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Case

FORREST GUMP—ACCOUNTANT: A STUDY OF ACCOUNTING IN THE MOTION PICTURE INDUSTRY

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THE CASE

Hollywood accounting can be every bit as creative as a good movie script. At least, that is what some lawyers and journalists seem to be telling us. According to news reports, the hit movie *Forrest Gump*, which won 'Best Picture of 1994' honors at the Academy Awards, claimed a worldwide theatrical gross of $661 million through May of 1995. That amount excludes videocassette and soundtrack revenues, and it does not include licensing fees on *Forrest Gump* products such as wristwatches, ping-pong paddles, and shrimp cookbooks. Yet, according to Paramount Studios, the film project lost $62 million on a box office gross of $382 million through December, 1994 (see Table 1).

Forrest Gump is the latest of a string of hit movies to report a loss. Other losers include *Batman, Rain Man, Dick Tracy, Ghostbusters, Alien, On Golden Pond, Fatal Attraction,* and *Coming to America*. Each of these motion pictures grossed well over $100 million, but in each case, costs were reportedly greater than revenues.

The production costs for a film, part of what the studios refer to as 'negative costs', represent only a fraction of the cost of the project. In addition, studios add advertising and promotion, distribution, and financing costs to the total cost of the project. A significant portion of

Table 1. Statement of Profit and Loss for net profit participants on the motion picture, *Forrest Gump*, through December 31, 1994

Box office gross revenues			$382
Amount retained by movie theaters (approx. 50%)			191
Paramount's gross revenues			$191
Negative costs:			
Direct costs:			
Production costs	$66.8		
Gross profit participation by director, actors, etc. (16% of studio gross revenues)	30.6		
Total direct costs	$97.4		
Studio overhead (allocated — 15% of direct costs)	14.6		
Total negative costs		$112.0	
Promotion and distribution costs	$67.2		
Advertising overhead (allocated — 10% of promotion and distribution costs)	6.7		
Distribution fee (32% of studio gross revenues)	61.1		
		135.0	
Financing costs (calculated at 3% above prime, on unrecovered costs — the 'loss' below)		6.0	
Total costs			253
Profit (loss) through December 31, 1994			($62)

the negative costs are the payments made to 'gross participants' on the basis of a percentage of the studio's gross revenues. This leads to what Hollywood accountants and lawyers refer to as the 'rolling break'. Two of the costs (the amount retained by the theaters and the financing costs) may, for some motion pictures, change with changes in the amount of the box office gross and over time. Alex Ben Block, executive editor of *The Hollywood Reporter* explains:

> "A rolling break means that the break-even point — that point at which a movie has gone from a loss to a profit — changes after the release of the film, depending on the payments made to the star talent involved. A picture that has a big profit participation by a star actor, director or producer is never considered by studio accounting to break even." (McDougal, 1991, p. F6).

How can the studios be losing so much money on their most successful projects? Sometimes what is referred to as a loss is not really a loss at all. Typically, profits are calculated based on contracts between the studios and the film's 'net profit participants'. In a typical net profit participation contract, 'profit' is calculated after deducting a distribution fee paid directly to the studio, studio overhead (some of which is allocated to the film as a percentage of the gross), and interest on the unrecovered costs, whether or not the film was financed with debt. One studio executive, Rob Friedman of Warner Bros., explains the accounting this way:

> "What you are looking at is not the profit and loss statement of the overall accounting of the motion picture. What you've got there is a statement

> reflecting a contractual agreement of contingent compensation for a particular individual. So whether it's *Batman* or any other motion picture, an accounting statement always reflects an individual arrangement based upon certain agreed-upon conditions. It's the studio's obligation to fairly and accurately comply with the contractual arrangement agreed upon by both the studio and that individual." (McDougal, 1991, p. F1).

In recent years, reported losses on hit motion pictures have resulted in lawsuits being filed by the net profit participants. In 1988, Art Buchwald and Alain Bernheim were awarded $900,000 by the Los Angeles Superior Court to cover their 19% participation in the net profits of *Coming to America*, even though the studio claimed the film never made money. Reported losses of more than $20 million on the movie *Batman* prompted a series of lawsuits from the net profit participants.

Winston Groom, the author of *Forrest Gump*, retained an attorney to get a share of the profits from the film, even though Paramount is reporting a loss. Groom was paid $350,000 for the movie rights to the book and is entitled to 3% of the film's net profits. Paramount says it expects *Forrest Gump* to eventually show a profit, and has advanced Groom $250,000 against his net profit participation.

At issue in these lawsuits is the way the studios calculate 'net profit'. Critics argue that some of the costs (such as the distribution fee), listed in a net profit participant statement (see Table 1), are not really costs at all; instead, they are studio profits disguised as costs. Overhead allocations such as 'studio overhead' and 'advertising overhead' are based on arbitrary allocations which, some have argued, are much greater than the actual overhead costs which are attributable to the film. In addition, some of the lawsuits have questioned whether the net profit participants should lose compensation because of cost overruns which are largely under the control of the director, the stars, and the studio.

Will Paramount ever report a profit for the film, *Forrest Gump*? That depends upon how you define profit and whose perspective you are taking. Actor Tom Hanks and director Robert Zemeckis have already made more than $20 million each, including a share of the 'gross'. However, from the point of view of the 'net profit participants' (e.g., Winston Groom), the film may or may not break even.

Required

1. What amount of box office gross revenues is required before *Forrest Gump* earns a profit according to the 'net profit participation' contract? Assume that the financing costs are fixed.
2. What amount of box office gross revenues is required before *Forrest Gump* earns a profit for Paramount? Assume that the financing costs are fixed.

3. Discuss the concept of the 'rolling break'. Does the break-even point really change after the film is released? Explain.
4. Is Paramount's calculation of net profit fair to the net profit participants?
5. Assume that Paramount expected *Forrest Gump* to gross \$700 million in total box office revenues over the life of the film. How much profit on this film would Paramount have reported in its 1994 external financial statements?
6. Would you expect Paramount's taxable income for 1994 to be the same as its financial accounting income which was calculated in question 5, above? Why or why not?