Creative Accounting Practices in Hollywood

An Honors Thesis (HONR 499)

by

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Abstract

Hollywood accounting is a term used in reference to often misleading and arguably corrupt practices carried out by large film studios. I will examine the history of Hollywood accounting and how financial and tax accounting play a role. I will be examining how Hollywood accounting presents ethical implications that reflect poorly on the accounting industry.

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Process Analysis Statement

My interest in this project comes from my long-time love of movies. Despite my lack of personal creativity, the world of filmmaking does not put limits on the stories people tell and how they tell them. As I began down the path of an accounting major, I began to realize that accountants are involved in everything, even movies. Like any business, films employ a wide range of skilled workers and deal with an array of budget dollars. Someone is needed to make sure everyone gets paid, and no one spends more than they are allowed to. This is where my interest in Hollywood accountants blossomed, leading to my thesis which allowed me an outlet to explore something that had interested me for quite some time.

My research began by looking at scholarly articles. These articles provided important information on how to proceed. I found a lot of information on how legal contracts in Hollywood had evolved, and how that affected actors and behind the scenes personnel. I also found that recent changes to the tax law were benefiting the film industry. However, I could not find how this might all connect, or the moral implications of an industry that lacked transparency.

Much of my time was spent in Ball State Libraries' databases researching past and present tax law, as well as the industry's evolvement in employee compensation. After compiling the research I found, I began to search for connections within articles that originally seemed independent of each other. Dr. Stanfield was able to assist in suggesting connections in tax laws and regulations, and in the process of connecting the research, I expanded my knowledge of financial and tax accounting.

Using my research, previous knowledge in the classroom, and real-world experience from two internships, I was able to use my paper to convey the various facets of the topic. I

learned a lot about how I best manage my time and I greatly improved my writing style. The entire thesis process taught me how to properly research, assemble, and communicate my thoughts and ideas. I have broadened my idea of both the film industry and future accounting career options.

Introduction

The film industry has been an elusive and intriguing financial environment and the layers involved in producing a movie are numerous and deep. From the studios financing the movie to paying the creative minds behind the project, the process of tracking revenues and expenses has been kept from public scrutiny and is often only known to industry insiders. What are the moral and ethical implications of Hollywood accounting practices? Studios claiming major tax benefits do so at the expense of other taxpayers. What kind of financial and tax accounting practices are allowing studios to claim million-dollar losses on seemingly profitable films? Many states provide incentives for studios to film in their cities. Are these incentives sufficiently benefitting the states and their citizens?

One finding in this paper is how critical the wording in the legal contract is in determining the assignment of revenue and ultimately income to entities, and specifically the impact on royalties to creators. This project may interest contracting parties and accounting professionals alike to examine how certain practices have led to lost tax revenue and ethical gray areas. This paper will provide insight into basic accounting terms relating to financial and tax accounting, as well as insight into changes that could be considered by the Financial Accounting Standards Board, Congress, Treasury Department, and Internal Revenue Service (IRS) to better define or regulate Hollywood's tax accounting practices. This paper used multiple sources, including primary sources such as tax laws and definitions pulled directly from irs.gov, and articles and other materials located using Ball State Libraries' databases like Academic Search Premier and Business Source Complete. These resources provide credible and relevant materials to further explore and explain how a world has been created that allows for a legal, but perhaps immoral, tax avoidance practice.

This paper will also dive deeper into a lesser-known area of the accounting world. Film studios are unique in their diversification and business strategies. Tax topics regarding film studios follow a similar unique pattern of following basic standards for any business but also having additional regulations they must follow. Additionally, film studios have evolved to hold an immense amount of power over a select number of states. Many studios have states wanting them to produce films within their borders, despite the fact that tax incentives may provide little to no benefit.

A basic understanding of the issues involved will be discussed before diving deeper into current and future problems. Additionally, I will be providing a base knowledge of accounting standards and common terms that will be found throughout the paper. This base knowledge lays the foundation for the results and theories of Hollywood accounting practices I will be discussing.

Background

According to FASB.org, the Financial Accounting Standards Board (FASB) establishes financial accounting and reporting standards for public and private companies and not-for-profit organizations following Generally Accepted Accounting Principles (GAAP). The FASB is recognized by the Securities and Exchange Commission (SEC) as the standard-setter for public companies. The FASB is the United States-based standard setter and does not function internationally.

Overseen also by the SEC, and Governmental Accounting Standards Board (GASB), GAAP has evolved based on input from experts and the ever-changing world of business. GAAP states how financial statements should be prepared and presented. It provides a consistent basis

for financial statement users so they can easily compare financial statement information across companies. While GAAP still allows companies to make some choices in financial reporting, it does hold authority over overall accounting practices.

Financial accounting is a term that has already been used multiple times and will continue to be used throughout this paper. It is used in reference to the recording and reporting of financial statements. The financial statements include the balance sheet, income statement, cash flow statement, and statement of retained earnings. Assets, liabilities, and equities are recorded on the balance sheet, while revenues and expenses are recorded on the income statement. In the United States, these reports are created using GAAP.

Tax accounting is another term that will be used throughout the paper. This type of accounting differs from financial accounting because it does not focus on the financial statements. While GAAP still plays a role in tax accounting, the Internal Revenue Code (IRC) is the set of tax rules set out by the IRS that individuals and businesses must follow when reporting income to be taxed. Since GAAP and the IRC differ in regulation, many times the income statement and taxable income report different ending values. This difference in value will be discussed in greater detail later in the paper.

It is also important to note that this paper is being written after the 2017 Tax Cuts and Jobs Act (TJCA) was enacted. Many tax laws were amended and include benefits for the film industry that were previously unavailable. The income tax rate was also reduced from 35% to 21% which will provide a significant decrease in tax liability for film studios. TCJA also repealed business deductions like the domestic production activities deduction (DPAD) which allowed companies with qualified production activities to take a 9% tax deduction beyond the costs of production. While the repeal of the DPAD negatively impacted film studios, positive

changes include allowing films to be considered qualified property for bonus depreciation purposes and will be expanded upon later.

Within tax accounting, several definitions are necessary for a full understanding of this paper. First, tax liability is a term used to reference the tax owed by a business to the taxing authority, the IRS in the United States. The goal of any individual or company is to maximize after-tax wealth, including profits from films, using various tax strategies. Second, gross profit describes the profit from a company's product sales after the costs to make it are deducted from the product revenue. This figure is found on the income statement and only considers direct costs. For movie studios, this would include direct labor associated with a film, equipment or costumes for the film, or shipping costs for getting the final product to theaters. Contrasting gross profit is the third definition, net income. Net income is gross profit minus any additional fixed expenses, or indirect costs. These would include advertising costs, selling and administrative expenses, and distribution fees. Net income, also found on the income statement, represents the company's profitability. If expenses are greater than gross profit, it is then called a net loss. The definitions of gross profit versus net profit are important to keep in mind. Later in the paper, discussion related to how creative players may lose out on royalties and additional percentages because the differences in wording are not fully understood will occur.

For a long time, "the United States Department of Treasury and Hollywood fundamentally disagreed about the nature of show business" (Hoyt 6). Going back to the 1930s, Hollywood stars would disagree on what should be deductible as a business expense from clothing to parties with industry leaders. This led to a rise in film corporations being formed in the 1940s. This was due to a loophole before a tax amendment that allowed personal income to be taxed at the lower corporate rate. Corporations were then used for producers to receive

“modestly taxed capital gains rather than heavily taxed earned income” (Hoyt 11). However, a 1950 tax code amendment removed this tax benefit. Today we see some studios continuing the trend of using any method available to them to reduce their tax liability. The most common is expensing high distribution fees. Film studios set up each movie they produce as a separate subsidiary of the company. This means the company formed for the production of the film belongs to the parent company, the film studio. They are independent of the studio because subsidiaries are their own legal entity, however, the studios still hold influence over the film’s company. This takes the form of the subsidiary paying the parent high distribution fees to “cover the overhead costs of running a studio, and deducting those costs” (Carvell 1). These distribution fees are taken after gross profit has been calculated, reducing net income. Often the distribution fees are so great, they are the reason a film is not profitable. Studios can justify high fees by assigning indirect costs to their subsidiaries that were not directly used in the production of the film.This creates a net loss for the project at the subsidiary, and if the second-tier creative staff is contracted to obtain a percentage of net income, they will not receive any money until revenue reaches a point that it allows the film to turn a profit.

Financial Accounting

In recent years, many financial analysts have determined that “the film industry is a mature industry that is unprofitable” (Leaver 8). This could be due to home video sales, not ticket sales, making up most of a project’s profits. While film studios saw an increase in revenue from DVDs “by $15 million” on average per film, “the average cost per film rose by $18 million over the same period” (Leaver 9). This continuous increase in cost over a lesser increase in revenue has been “resulting in a cycle of perpetual restructuring” (Leaver 11). This also leads to an increase of pressure on directors and stars to negotiate deals favorable to the studio. However,

the film industry is an anomaly in the business world. Ticket prices for one movie are the same as the movie showing in the theatre next to it. This means that studios cannot hope to price a higher budgeted movie at a higher ticket price than a low budget production.

Hollywood's pursuit of profits has been laid out in court documents for the public to see. In 2010, the Walt Disney Company was ordered to pay *Who Wants to be a Millionaire* creators $269.2 million in damages. They claimed they did not receive their share of profits because the show never earned any money. In fact, the show reported a $73 million loss despite $515 million in licensing revenue and $70 million in merchandising revenue. Most likely due to the Walt Disney Company's ownership of ABC, the network that aired *Who Want to be a Millionaire,* Disney was able to charge a high licensing fee. This is evidence of the effects vertical integration has had on the film industry. Companies like Disney were allowed to purchase TV networks like ABC which prevents negotiations between studios and television networks from being arm's length transactions. Arm's length transactions occur when the parties entering into the transaction are independent of each other so that no pressure can be applied by one party onto the other. This has prevented producers from going to each studio and negotiating for the best deal.

This can also be seen in highly successful movies like *Return of the Jedi* and *Harry Potter and the Order of the Phoenix.* While *Return of the Jedi* "grossed $475 million on a $32 million budget," (Thompson 1) the fees charged by the studio to the product overtook any gross profit. This led to several consequences for many parties involved in the production, including the actor who played Darth Vader, David Prowse, receiving no residuals to date from a film released in 1983. *Harry Potter and the Order of the Phoenix* is another blockbuster example where cumulative gross profits from ticket sales exceed $612 million, but distribution,

advertising, and interest fees imposed by Warner Bros. add up to about $350 million. These fees, in combination with other expenses, have left the movie with a $167 million loss.

These are just a few examples of how Hollywood goes against the financial grain of other businesses. There is a lack of transparency between studios and the creative staff they employ. Those involved in the production of a film are treated more like contractors than employees, with percentages of profits and salaries hidden from them. When Sony's emails were leaked in 2014, revealing Jennifer Lawrence only received 7% of profits versus her male co-stars receiving 9%, many were shocked. If one of Hollywood's most popular actresses cannot receive a fair percentage, how can it be assumed that those behind the scenes are receiving any fairer treatment? Film studios have discovered that they can make money by increasing costs, rather than minimizing them. There are multiple ways to determine how items will be recorded. For example, a film studio purchasing a new camera has a decision to make. They can either expense the cost of the camera or capitalize it. The Business Literacy Institute clearly explains the difference between expensing and capitalizing by stating, "expensing a cost indicates it is included on the income statement and subtracted from revenue to determine profit. Capitalizing indicates that the cost has been determined to be a capital expenditure and is accounted for on the balance sheet as an asset." In many cases, capital costs are slowly expensed over time, unless the asset is land or goodwill. This is saying the camera can be taken as an expense even if it is capitalized. Instead, the expense is taken at a much slower rate because the camera's useful life exceeds a single accounting period, termed a long-term asset. When equipment is determined to be an asset that can be used long-term, depreciation occurs. Depreciation represents the use of the asset leading to a decline in its value, both in terms of usefulness and price if sold. So, the camera's expense is broken up over time, as the camera is used and its value goes down. While

depreciation is an expense still taken from revenue, it is taken in smaller increments over a period of time instead of all at once when acquired. While the evidence is scant because of the private nature of most contracts, most likely studios are capitalizing large expenses and depreciating it over time, but charging the entire cost of assets like cameras to a singular film. That would immediately begin bringing the net profits of the film down, versus allocating the cost of the camera over multiple films which would not yield the same impact on net profit.

Additionally, the time of executives and various permanent employees of the film studios could be expensed the same way. Theoretically, since films are considered subsidiaries of studios, professional and support charges for services like management and consulting can be charged to the film by the studio. If executives decide to visit the set and spend time observing how production is progressing, billing the film for a consultation fee would be a justifiable expense, though the parent studio realizes no direct change in its costs (the executives' pay presumably does not change). Film franchises are particularly prone to such a practice. The Marvel Cinematic Universe boasts 28 movies so far on its official website, Marvel.com, that have release dates as late as 2022. So how does such a large cinematic franchise stay consistent and avoid plot holes? The answer is Kevin Feige. As President of Marvel Studios, he oversees the entire slate of Marvel films. It is reasonable to assume that he closely monitors, or has his staff monitor, the progress of each franchise installment. Feige's actions could be considered consulting for the film. Many businesses charge and expense consulting fees, however, the aforementioned lack of transparency in the film industry does not compel Marvel Studios to fairly allocate costs. Feige's fees could instead help decrease net profits by allocating a higher fee to a film with royalty payouts greater than a film with an equal amount of consulting hours.

Neither capitalizing expenses or charging for consultations are illegal. However, it does explain how so many films can produce a net loss on seemingly profitable films.

Tax Strategies

Studios are also able to use various tax strategies to reduce or defer their tax liability. While this information is not publicly available on a film-to-film basis as most taxpayers' tax returns are private, including these corporations and other business entities, examining tax law and various disclosures can help determine how studios may be practicing tax avoidance. Tax avoidance is different from tax evasion. Tax evasion is illegal while "tax avoidance is the use of legal methods to modify an individual's financial situation to lower the amount of income tax owed" (Kagan).

For the purposes of this paper, the scenarios discussed are for qualified films as defined under IRC §181. This means "75 percent of the total compensation of the production is qualified compensation" (IRC §181(d)(1)). Qualified compensation is "for services performed in the United States by actors, production personnel, directors, and producers" (IRC §181(d)(3)(A)). This 75 percent would be made up of salaries agreed upon before adding in any royalty income.

Another important thing to note is that each film is not taxed. Instead, the film studio the film is produced under is taxed. Studios such as The Walt Disney Company are taxed on their films on one tax return, consolidating each film's revenue and expenses. This is important because many parts of the tax code focus on how studios should treat films as a whole, not how each film should be treated. This leads to a large book-tax gap between the tax and financial income of individual films.

Taxpayers begin computing tax liability using gross receipts. For tax purposes, studio revenue is made up of "leasing, renting, or licensing those films to distributors or movie theater operators" (Checkpoint ¶625). Additional revenues are then added in, including merchandising and joint promotion revenue or miscellaneous revenue from music and events. Revenues are then followed by expenses, similar to an income statement. However, tax laws allow for differences in tax expensing from financial accounting expensing. While there are no limitations to what can be expensed to reduce net profits, laws like IRC §181 have a limitation of a $15,000,000 aggregate cost for each film in most circumstances. After enacting TCJA, film studios can now list films as qualified property, a title previously reserved for most tangible property.

Listing a film as a qualified property is important because it allows the studio to depreciate the film itself, and currently to fully expense it in the first year under 100% bonus depreciation. This is all allowed under IRC 168(k). Taking 100% bonus depreciation is important because it allows film studios to accelerate their deductions and decrease the amount of income taxed. This is an expansion under TCJA and includes an additional requirement that 75% of production costs must occur within the United States. Accelerating deductions is a tax strategy used by companies and individuals alike. It allows the deferral of tax liabilities on film profits to later years since 100% bonus depreciation can only be taken once on a qualified property. Film studios produce multiple films a year, so they can securely fully depreciate all films produced in the current tax year since there will be more to depreciate in the following years. Allowing 100% depreciation, and stipulating that 75% of costs must occur domestically, benefits both taxpayers and the economy by simultaneously reducing studios' tax liability and protecting Hollywood from outsourcing production.

When studios reduce their tax liability, they are able to put the cash savings into new productions or bonuses for top executives. That saved money is rarely if ever distributed to those waiting for royalties whose films helped generate tax breaks.

State Incentives

Beyond federal tax laws, film studios receive tax incentives from states so they will film there. States have different levels of incentives with the most common types being “rebates, grants, refundable tax credits, or transferable tax credits” (Button 318). A state well known for offering tax incentives to studios is Georgia. According to Broderick Johnson, producer of films like *The Blind Side* and *Blade Runner 2049*, states, “Georgia’s tax break is one of the best, if not the best, in the country” (Egan). This is because, according to the “Film Incentives” page of Georgia’s website, up to 30 percent of tax credits can be earned. The first 20 percent is achieved through a $500,000 minimum spending threshold that can be met with one or multiple productions. The remaining 10 percent is achieved by putting the Georgia logo and link to ExploreGeorgia.org/Film on the production. For example, Disney filming a project with a $32 million budget in Georgia would provide them with 20% of the credit, provided at least $500,000 of the film’s cost is spent in the state. The final 10% is provided when the end credits include Georgia’s logo and link before the classic Disney castle logo. This credit is used against the studio’s Georgia tax liability, or the credits can be sold to another Georgia taxpayer. According to the Fiscal Research Center, from 2009-14 the program cost Georgia just over $925 million. This is most likely because Georgia does not cap the amount of credits that can be used. However, Georgia claims that films provided a $6 billion benefit to the state.

New York follows a similar system to Georgia by providing two levels of incentives. The first level is a "refundable credit of 25% of qualified production and post-production costs incurred in New York State" (NY.gov). The second level applies to productions with budgets of over $500,000 that take place in certain counties. These productions "can receive an additional 10% credit on qualified labor expenses" (NY.gov) However, unlike Georgia, New York caps their credits at $420 million a year. Not only is New York's incentive program costing them less than Georgia's, but it also provides "an estimated $22.7 billion in spending" (McDonough).

While these incentives do not heavily relate to financial accounting, they are a great tax strategy and are an important part of the studio's total financial performance. Studios can film in multiple states and benefit from the incentives unique to those states. However, many experts debate if states receive any benefit by providing these incentives. Most likely the answer lies with the residents of the state. Many states either require a certain number of residents are on the payroll or provide an additional percentage of tax breaks for doing so. Additionally, with film credits becoming the norm, states that dismantle their programs face losing an entire industry's workforce. Cameramen and lighting directors that reside in Georgia might move to New York or Los Angeles if studios stopped using the state for productions.

Conclusion

While Hollywood's accounting practices are important to examine as a member of the accounting industry, there are moral and ethical implications these practices have on the filmmaking industry. The filmmaking industry is irregular. Employees are contracted "to work on one project at a time, with extended periods between projects" (Wilson 693). Royalties have become a preferred payment method so there is a steadier source of income for creative minds

and the studio avoids making large up-front projects for material that never produces revenues. However, when the studio is in a position to dictate the contract terms as well as keep close control on the allocation of costs, those in power benefit while the small players suffer. In many cases, the small players are screen extras, directors, and writers. Without them, Hollywood's productions would suffer and might not even exist. However, studio capital is essential to produce nearly all films, so studio executives, producers, and A-list celebrities have negotiated to receive royalties from gross revenues and are in control of how expenses are distributed and recorded among films, leaving little for the remaining players. Lucrative royalty agreements in Hollywood's contracts will not be something power players will give up easily. It has become an easy way for studios to avoid paying out more than necessary.

Additionally, the industry has found a way to practice large scale tax avoidance. At the federal level, films are able to fully expense assets and record large expenses. Then, studios can take full deductions on the value of films they produced. This creates a large book-tax gap. This will occur indefinitely because the studio's only job is to produce films. At the state level, there is no evidence to suggest that tax incentives are beneficial to states, instead, they prevent harming the economy. Following the model of the industry, the jobs studios provide are temporary and limited. The two states examined, Georgia and New York, have few requirements for receiving the incentives. There are minimal dollar amounts that must be spent within the state's limits, and no employment requirements to hire state residents to work on the productions. While this is an issue with the state legislation, Hollywood is comfortable taking large tax credits and not investing in the states providing the credits.

The accounting industry is built on ethics. Accountants are held to a high standard and that should be reflected in all facets of the profession, but there is often disagreement on what is

ethical. Instead, further examining how studios allocate costs and take advantage of credits could benefit taxpayers and Hollywood's creative minds alike.

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