has in many years been the most-watched television show in the world (with an audience greater than 70 million). Goldman Sachs had sought more than $400 million for its 50% interest in the programs. The other half is owned by CBS.

The NBC deal for renewal of the *Friends* series, in which each of the six stars was to receive $750,000 per episode plus a percentage of the backend profits ($40 million over two years), is described in the *New York Times*, May 15, 2000. Note also that in 2001 *Frasier* star Kelsey Grammer was able to negotiate for the upcoming tenth and eleventh seasons (48 shows) a record $1.6 million per episode. Also see Carter (2002b), which explains that the contract extension for *Friends* was based on NBC's paying $7 million per half-hour episode, with each of the six stars being paid $1 million per episode. Carter (2006, p. 50) indicates that in an attempt to gain one last season, NBC offered Jerry Seinfeld $5 million an episode ($110 million total). A second extension of *Friends* into a tenth season (see *New York Times*, December 21, 2002 and Nelson and Flint 2002) was made possible by a December 2002 agreement to pay Warner Bros. around $10 million (up from $7 million) for each half-hour episode, a record for a 30-minute series. A similar situation concerning NBC's potential renewal of *Frasier* is discussed in the *New York Times* and *Los Angeles Times* of December 7, 2000, with *Dharma & Greg* discussed in Carter (2001b). Flint (2001) covers the resolution (three years and a bit more than $5 million per episode) of the NBC and *Frasier* negotiations. By comparison, Fox's highly popular *American Idol* was generating $630,000 per 30-second spot in the 2007 season and in the low $900,000s in the WGA strike-affected 2008 season. And until 2012, voice actors on *The Simpsons* had been paid $440,000 an episode, or about $9 million a year for a minimum of 20 episodes.

In effect, networks now extract ownership in shows from outside suppliers in return for airtime. In reaction to such price increases, as Weinraub and Carter (2002) note, networks make increasing use of shows that they own and develop themselves through multipurpose exposures on their other secondary and cable outlets. Carter (2011c) writes of the ratings problems that networks have encountered in using high-cost dramas at 10 P.M. Production of network hour-long dramas typically costs $2 million to $3 million an episode, whereas cable shows on the History Channel and MTV cost much less than $1 million and sometimes as little as $250,000 to produce, yet attract sizable younger audiences favored by advertisers. At $4.0 million an episode, the 2012 NBC network show *Smash* was unusually expensive.

71. This is noted in Owen and Wildman (1992, p. 48). In the case of a popular series coming off-network, such syndication window revenues can be substantial. For instance, a record total of $200 million ($1.5 million per episode) was initially received in the mid-1980s by MCA for the one-hour series *Magnum, P.I.* And syndication of the half-hour *Seinfeld* in 1998 brought a record $6 million an episode for a total $1.6 billion, which compares with the previous record of $600 million for half hours of the *Cosby* series in 1988. *Seinfeld* is the only major series besides *M*A*S*H* to take in more money in its second-cycle syndication than in the first. The *Friends* second cycle of around $1 billion total was about equal to the first cycle, which means that through two cycles and the license fees for the 236 episodes, the show generated $3 billion, a total only exceeded by *Seinfeld* in its third cycle. *Seinfeld, Frasier*, *Friends*, and *Everybody Loves Raymond* each had enough episodes and high enough first-cycle per-episode prices to be billion-dollar properties. First-cycle cash-license values (in $ millions) per episode for those shows were, respectively, $3.3, $3.1, $3.0, and $2.5.

The syndication value of long-running series is illustrated by the early 2011 cancellation by CBS and Warner Bros. of the high-rating sitcom *Two and a Half Men* due to disputes with the show's principal actor. According to Carter (2011b), cancellation during its eighth season resulted in an expected syndication revenue shortfall from future episodes for Warner amounting to $100 million, while CBS would see an advertising shortfall (at $200,000 per 30-second spot) of around $160 million, before taking account of other-show advertising and program substitutes that would be less costly to CBS than the $4 million license fee that CBS paid Warner for each episode. In 2010, CBS took in around $155 million in advertising on the program, and Warner generated $268 million in syndication barter sales from repeats of the show (e.g., on cable network FX for $850,000 an episode in 2010). In its 2006 first-cycle broadcast syndication, this series fetched license fees for Warner Bros. of around $2 million per episode from stations as well as participation in national advertising that added another $2 million per episode. A second-cycle sale in 2010 garnered more than the usual 50% of the first-cycle rate. See *Variety*, March 23, 1998, and Flint (2004). The first syndicated show was *The Lone Ranger*, a western series than ran from 1949 to 1957.

Many series, especially hour-longs, have not until recently even come close to the positive results shown in Table 5.12. *Walker, Texas Ranger* was sold in 1996 for $750,000 per episode to the USA Network and for about the same from weekend runs on broadcast stations. As of 2005, the leading cable syndication prices per episode were $2.5 million for *Sopranos* (A&E), $1.9 million for *Law and Order: Criminal Intent* (Bravo and USA), $1.6 million for *CSI*, and $1.2 million for *West Wing*. See *New York Times*, February 1, 2005. Lifetime also pays $1.35 million an episode for *Medium*, and TNT paid $1.4 million for *Cold Case* (in 2005). In a throwback to earlier times, rerun rights of the network series *NCIS: Los Angeles* were sold in 2009 to the USA Network for $2.35 million an episode after appearing on CBS for only seven weeks. USA Network also paid $1.4 million per episode in 2013 for ABC's *Modern Family*.

In 2010, Warner Bros. sold *The Big Bang Theory* at a record price for a half-hour sitcom to TBS for around $1.5 million and Fox TV for around $0.5 million per episode, and cable's A&E network bought HBO's *The Sopranos* for $2.5 million an episode. Warner also sold *2 Broke Girls* to TBS for $1.7 million an episode in 2014. In 2011, Netflix struck a deal with production company Lions Gate to eventually stream all 91 episodes of *Mad Men* for nearly $1 million an episode. *Mad Men* originally appeared on cable network AMC for seven seasons. Other AMC hits, including *Walking Dead* and *Breaking Bad*, have similarly high downstream-market sales prospects. In a programming strategy shift, USA Network in 2013 bought *Modern Family* from Fox Television for around $1.4 million per episode. And also in 2013, Fox comedy cable network (FXX) acquired (from production sibling Fox Television) cable and streaming rights to more than 550 episodes of *The Simpsons* at around $1.5 million a unit for a total of $900 million or so. The possible adverse affect from VOD on such prices is discussed in Lieberman (2005). See also Chozick (2009, 2011b) and Sharma (2014a).

In 2007, an unusual reversal in the flow of episodes involved *Law & Order: Criminal Intent*, a series costing about $3.5 million an hour to produce and for which NBC decided to first air originals on its USA cable network and then later repeats on NBC. As discussed in Barnes (2007b), scripts for the series are also being adapted to the cultures of other countries and, as such, provide an emerging new source of US TV export revenues (totaling around $8 billion). Chozick (2011a) describes how TV concepts, modified for use in other cultures, are lucrative.

The repurposing of programs from cable to network television also picked up steam after the writers strike in 2008. Shows such as *Dexter*, repurposed on CBS from Showtime, and *Monk and Psych*, repurposed from the USA cable network to NBC, are examples of series that, having originally been shown on cable, became repeat episodes on broadcast television, but with much lower license-fee requirements. Digital syndication for streaming of older series became significant in 2011 when Netflix agreed to pay Lions Gate at least $75 million for rights to the entire *Mad Men* series, and to pay Warner Bros. around $200,000 per episode in a four-year deal for *Nip/Tuck*. In 2013, Amazon also committed $750,000 per episode for CBS summer hit *Under the Dome*. See Vascellaro, Schuker, and Schechner (2011).

Soon after the record price for *Magnum* (which ultimately averaged \$1.7 million per episode) was obtained, television industry demand for hour-long series plummeted and, through the second half of the 1980s, most off-network hour-long series could not command more than \$300,000 to \$400,000 per episode – scarcely enough to cover the costs of marketing and of residual payments. For example, eight of the top ten programs in the 1983–4 season were one-hour dramas, but the number had fallen to nearly zero by the end of the decade before a revival, led by the Fox network, ensued in the early 1990s. Licensing to cable networks has thus developed as an attractive alternative to syndicating to local TV stations, especially in that Hollywood guilds take 10% of the cash license fees in cable sales, which is half the cost of broadcast-deal residuals. Hour-long series sold to such networks for prices up to \$250,000 an episode include *Murder She Wrote*, *Cagney and Lacey*, and *Miami Vice*. And hour-long dramas such as *E.R.* have later been sold to cable for \$1.2 million an episode. Lifetime, owned jointly by Disney and Hearst, bought rights in 1996 to 112 episodes of the sitcom *Ellen* for more than \$600,000 per episode, a record for a cable network purchase. See also Goldman (1992).

72. As of the early 2000s, most magazine-style shows had weekly production budgets upward of \$450,000 a week (double the cost of the early 1990s), whereas most new game and talk shows cost in the range of \$175,000 to \$275,000 a week to produce. Most such shows would need to attract at least \$100,000 a week in national barter advertising to reach breakeven. The theme and content of a program such as *Entertainment Tonight*, however, bring production costs up to more than \$500,000 a week. Such magazine shows would have to maintain a minimum household rating of 4.5 to be profitable. Introduction of the syndicated Katie Couric talk show *Katie* in 2012 is also instructive. As described in Stewart (2012b), Disney's ABC network began with two-year agreements with local affiliates. ABC is entitled to recover its production costs and take production and distribution fees (perhaps \$40 million a year), but anything above that goes to the show's owners, Jeff Zucker and Katie Couric. Popular shows in this genre have the potential to generate much more than \$100 million in advertising.

But not all first-run series are necessarily low-budget productions: *Star-Trek... The Next Generation*, with an initial per-episode budget of \$1.3 million plus \$75,000 for special effects, had been among the costliest first-run series produced in the early 1990s. Nor are all network productions high-budget; for example, as of 1997 it had cost about \$400,000 an hour (one-third as much as drama) to produce network news-magazine programs such as *60 Minutes* (CBS), *20/20* (ABC), *PrimeTime Live* (ABC), and *Dateline* (NBC). Similarly, *Who Wants to Be a Millionaire* (ABC) is estimated to have averaged \$750,000 because the top prizes were not usually won in most episodes. With ad unit prices averaging \$300,000 and with exposure in four prime-time hours a week (200 episodes a year), it is estimated that *Millionaire* generated more than \$1 billion of revenues and perhaps \$800 million of EBITDA for ABC in the year beginning with the fall 2000 season. In 2010, a \$270 million suit by the program's creator, Celador International, won against Disney, claimed that complex accounting schemes hid substantial profits. According to Disney's accounting, the show generated \$515 million in license fees and an additional \$70 million in merchandising revenues during its three-year run in prime time, yet ran a \$73 million deficit.

73. As of the mid-1990s, U.S. distributors took in an estimated \$225 million in foreign sales of two-hour movies. Titles generally gross between \$400,000 and \$1.4 million overseas, with producers of major telefilms able to get a \$400,000 to \$900,000 advance from a distributor for foreign sales rights. This often amounts to one-third of the financing of a network TV movie. In all, some 250 such films are made each year. Also, as recounted in

Bruck (2003, pp. 206–8), these types of films first began to be produced in the mid-1960s by MCA.

74. For example, in syndicated television, talent unions have negotiated a sliding scale of residuals that calls for 75% of original pay for the first and second replays, 50% for the third through fifth, 10% for the sixth, and 5% for every run beyond that. However, for cable network syndication, there is only a one-time flat 10% of the gross that is divided among writers, actors, and directors. Thus, syndication of an off-network series to one of the national cable networks for, say, $150,000 an episode would cost the distributor only $15,000, whereas broadcast syndication of six runs of the same series to broadcast stations could cost anywhere from $120,000 to $150,000 an episode in residuals (because the charge per episode is fixed no matter what the license fee). In addition, selling into broadcast syndication incurs more expense because the series must be sold market by market instead of to just one buyer. This means that, for the distributor to profit from a broadcast syndication of an off-network series, gross revenues generally must well exceed $300,000 an episode – which is nowadays difficult to amass.

75. The number of prints needed for national syndication can be reduced by "bicycling," the swapping of episodes from one station to the next, only when the sequencing of episodes does not matter. In theory, however, increased use of low-cost distribution by satellite technology promises that ultimately only one print will be required.

Prior to the advent of "superstations" – local television stations that send their signals via satellite to cable systems around the country – syndicated programs in a local market had been protected from competition through contract exclusivity clauses. Such protection was restored only in 1990, when the Federal Communications Commission (FCC) reinstated such exclusivity with so-called syndex rules.

76. Constraints on self-production were the result of a 1980 consent decree that limited each network to in-house production of two-and-one-half hours on average per week until the fall of 1985, when the cap began to rise gradually toward five hours per week in 1988. In actuality, however, networks have to date not proven to be particularly efficient in production. An episode of the once-popular one-hour series *Moonlighting* produced by the ABC network reportedly set a 1980s record at a cost of $3 million. NBC's *Studio 60*, introduced for the fall 2006 season, reportedly cost (*Wall Street Journal*, May 15, 2006) at least $2.5 million an episode. The pilot cost $6 million, and the initial marketing budget was set at $10 million. According to Chozick (2011d), the first two-hour pilot of *Terra Nova*, an adventure series filmed in 2011, cost around $16 million.

The end of fin-syn rules has made it more likely for a network to own a stake in new series productions, but as Flint (2002b) suggests, such arrangements do not necessarily lead to successful program schedules or to smoother relations between producers and distributors. As an example, in 1992, ABC made an agreement with Wind Dancer Productions to fund the entire cost of producing a new series rather than paying a flat license fee, which typically compensates the producer for only 80% to 85% of the full cost of production. By owning such a stake, ABC would participate in potential syndication revenues should the shows succeed in the ratings comparisons. Disney, for instance, also decided not to incur deficits on the show *CSI: Crime Scene Investigatio*n when it was picked up by CBS, the network rival to Disney's ABC. The show went on to garner huge ratings, and Disney thus gave up not only the large advertising income that would have accrued if the show had been kept by ABC but also the enormous later profits from syndication sales. Manly (2005a) notes that after an upsurge favoring sister production companies, networks have become more open to buying from outside producers.

With broadcast networks now owned by studio/distributors, there have been instances in which producers and other profit participants have sued the distributors for self-dealing (i.e., selling a show into syndication to a distributor's sibling branches at less than market prices). In 1999, in addition to the Wind Dancer/*Home Improvement* dispute alleging that Disney sold the show to its own ABC network at a discount, there were similarly based suits against Fox involving the *X-Files* and *NYPD Blue* series. A more recent situation with regard to in-house cable-network sales involved NBC's *Law and Order* series franchise and is described in Dana (2008). See Lubove (1999) and the *Los Angeles Times* of April 9, 2001 on the settlement of *NYPD Blue* issues.

A similar suit, discussed in Johnson (2005a), was brought against New Line Cinema by *Lord of the Rings* director Peter Jackson, claiming that self-dealing among different parts of the New Line–Time Warner conglomerate underpaid him by as much as $100 million.

Incongruous arrangements have also developed, as in the case of *Scrubs*, in which NBC derives revenues only from broadcast advertising sales because it doesn't own the show. ABC is the developer and producer of *Scrubs* and will receive the DVD and syndication fees that will be generated in the future. See Rhodes (2006).

77. Both the Syndication and Financial Interest and the Prime Time Access Rules were adopted by the FCC in 1970 in response to conditions that had existed in the 1960s, when the networks had been at the peak of their relative competitive strength. These rules had originally been ostensibly proposed as a means by which independent producers could flourish and to prevent program domination by the three major networks. Up to that time, the networks owned and produced many of the shows they aired. But as described in Bruck (2003, Chapters 4 and 5), the political backstory is that MCA Inc. didn't want the network competition and set the wheels in motion for these rules to be implemented. The disallowance of network financial interest went into effect on August 1, 1972, and of network syndication on June 1, 1973.

In 1980, the three national networks also entered into consent decrees in connection with antitrust suits brought against each of them by the Department of Justice in the early 1970s. These consent decrees contain provisions that parallel but are not identical to the original Syndication and Financial Interest Rules.

In 1983, movement toward deregulation encouraged networks to challenge some of the restrictions, and a bitter political battle ensued between the networks on one side and independent producers, independent television stations, and movie studios on the other. The independents feared that the networks would stifle their creative and financial well-being, while the networks contrarily argued that they were no longer oligopolistic because of the inroads made by strongly competitive cable and home-video industries. See Section 7.1 and also Crandall (1972), Colvin (1983), Landro and Saddler (1983), Kneale and Carnevale (1991), Owen and Wildman (1992), and *Variety*, August 10, 1983.

Relaxation of the restrictions on network participation in foreign syndication and ownership of financial interests was first approved by the FCC in April 1991. As of 1992, rule modifications had allowed a network to distribute or to have an interest in the proceeds from distributing its own product. And in prime time the networks were allowed to produce or coproduce up to 40% of their schedules. But by early 1993, almost all restrictions on financial interest had been dropped, and all restrictions expired in late 1995. Networks can now negotiate for equity, syndication rights, longer license terms, and more network replays. Or they can produce shows themselves. See Stewart (2012a). The Prime Time Access Rules, restricting affiliates in the top 50 markets from running syndicated off-network series in the hour before prime time, were allowed to expire in 1996. Subsequent developments are described in *Entertainment Media*, January 29, 2001. The impact of the FCC media ownership rule changes of 2003 on producers is explained in Carter and Rutenberg (2003).

78. The Fox network evolved in the late 1980s. Because it did not program a full week's schedule and because it thus did not fall under the FCC's definition of a network, it was free to own syndication interests in its self-developed shows. Under the modified fin-syn rules of 1991, Fox was allowed to broadcast no more than an average of 15 hours of programming per week in prime time during any six-month period (and an unlimited number of hours of nonprime-time programming). News Corp., the parent company, thus owned a movie studio, a quasi-network, and a television-syndication arm prior to the 1993 relaxation of the rules. By 1994, however, other network–studio combinations had begun to form, with United/Paramount (UPN) and Warner Bros. (WB) becoming the fifth and sixth networks. And, in 1995, Disney bought ABC. After more than a decade in which cumulative losses mounted into the billions of dollars, UPN and WB were merged in 2006 to form the CW network. Here stations bid to become affiliates through "reverse compensation" to the network. See also Barnes (2006b).

79. However, the cash flow sequence may begin with up to a 10% down payment upon signing or upon first availability date and be followed by three annual installments of 30% of total revenues due. Following standard accounting procedures, the future cash receivables are then discounted, using an appropriate interest rate, to a present-value receivable that appears on the balance sheet.

80. Foreign receipts would also normally be booked on an episode-by-episode cash basis, but unlike the domestic situation, without regard to whether a show is self-produced and/or owned.

81. Mr. Garner's *Rockford Files* (NBC, 1974–80) agreement with Universal had entitled him to 37.5% of the net profits of the show in return for taking a smaller upfront fee. By 1988, receipts from the show had totaled $119.3 million according to Universal's own accounting. Nevertheless, Universal claimed that the show would have to earn another $1.6 million before it would realize net profits as described in Garner's contract.

According to the accounting statement, as described by Scholl (1989b), subtracted from the $119.3 million was $32.6 million for distribution fees. Then another $14.6 million was deducted for distribution expenses, including the cost of prints and storage. Then another $57.8 million was taken off for production costs, which left only $14.2 million. That $14.2 million, by Universal's accounting, was insufficient to cover the $15.8 million in interest expenses that the company (and most other studios) charges on the theory that the money spent on production could have been invested at risk-free rates.

However, according to Garner's auditors, Universal overstated costs and/or underestimated receipts by at least $10.9 million. For example, the auditors claimed that Universal failed to pass along quantity discounts (of $443,000) received on development of extra print copies.

Another issue involved whether to count print and dubbing costs as gross receipts or as expense reimbursements. If counted as the former, Universal would take a 50% fee off the top, whereas in the latter case they are a direct expense reduction that leads to faster profitability for the participant. An even larger amount ($7.9 million), and one that is at the crux of the interest payment charges issue, involved Universal's alleged practice of immediately recording expenses while deferring the recording of revenues and profits until cash was in hand. As Scholl (1989a) indicates, the Garner suit, initiated in 1983, was settled in 1989 for approximately $10 million.

A more recent similar case that came to court in 2010 involved actor Jack Klugman, who claimed a 25% participant share of all "net profits" for the Universal series *Quincy,* *M.E.*, in which he starred. According to the lawsuit, Universal's statement indicated that the show had generated more than $242 million in total gross receipts in its lifetime but that Universal had reported a $66.4 million net loss on the show.

82. See also Salemson and Zolotow (1978).

83. This is especially seen in preliminary distributor weekend box-office estimates, which are made by (sometimes aggressively) extrapolating Entertainment Data Inc. (EDI) and Rentrak Friday and Saturday tallies through Sunday and by estimating uncounted results from small and rural theaters to gain position in early weekend rankings. Lippman (2004), however, explains that data on actual number of tickets sold are not sent by theaters until their contracts obligate payment to studios, about six weeks after a film opens. Per-screen box-office averages may also be misleading, as a film that plays on three screens in the same multiplex is still counted as playing on one screen. This may mean that the audience is smaller than the reported per-screen averages might suggest.

84. Settlements may further involve backdoor payments or other rewards for placement of trailers, picking up costs of newspaper ads, paying the cost of broken reels, and sharing a larger slice of the box office with the exhibitor. See Munoz (2004). Bart and Guber (2002, p. 231) have likened contracts between exhibitors and distributors to prenuptial agreements in that the contracts are an invitation to endless negotiations.

85. See Cones (1997, p. 44).

86. During periods of high interest rates and economic duress, playing the float is obviously not unique to entertainment businesses.

87. The practice of settlements, also known as selling subject to review, is sometimes pushed to the ethical borderline and, interestingly, does not seem to apply in reverse. That is, if a picture performs better than expected, distributors do not ordinarily extract stiffer terms from exhibitors. Settlements are much less likely to be found in exhibitor contracts that are bid rather than negotiated. Universal, Fox, Sony, and DreamWorks apparently negotiate on the basis of "firm terms," which are terms supposedly not reviewable after a movie closes. But many studios and exhibitors favor "settling" terms 60 to 90 days after a picture opens, and even those studios with firm terms may compensate exhibitors for box-office losers by granting better terms on future releases. See *Variety*, March 17, 1997, and Cones (1997).

88. Other unscrupulous practices that can be used to skim rentals properly belonging to the distributor include the following:

- Bicycling (i.e., using a single print, without authorization by the exhibition contract, to generate "free" revenues by showing it at more than one location owned by the same management). In multiscreen theaters, for example, a picture that is not playing to capacity might, in violation of day and date (simultaneity) contract terms, be replaced in some showings by another feature that is unauthorized but more popular. And with what is known as interlocking, two screens might be serviced with one projector/print, often without the distributor knowing.
- Running the film for an extra showing unauthorized by contract.
- Palming tickets (i.e., leaving the ticket untorn and recycling it to the box office, where it can be resold without disturbing the number sequence of the ticket roll).
- Changing the ticket roll after a few hundred tickets have been sold. Ticket sales on the substituted roll then go unreported.
- Unauthorized reprinting of the negative. Nowadays this includes felonious reproductions of DVDs, tapes, and Internet site downloads, the distribution of which results in significant diminishment of revenues.

- "Product-splitting" practices (discussed in Section 4.4) that reduce bidding competitiveness and, in turn, the percentage of box office received by distributors.

89. Blocked currency funds have occasionally served as a source of new film production financing. Normally, different companies or industries operating in a country accumulate such funds and, as long as the funds are used within that country, it does not matter if the funds were generated in selling automobiles or textiles. See also *Variety*, August 20, 1986.
90. There are several foreign sales organizations, but most are relatively small. The most famous of these, mentioned in Paris (1984) and Salamon (1984), was Producers Sales Organization, which eventually went out of business.
91. Bakker (2005, p. 37) makes this point in discussing how Hollywood came to dominate world cinema. See also Bakker (2010), "The Economic History of the International Film Industry," at EH.net.

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