Motion Picture and Television Profit Participations

October 12, 2019 | 11:30 am – 1:00 pm

Program Description

Steven Sills will moderate a panel of four experts who will discuss the Motion Picture and Television Audit and Litigation process with focus on current audit issues as well as the following:

- Bob Getman, Transactional Attorney – Negotiating the deal for talent; upfront and backend compensation; historical participations versus streaming buyouts.
- Teena Munroe, Studio Executive – Negotiation with talent; negotiating with co-financiers; competing with streamers.
- Ilan Haimoff, Participation Auditor – The process of deciding when to audit: studio queues and audit timing; allocating fees amongst multiple clients; audit costs; converting from a percipient witness to an expert witness when litigation ensues.
- Ron Nessim – Litigator – The litigator's involvement in the audit process, including settlement; studio arbitration clauses; mediation vs. arbitration vs. litigation; recent cases.

Lead Facilitator

Steven Sills, Green Hasson Janks, Los Angeles, CA

Speakers

- **Litigator**: Ron Nessim, Bird, Marella Boxcer, Wolpert, Nessim, Drooks, Lincenberg & Rhow, Los Angeles, CA
- **Auditor**: Ilan Haimoff, Green Hasson Janks, Los Angeles, CA
- **Transactional Attorney**: Bob Getman, Jackoway Austen Tyerman Wertheimer Mandelbaum Morris Bernstein Trattner & Klein, Los Angeles, CA
- **Studio Representative**: Teena Munroe, EVP Participations, Lions Gate films, Santa Monica, CA
Program Materials

1. Audit Process Overview, By Green Hasson Janks
2. Raising the Red Flags: When You May Need a Profit Participation Audit, By Ilan Haimoff, Partner and Peter Klass, Senior Manager
4. What Makes a Film Successful in China? By Tracy Liang
5. Who is Watching the Subdistributors? By Michael Sippel
6. Choosing Your Profit Participation Auditor, By Ilan Haimoff and Michael Sippel
7. Studio Queue Survival Guide, By Sherri Carstens and Ilan Haimoff
8. Crash Course in Profit Participation Tolling By Ilan Haimoff and Michael Sippel
9. Brave New Media World: The Various Forms of New Media, Studio Reporting and Potential Concerns By Michael Sippel
11. Case Law: TWD First Amended Complaint, Superior Court of the State of California, County of Los Angeles, Central District, Nov. 2, 2017
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Audit And Settlement Process

• An Audit must be done in accordance with the agreement (regarding tolling, audit notices, timing, etc.)
• In many cases, it can take a couple of years to get on the studio’s audit calendar ("The queue")
• Depend on the studio, audits could take 6 to 12 months (or more, depending) to complete
• Findings include the following:
  - Errors and contract non-compliance claims
  - Contractual interpretation claims
  - Equity claims
  - Open items
• A client representative, typically a lawyer, is involved in settling such audits.
Raising the Red Flags: When You May Need a Profit Participation Audit
By: Ilan Haimoff (Partner, Green Hasson Janks) and Peter Klass (Senior Manager, Green Hasson Janks)

Whether you are an individual, company stakeholder or the beneficiary of a trust or estate with profit participation rights to movies and television shows, you may be at risk for underpayment or delayed payment of your participation profits by a studio or other distribution company. At a minimum, we recommend that you review your statements periodically. Depending on certain risk factors, you may consider consulting an expert to perform a participation audit.

What should you look for as you review your participation statements? As you assess the need for an audit, you may want to consider the following risk factors related to statements, agreements and market trends.

THE STATEMENT

*In the Black vs. Red*

If you are being paid by the studio in excess of the initial advance or minimum guarantee, the studio may be more focused on minimizing their risk of overpayment. They may do this by potentially delaying reporting of revenues or over-reporting expenses such as reserves. Although you should review all statements, you should be more diligent with review of the statements after the recoupment of your initial advance or minimum guarantee. If new or unusual entries were added soon before or after you are recouped, this may represent a red flag.

*Potential Inconsistency between the Statement and the License Agreement*

The statement is often issued by someone who was not directly involved with drafting the license agreement’s terms, conditions or intent of the agreement’s language. This increases the risk of errors and omissions in developing the statement template.

Additionally, when developing the template or algorithm (for more sophisticated studios), participation staff could be interpreting unclear or “grey” terms and conditions of your agreement subjectively, which likely may be in favor of the studio and could potentially result in under-reporting of revenues or over-reporting of expenses.

To mitigate this risk, you should review the statement for improper application of the agreement terms within the statement. If you identify any inconsistencies, this could be a symptom of larger issues, and therefore, would also represent a red flag.

*Unusual Entries on the Statement*

The high volume of statements issued by studios combined with the limited studio staff (the result of studios’ efforts to minimize overhead) may reduce statement quality control and lead to increased errors on your statements. Unusual entries, such as negative revenues and unfamiliar expense accounts could indicate a risk of other errors on the statement.

THE AGREEMENT

*Complexity of the License Agreement*

Generally, the more complex your deal is, the higher the risk of errors and omissions. This represents an inherent risk which should be considered as part of your decision to conduct a participation audit.
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Versions of the Agreement

If an agreement remains unsigned due to unresolved differences between you and the studio, there is potentially an expectations gap in reporting on the statement. The studio may be applying its version of the terms of the agreement. It will help if you are aware of the differences between the agreement versions. Also, as part of your monitoring process, you should scan the statement to identify instances where the studio has reported in a manner different from your expectations. If any are identified, it may require further evaluation.

Audit and Tolling Rights

Remember that the studio will not be calling you the day your audit or tolling rights expire. While you may have concerns about the statements, depending on your agreement, it may be too late. If your rights will soon expire, you may want to consider evaluating the need for an audit.

MARKET TRENDS
New Media Reporting:

In recent years, there has been a growing risk of underreporting for new media revenues. Studio systems and processes are yet to be upgraded to identify and account for all new media revenues. Such challenges will continue as new forms of revenue streams are developed. Also consider that your agreement may not have addressed new media exploitation, resulting in potential underreporting of revenues on your statement. Be sure to monitor the statement for new media revenue reporting.

Foreign Activity

As distribution overseas is becoming more significant, so is the question of accuracy and completeness of foreign distribution revenues. Depending on the studio monitoring controls and specific laws and regulations at the various territories, revenues may not be transmitted or classified properly, potentially resulting in errors and omissions. Although it may be difficult to monitor the overall accuracy, this inherent risk should be considered as part of the overall decision to audit.

Vertical Integration:

There appears to be a trend toward more and more self-dealings between relates parties (e.g., studio and network may be owned by the same media company), as the industry continues to consolidate due to competitive pressures. Although difficult to see on the statement, you may want to evaluate whether the related party transactions did not result in under-reporting of revenues or over-reporting of expenses on your statement.

Distracted Studios

If the studio is going through a significant change, such as an acquisition, merger, lawsuit, change in leadership, layoffs or system changes that you become aware of through news articles or rumors, it could potentially mean that the level of quality controls in statement issuance has been impacted.
With the new age of digital streaming and an abundant amount of on-demand content available for 24/7 consumption, many consumers have opted to stay at home on a Friday night binging on television series and movies as opposed to the traditional theater viewing experience. One attempt to draw moviegoers back into theater seats is the creation of MoviePass, a low-fee subscription-based movie service which allows subscribers to use a mobile application and prepaid card to view one movie per day at participating locations.

MoviePass, founded in 2011, was originally backed by investors such as True Ventures, AOL Ventures and Chris Kelly (former Chief Privacy Officer of Facebook). With an original price hovering around $50 per month, MoviePass initially had difficulties growing their subscriber base. In 2016, MoviePass hired Mitch Lowe as CEO, a previous executive at both Netflix and Redbox. Lowe identified the significant issues and began focusing on the pricing structure of the service. In July of 2016, MoviePass announced alternative subscription plans allowing subscribers to view two, three or unlimited movies per month with the lowest tier starting at $15 per month. Even with the new pricing model, the subscriber base had only reached 20,000 and MoviePass was still searching for a way to appeal to the masses.

In August 2017, analytics firm Helios and Matheson obtained a majority stake in MoviePass and brought a fresh business model to the company. Through their analytics background, they saw the true potential of using MoviePass to follow a platform, similar to Facebook and Google, where the emphasis was on data collection and targeted advertising as opposed to high subscription fees. In the same year, monthly subscription fees for unlimited films were dropped to $9.95 as their priority was to increase the subscriber base. While this new price point has created a surge in new subscribers, it may also cause MoviePass to operate at a loss due to the fact that MoviePass must subsidize the difference between the full ticket price and the amount collected in monthly subscription fees.

MoviePass has already anticipated such losses and is focusing on selling its users’ data to create additional revenue streams to offset potential losses. By accessing its users’ mobile files, pictures and offering users the ability to sync with their Facebook profiles, MoviePass will be able to offer major film studios the opportunity to measure the effectiveness of their movie marketing campaigns. To date, movie studios have the ability to promote their films through social media platforms, strategically targeting specific demographics, but do not have the ability to track who, within the targeted demographic, actually viewed the film. Another alternative plan to boost revenue is a potential launch of an online streaming service which was suggested by Lowe in a recent interview with CNBC. Currently the subscriber base is up to 600,000 and growing.

While the amount of subscribers has exponentially grown in 2017, MoviePass still has to overcome multiple challenges to ensure its success for the future. With approximately 90% of U.S. theaters participating in the subscription program, MoviePass is pressured to continue this rapid growth in order to keep exhibitors enticed and increase the overall sales of concessions, the main source of profit for exhibitors. Another reason MoviePass must increase its subscriber base is to obtain valuable user data that can be sold to movie studios in an effort to provide them with the tools to create more effective marketing campaigns at lower costs.
Assuming MoviePass changes the theater-going experience like Netflix transformed the way we consume content, the end result could be a real game changer. The exhibitors would see a spike in both ticket and concession sales, movie studios will receive additional theatrical revenue and actionable data to lower their marketing campaign costs, and ultimately profit participants should expect to share in higher theatrical revenue and lower overall marketing costs.

Will MoviePass be successful in revitalizing the traditional theater viewing experience or will the current shift to anywhere, anytime viewing continue? Only time will tell.

About the Authors:

Bryan Golerkansky is a supervising senior associate in the Contract Compliance and Forensics Practice. His primary focus has been distribution audits of motion pictures and television series on behalf of third-party participants and investors. Prior to joining Green Hasson Janks, he worked in the corporate reporting department at the Walt Disney Company and performed financial audits in various industries at the national public accounting firm, JH Cohn. Bryan is a Certified Public Accountant and Certified Fraud Examiner.

Ryan Dunner is a supervising senior associate in the Contract Compliance and Forensics Practice at Green Hasson Janks. Since joining the Firm in December 2015, Ryan's primary focus has been performing distribution audits of motion pictures and working on consulting engagements on behalf of third-party participants, investors and production companies. Ryan supervises the fieldwork for his engagements at several studios, including Lionsgate and Universal Pictures. Prior to joining Green Hasson Janks, Ryan worked in the participations department at Sony Pictures Entertainment and worked as a manager for Capgemini consulting in the entertainment industry. Ryan received his degree in Finance and Economics from Santa Clara University.
Hollywood filmmakers are continually searching for ways to promote their films to an international audience. A big focus is on China, the world's second largest theatrical market. However, the Chinese film market seems to be particularly challenging to understand. One of the latest examples is Star Wars: The Last Jedi, which made only $42 million dollars in China box office, in sharp contrast to its worldwide box office of $1.3 billion dollars. We have also seen other cases, such as Warcraft and Resident Evil: The Final Chapter, where China can "save" a movie from its underwhelming performance in other territories.

You may ask, is China an entirely different country with a unique taste compared to the rest of the world? What makes a foreign movie successful in China?

To answer these questions, let us first look at the film ratings comparison below for the top 20 foreign films in China for the year of 2017.

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<tr>
<th>#</th>
<th>Genre</th>
<th>Movie Title</th>
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<th>IMDB Rating</th>
<th>Rating Variance</th>
<th>China BO Gross (USD)</th>
</tr>
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<tbody>
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<td>1</td>
<td>Action</td>
<td>The Fate of the Furious</td>
<td>7</td>
<td>6.8</td>
<td>0.2</td>
<td>$892,807,017</td>
</tr>
<tr>
<td>2</td>
<td>Action</td>
<td>Transformers: The Last Knight</td>
<td>4.8</td>
<td>5.2</td>
<td>(0.4)</td>
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</tr>
<tr>
<td>3</td>
<td>Action</td>
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<td>Animation</td>
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What Makes A Film Successful in China? (cont.)

Do action films or heavy visual effects films mean higher ratings among the Chinese?
Contrary to popular belief, compared to the global audience, the Chinese audience does not necessarily favor action and visual effect films. The analysis above includes 16 action films. Six of the 16 action films received similar ratings among Chinese and global audiences (within a 0.2 variance on a 10-point scale). Four other films are rated between 0.4 and 0.9 higher by the Chinese. The remaining six films, including big-budget titles such as The Mummy, Thor: Ragnarok and War for the Planet of the Apes, received 0.4 to 0.8 lower Chinese ratings than the global audience ratings.

What type of films does the Chinese audience rate more favorably?
The two films that received much higher ratings among the Chinese are Resident Evil: The Final Chapter (0.9 higher) and A Dog's Purpose (0.8 higher). One of the key factors that contributed to their high ratings is the highly targeted marketing campaigns implemented by the Chinese local distributors and marketing partners. Thanks to big data resources from China's online ticketing platforms, social media and e-commerce platforms, the promotion activities for The Final Chapter were designed to target Resident Evil's large videogame fan base in China. Similarly, the marketing campaigns for A Dog's Purpose focused on pet lovers, female moviegoers and families. When the majority of the audience is already connected to the theme and the story, it is not a surprise that they give higher ratings. A similar successful story of targeted marketing strategies is the 2016 videogame based movie Warcraft (Douban rating 7.7; IMDB rating 6.9), which made $213M in China compared to $47M in the U.S.

Do Chinese and Global moviegoers share the same favorite films?
Yes, the three highest rated movies are the same according to Chinese and global audiences: Dangal, Coco and Logan. This confirms that the best stories are universal – they can transcend age, nationality or culture. As Chinese moviegoers are becoming more sophisticated in choosing movies, word of mouth does matter – both Dangal and Coco earned more during second and third weekends than the opening weekend in China and enjoyed an extended run at the theaters.

So why do people have the misconception that Chinese moviegoers love nonstop action and visual effects without caring much about the quality? This is because we often reach the conclusion by focusing on how much these films earned at China's box office. As is true in every movie market, financially successful movies do not always get the highest ratings. Below are some factors to consider:

- Action films are easier for an audience to access than a movie with a lot of dialogue, especially when it comes to foreign language movies. Same explains the popularity of Chinese Kung-Fu movies among the western audience.
- Movie stars still have major box-office power in China. For example, xXx: Return of Xander Cage (Douban rating 5.6) has made over $160M in China's box office, and its cast includes Vin Diesel, a familiar face to the Chinese audience thanks to the Fast & Furious franchise, Donnie Yen, a top Chinese action star who appeared in many popular Chinese films, and Krish Wu, one of the hottest Chinese rising stars with a huge following (he is also the Super Bowl LII Ambassador for NFL China).
- Release schedules makes a big difference. If Hollywood titles are going up against each other around the same time, they are simply competing for the same slice of pie. For instance, Geostorm, Blade Runner 2049 and Thor: Ragnarok were released within one week of each other (on 10/27, 10/27, 11/3 respectively), and these three titles collectively made $189M in China. In comparison, Transformers: The Last Knight, released on 6/23/2017, made over $228M in China despite the 4.8 ratings on Douban. It is worth noting that only two other Hollywood titles were in the theaters at the same time as Transformers: The Last Knight (The Mummy was released two weeks prior and Despicable Me two weeks after) and 90 percent of Transformers’ box office was generated during the first two weeks.

As we look ahead, let us not be surprised by the next Hollywood hit in China. Considering China’s enormous moviegoer base, as long as a film has a selling point that resonates with a particular audience group, combined with a favorable release schedule, it should not be difficult to achieve good results in the China box office.

About the Author:
Chenxi “Tracy” Liang is a part of the Green Hasson Janks Contracts, Compliance and Forensics Practice and has experience in entertainment accounting and forensic investigations. She specializes in profit participation and royalty audits on behalf of clients in film and television, video games, music, live entertainment and merchandising industries. Tracy has also provided consulting services in entertainment litigation matters. Prior to joining Green Hasson Janks, Tracy worked as a royalty auditor at Hurewitz, Boschan & Co., LLP. Tracy is a licensed CPA in the state of California and is fluent in Mandarin Chinese.
All major and mini studios utilize some form of subdistribution. In the foreign markets, a number of studios (mostly minis) only use subdistributors, and some minis use subdistributors in the domestic market as well. In many cases, the studios look for subdistribution relationships in certain territories based on various factors, such as financial (major studios may elect to go with a local subdistributor in smaller territories as opposed to setting up their own local branch), among others. The subdistributors have strong local market relationships and contacts, which are extremely vital for success in that territory.

With increasing revenues coming from the foreign markets, including those coming from territories which are subdistributed, it is important to develop a monitoring/auditing program of such relationships.

The reporting by the subdistributors, to the studios or other distributors, is based on a licensing or subdistribution agreement between those two parties. In most cases, the agreements are complex and subject to numerous variables, such as distribution fees, royalties, reportable share percentage, minimum guarantees, theatrical shortfalls, exchange rates, caps and cross-collateralization. Each of these might vary depending on the media being granted/distributed. As a result of the complexity and lack of consistent accounting processes between subdistributors, there is a risk of error of the underlying deal terms. This misunderstanding can potentially cost the studios or other distributors millions.

As studios look to develop a monitoring/auditing program, several key questions include:

- Are the revenues from all territories and media, that were granted rights per the agreement, accounted for properly?
- Are the distribution expenses charged allowable and legitimate direct (or directly allocable) title-based expenses?
- Are the minimum guarantees calculated correctly? This is often a negotiated amount, or calculated as a percentage of the production cost budget and/or final actual production costs, and would require further review to verify. In some instances, the agreement may or may not allow for revisions to the MG based on budgeted vs actual production costs.
- Are any overages due and/or delinquent? (e. was the MG exceeded?). This requires review of the agreement and statement to determine whether or not the proper distribution fees, expenses and reportable shares are in accordance with the agreement.
- Examples of a typical deal structure to determine the reportable share to the studio are as follows:
  
  **Theatrical:** Film rental less 10% distribution fee less all deductible expenses = net theatrical revenue subject to 75% reportable share to Studio
  **Television:** Revenues: 70% reportable share to studio
  **Home Video:** Revenues:
    - **EST:** 25% royalty reportable to studio
    - **Sell Thru/DVD/BluRay:** 100% revenues less all deductible expenses = net home video revenue subject to 50% reportable share to studio
    - **Rental:** 40% royalty reportable to studio

  If Total reportable share to studio is greater than the minimum guarantee (calculated based on 5% of Production Cost Budget, for example), then overages may be due. In many instances, it may be possible that the subdistributor did not anticipate exceeding the MG, and, therefore, has not prepared the proper statements. Historically, we find that it may result in an audit to ensure that the subdistributor can issue an overage statement and pay such overages due.

- Keep in mind that in some instances (which should be delineated per the agreement), overages from one title might be cross-collateralized to other titles that have not exceeded their applicable MGs.
- It is also possible that the agreement was written in the English language, but when translated to the local territory language, especially for complexities, it was improperly interpreted to the benefit of the subdistributor.
Overall there are numerous and varying pertinent elements of reporting from the subdistributors to the studios. Because of the complexity of the underlying agreement, and as previously noted, there is a higher risk of errors or other issues, causing underpayment to the studios.

Due to the significant dollars involved, studios and distributors should ensure that a monitoring program is in place, which may include periodic audits. Although subdistributors might require that the audit take place in the local territory, it may also be possible to perform a “desk audit”, whereby the pertinent supporting documentation is emailed or otherwise delivered to the studio.

At Green Hasson Janks, we have significant, first-hand experience auditing the statements and agreements between the subdistributors and studios. We have encountered various issues, ranging from simple errors to enormously complex contractual issues. If you have any questions or concerns, please reach out to myself or other members of Green Hasson Janks and we can discuss, including available audit options or assessments.

About the Author:

Michael Sippel is a senior manager within our Participations Audit Practice and specializes in contract compliance and forensics. Prior to joining the firm, he was a staff accountant at Hagen Streiff Newton & Oshiro, working within their Insurance and Forensic Litigation accounting practice. He earned his bachelor’s degree from the University of California, Berkeley in Business and Economics.
Choosing Your Profit Participation Auditor
By: Ilan Haimoff (Partner, Green Hasson Janks) and Michael Sippel (Senior Manager, Green Hasson Janks)

Unlike compliance services, such as tax preparation or financial statement audits that represent more of a commodity service offering, profit participation audits represent a forensic consulting engagement. In most cases this requires extensive, specialized experience and can only be performed once. Therefore, as we learned from Indiana Jones and the Temple of Doom: “choose wisely” when picking your profit participation auditor.

We recall several instances that highlight our concern with the auditor selection process. We have seen participants chose a less experienced auditor who:

a) Could not complete the audit due to dissolution of the audit firm or abandonment of the project
b) Did not identify any issues
c) Highlighted a significant issue which turned out, after incurring additional litigation fees, to be immaterial or factually incorrect.

So to help participants, we compiled a “cheat sheet” to use when looking for an audit firm.

In choosing a (profit participation) audit firm, it is important to consider the following factors:

- Experience: Generally, the more experience the audit firm can demonstrate – particularly current experience at the studios – the more value is derived from the audit. This is the most important factor, since such experience would help the audit firm provide you with a reliable recommendation as to whether or not an audit is worthwhile. If an audit is needed, the auditor is able to determine what areas of risk need focus. In addition, the audit firm may provide you with insight regarding the studio’s culture, which is helpful while you navigate through the audit and settlement processes. (Note that the audit firm would not be able to share specific potential issues due to non-disclosure restrictions)

- Return on Investment: The relative costs and ultimate value are typically considered by clients. The audit firm you choose should have the necessary experience and technical savvy to identify those issues that result in the most settlement value and do so with efficiency and cost-saving strategies. While there are no guarantees, the key would be the underlying experience at the studio and the general technical knowledge.

- Reputation: Our entertainment industry, especially in relation to profit participation audits, is a small community. You should consider asking for a recommendation from colleagues or friends in the industry who can provide a solid recommendation based on their past experience.

- Pre-approved Audit Firms: The studios often pre-approve audit firms within your agreement (Refer to the audit paragraph of the contract for a list of such firms.) Should you choose an audit firm that is not pre-approved, be sure that your selection is acceptable to the studio.

- Viability of the Audit Firm: In most cases, an audit can take a substantial amount of time to complete and settle. It is important that the audit firm you select is viable and will be able to perform the review, complete the audit report and be available to assist with the settlement discussions (or litigation, if necessary).

- Customizable Approach by the Audit Firm: Regardless of whether the audit relates to a motion picture or television series, the structure of the underlying participation deal – or the applicable studio or distribution company – the audit procedures and related audit fees should be properly tailored (limited or extensive review) and focused on cost/benefit analysis and risk analysis. When choosing an audit firm, ensure that the proposed scope has been developed to address your needs and the key areas of risk applicable to your deal.
Choosing Your Profit Participation Auditor
By: Ilan Haimoff (Partner, Green Hasson Janks) and Michael Sippel (Senior Manager, Green Hasson Janks)

• Client Service: It is important to pick an audit firm that is responsive and available throughout the audit process. From the initial statement review and recommendation stages through review of the final settlement agreement and amount, the audit firm you select should be available and provide you with support as needed.

• Price: While the price factor is important, consider the following:
  o Does the audit firm represent other participants with which the fee can be shared? If yes, the overall cost of the audit may be shared, which can be cost efficient to you.
  o Are the proposals you receive comparable? If an audit firm charges less, will they put in the same number of hours and effort? Through what point of engagement will the fee cover? (e.g., through issuance of final report, assistance in settlement discussions, etc.)
  o Have you considered the ultimate return on investment based on the experience of the audit firm? It is possible that while your audit fee may be lower, the ultimate settlement could also be significantly lower.

• Timeliness of Audit: With contractual tolling restrictions, length of the queue and the limited studio resources available to support profit participation audits, there are certain limitations beyond the audit firm's control to be able to anticipate the date by which an audit can start. If you have reasons to have a “rush” start, this should be discussed with the studio to see if they could accommodate, regardless of your audit firm selection.

If you have any questions on the selection process, please do not hesitate to contact us at 310.873.1600.

About Ilan Haimoff (Partner, Green Hasson Janks)
Ilan leads the Entertainment and Media Practice and the Contract Compliance and Forensics Department. His specialty includes profit participation and forensic accounting on behalf of talent, investors and co-producers at both the major and mini studios. Ilan has over 23 years of accounting experience in public accounting and private industry serving clients primarily in the entertainment, financial services and distribution service industries.

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Studio Queue Survival Guide

By Sherri Carstens, CFE (Senior Manager, Green Hasson Janks) and Ilan Haimoff (Partner, Green Hasson Janks)

Let’s imagine the perfect world when it comes to a profit participation audit of a studio film or television series distribution statement:

You (Producer) wake up on a Monday and decide it is time to audit. Within days, your attorney sends an audit notice to the studio, and by the end of the week, the audit firm is set to start the audit the following Monday, after confirming with their contacts at the studio.

In reality, the time it takes from the moment you decide to audit to the moment an audit actually can start may take months or even years, depending on the studio and your underlying audit rights. Assuming there is no explicit agreement provision that requires an audit to start within a specified time or scheduled on a priority basis, the primary reason for the delay in commencing is due to the limited resources available at the studio to support all audits at the same time. While each studio has a different process, the timing of each audit may be determined based on the audit notice date.

The following are ideas and tips to consider as you contemplate sending an audit notice to a studio:

**Be ahead of the game:** If there is the possibility that you may want to audit, depending on certain factors, you may want to consult with your representative as to whether to submit an audit notification as soon as you receive your first participation statement. When weighing the risk of missing a tolling deadline vs. sending an audit notice too early, it is important to also consult with the audit firm – who may be familiar with the studio processes – which should be considered as part of such decisions.

**Monitor your tolling rights:** A designated representative (attorney, agent or business manager) should be monitoring your tolling rights to ensure that a decision to audit is made timely and/or none of your audit rights expire.

**Consult with an audit firm:** Since each studio has a different process, you may consider consulting with an audit firm as to the best timing to notice and whether an audit would be worthwhile. Note that in some cases, an audit is not necessarily the right answer.

**Plan ahead:** Assuming you have more than one picture or television series, you may consider developing a process through which you maintain your tolling and consult timely with your representatives – including the audit firm – to ensure that an informed decision is made as to whether to audit and when to send the audit notice. As an example, assume that:

1) A studio has one queue for multiple audit firms with an estimated wait of three years and has a system of first-in, first-out approach to starting audits
2) You need to notice within a month to be able to audit to inception
3) Your picture is in its early distribution life cycle, as you expect much more revenues and expenses will be recorded in the coming three years
Studio Queue Survival Guide (Cont.)

After confirming with the audit firm that an audit would be warranted, it may make sense to send the audit notice within the coming month.

*If unsure, you could ask for a tolling extension:* Sometimes – for various factors – it may be difficult for you to make a firm decision as to whether to audit or not. Under those circumstances, you may try to negotiate a tolling extension, which would give you additional time to decide. There is no guarantee that the studio would agree. However, it may be worth trying under certain circumstances.

The profit participations team at Green Hasson Janks is here to assist you if you still have questions about the audit notification process.

**About Sherri Carstens (Senior Manager, Green Hasson Janks)**
Sherri Carstens joined Green Hasson Janks in 2000 and has over 16 years of auditing experience within the entertainment industry. Her specialty includes profit participation audits on behalf of talent, investors, producers and directors at major studios. Currently she manages audits at Warner Brothers. Prior to Green Hasson Janks, Sherri was the internal auditor at Panavision – auditing Panavision's agents worldwide. Sherri earned a Bachelor of Science Degree with honors from California State University, Fresno. While in college was an active member of Beta Alpha Psi. Sherri currently resides in Santa Clarita.

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Crash Course in Profit Participation Tolling

By Ilan Haimoff (Partner, Green Hasson Janks) and Michael Sippel (Senior Manager, Green Hasson Janks)

Profit participation agreements generally include incontestability language, which only allows the profit participant to audit statements issued up to two or possibly three years prior to the date of the audit notification. On one hand, the rationale for this restriction may come from the challenge of storing documents, so the longer the tolling period, the longer the studio has to maintain the books and records supporting the profit participation statements, which can be costly and administratively challenging.

It's also likely that the tolling restriction is derived from a business risk mitigation standpoint, whereby the shorter the tolling period, the less risk there is of incurring audit claims. On the other hand, profit participant representatives (attorney, business manager, agent or talent manager) are frustrated with the complexity and difficulty of tracking the dates for each statement issued, which might potentially result in confusion and, consequently, in missing contractual deadlines.

**So what to do?**

As a first step, it is important for the profit participant's representatives to come to an agreement as to who is tracking the tolling. Oftentimes, there is confusion and misunderstanding on this issue. Next, a tracking system should be developed to account for each agreement and subsequently issued statements. Depending on the volume of agreements and statements, the tracking system can range from a simple Excel file to a complex management system. Such tracking system would include each statement and its applicable tolling deadlines.

Once a system is in place, and as the statement tolling deadlines are likely soon to be reached, you should consult with a profit participation auditor like Green Hasson Janks to assess the feasibility of an audit. If the client decides to pursue an audit, based on the auditors' recommendation, an audit notification would be sent to the applicable studio. Depending on the circumstances, as opposed to sending an audit notification, one could negotiate a tolling extension, which can defer the decision of auditing while preserving the tolling rights.

It is important to note that the first several statements are critical to the viability of a participation audit, as such statements include the initial P&A and production costs, which often exponentially outweigh the remaining deductions. If the tolling rights expire for those statements, a significant portion of transactions would be incontestable and it's quite possible that the entire audit would not be worthwhile. Also, during the recommendation stage, you should not be discouraged by large recoupment deficits as you review those first statements as often – particularly for television shows – the revenue will not come for some time, possibly years. However, considering that we may have queues at some studios, it is possible that by the time we audit, the statements may be recouped.

**Once the audit notification is sent, are you done?**

As a courtesy, while profit participation auditors may alert a client of a potential tolling expiration during an audit, it is the responsibility of the client (or a designated representative of the client) to track the applicable tolling.

While each studio operates differently, it is important to continue tracking the tolling and request for extensions, as needed. Examples could be as follows:

(Continued on back)
1. The audit may not commence for another several years, and you may need to ask the studio to extend the tolling to commence the audit
2. The audit may be in progress; however, the audit may not be completed in time to meet the tolling deadlines, and an extension may needed
3. It is possible that while you were able to meet the deadline to submit the audit report, more time may be needed to assess whether litigation should be pursued, and tolling may need to be extended further

Considering each agreement may be different and each studio may have different policies and practices regarding tolling, please reach out to our participation audit group with any questions.

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About Ilan Haimoff (Partner, Green Hasson Janks)
Ilan leads the Green Hasson Janks Entertainment and Media Practice, and his specialty includes profit participation audits on behalf of talent, investors, and co-producers at both the major and mini studios. He currently oversees participation audits at various studios, including 20th Century Fox, Sony, Starz, as well as other prominent studios. He is a co-author of Green Hasson Janks’ recent whitepaper, *New Media Trends: Consolidating to Meet Consumer Demands*.

About Michael Sippel (Senior Manager, Green Hasson Janks)
Michael is a senior manager within our Participations Audit Practice and specializes in contract compliance and forensics. Prior to joining the firm, he was a staff accountant at Hagen Streiff Newton & Oshiro, working within their Insurance and Forensic Litigation accounting practice. He earned his bachelor’s degree from the University of California-Berkeley in business and economics.
Brave New Media World: The Various Forms of New Media, Studio Reporting and Potential Concerns
By Michael Sippel (Senior Manager, Contract Compliance and Forensics, Green Hasson Janks)

EST, VOD, SVOD, FVOD, and ADSS... What do they mean, and why do we care? The ascent of new media markets – with the simultaneous decline of the hard goods home video industry – is evidence of a diversifying brave new media world. Understanding the nature of the emerging markets themselves and how the different studios report them is imperative for those who follow entertainment trends – as well as advocates on behalf of the actors, directors, producers, creators and investors of film and television series, such as lawyers, business managers and participation auditors.

The major new media streams can be broadly defined as:

- **EST (Electronic Sell Thru)** is a permanent digital copy granting the viewer unlimited access forever. Purchases primarily occur via online, mobile (through a smart phone or tablet) and/or Smart-TV at home, through vendors such as Apple and Amazon.
- **VOD (Video-On-Demand)** is a temporary download allowing the viewer to watch the film/series a limited number of times within a limited number of days. Rentals of such primarily occur on your television set at home, online and/or mobile through vendors such as DirecTV, InDemand and Apple.
- **SVOD (Subscription Video-On-Demand)** is subscription based and allows the paid subscriber to watch the film/series an unlimited number of times within a limited license period (usually one year). This primarily occurs at home, online or mobile through “over-the-top” vendors like Netflix and Amazon Prime.
- **FVOD (Free Video-On-Demand)** is similar to SVOD but is primarily related to network and basic cable providers like ABC.com, FX.com and Hulu and does not require any additional payment by the viewer.
- **ADSS (Advertising Supported Streaming)** is very similar to FVOD but generates revenues by selling commercial time and/or “pop-ups” within the broadcast.

With these variations, you care about convenience and costs if you are a consumer. However, if you are the talent or the investor involved in the film/series or their representatives, you care about how the related revenues, if any, are derived and reported to you or your client.

In newer contracts, reporting requirements are often contractually defined. However, older agreements are often silent as to how such revenues will be treated. In most cases, the actual reporting of the noted new media is as follows:

**EST revenues** are derived on a per-buy basis, and the retail sales price generally fall within a range of $10 to $20. The studio generally receives the greater of (a) a minimum amount per buy, ranging from $6 to $15 or (b) 50-70 percent of the retail sales price.

Studios emphatically state that EST is merely a replacement for standard home video and, as such, EST revenues received by the studio are always reported at the standard home video royalty rate (typically 20 percent).

As a participations auditor, I might argue the reporting is unfair, as the 20-percent home-video royalty is a historical standard based on a 50/50 split after deduction of all related costs – most significantly manufacturing, mastering, advertising and distribution. However, as EST has no related manufacturing or distribution expenses and little
to no mastering and advertising costs, one can make the argument that the 20-percent royalty is unjust and not within the original intent of the historic royalty arrangement.

Also, depending on the age of the product, reporting requirements for EST might not be included in the contract between the participant and the studio. If such is the case, and depending on the definition of “home video” (which may make specific reference to words such as “device” and being that EST is not a “device” of any sorts), one might again take the approach that EST revenues should be reportable at 100 percent.

**VOD revenues** are derived on a per-buy basis, and the retail sales price generally fall within a range of $4 to $6. The studio generally receives the greater of (a) a minimum amount per buy, ranging from $2 to $4 or (b) 50-70 percent of the retail sales price.

The reporting of VOD revenues differs by studio; however, most studios state that VOD also functions as a replacement for standard home video and as such, VOD revenues received by the studio are most commonly reported at the standard home-video royalty rate.

Similar to EST, one can make the argument that the 20-percent royalty is unjust because little to no costs exists. However, an additional argument exists to report VOD revenues at 100 percent based on the standard reporting of pay-per-view (PPV), which is nearly identical in nature to that of VOD. The only major variances between the two is that PPV can only be viewed linearly at scheduled increments (e.g., from 2 – 4:30 p.m.), whereas VOD can be viewed anytime (e.g. 2:21 p.m.) inclusive of the ability to rewind, pause and fast forward during the 1-2 day window.

Another argument also exists that the residual amounts paid to the guilds are contractually based on 100 percent of the VOD revenues received while home video and EST are based on 20 percent or a number of downloads. Therefore, the participant is receiving only 20 percent of the VOD revenues but is charged with 100 percent of the residual expenses based on 100 percent of the VOD revenues.

**SVOD revenues** are not derived on a per-buy basis but are instead generated from monthly subscription revenues from SVOD customers. The revenues received by the studio are based entirely on negotiated license fees, extremely similar to those of free and pay television.

The reporting of SVOD revenues differ by studio. However, because of the nature and revenue recognition noted above, they are most commonly reported at 100 percent. For those studios reporting SVOD at a royalty, it is often that the agreement simply does not define the difference between VOD and SVOD and simply says “VOD.” Thus, even though the nature is drastically different, the studio takes the more aggressive approach and subjects such revenues to a royalty because SVOD contains the words VOD. Some studios may agree that if the SVOD window is replacing the first pay television window, SVOD revenues should not be subjected to the royalty.

To make things more interesting, per Wikipedia, the pay television provider Epix, which is owned by Paramount, Lionsgate and MGM, signed a distribution deal with Netflix in August 2010 allowing its subscribers to view the movies only 90 days after their pay television premiere. Certainly, participation auditors and representatives of the

*(Continued on next page)*
talent/investors might be concerned with the overall reporting, if any, of such an arrangement.

**FVOD revenues** are generally not directly derived from FVOD exhibition because they are offered free to the customer. However, similar to ADSS, the platform may include abbreviated commercials and/or pop-up advertising. As such, FVOD revenues received by the studio, if any, are typically very immaterial. FVOD exhibition is much more prevalent in relation to television series than film.

Similar to SVOD, the reporting of FVOD revenues differ by studio. Some studios report FVOD revenues at 100 percent and others at the standard royalty rate. The arguments generally made by participation auditors and representatives of the talent/investors of the film/series are not based on the percentage of the amount reported to the participant but more specifically, exactly how much, if any, the studio is receiving from the applicable FVOD licensees, such as ABC.com or FX.com, etc., and Hulu, who is owned by NBC, Fox and Disney.

It is common that FVOD licensees do not report any applicable advertising revenues, etc., to the studio. Therefore, on a purely contractual/auditing basis, the studio won’t report what it does not receive. However, this does not change the fact that they should usually be receiving revenues from the FVOD licensee. And, in many instances, the studio and the FVOD licensee are vertically integrated (ABC/Disney or FBC/Fox, for example).

The typical studio response to such emphasizes the silence or ambiguity of the language included within the agreement between the studio and the FVOD licensee. And, as they may effectively be a part of the same company, it is not uncommon to have verbal agreements and/or unsigned written agreements, resulting in the inability of either side to pursue legal action.

Participation auditors and representatives of the talent/investors of the film/series are generally of the opinion that the FVOD licensee should adequately compensate the studio, especially if they are vertically integrated, for the free content exploited on its websites, etc., some of which may generate advertising revenues but more of which is indirectly involved in building an audience for the FVOD licensees brand (i.e., free content drives consumers to the FVOD licensees website, which includes ads and other information regarding other products and projects and ultimately builds customers and promotes the entire brand).

**ADSS** is similar to FVOD in many ways but is different because, most of the time, the website is funded almost entirely by the generation of advertising revenues, usually through abbreviated and full-length commercials, pop-ups and banner ads.

Typically, the advertising companies will pay the ADSS licensees by spot or by number of clicks. The studios generally receive 60-70 percent of the ADSS revenue earned during the film/series exploitation. In many instances, the website is not affiliated with either (a) the studio involved in distribution and production or (b) the network or basic cable company airing the series. As such, studios report 100 percent of ADSS revenues to the participants.
The primary concern of the participation auditors and representatives of the talent/investors of the project is completeness and the inability to verify that the studio is receiving everything it should and reporting everything it receives. Another concern, for both talent and studio, is general piracy. Similar to Napster for music, many websites are not licensed to exploit the film/series and do so illegally. As such, the studios do not receive any related revenues. Piracy concerns are severe and trickle down to every market. If you know you can watch it for free, why buy the home video or download the digital content? Studios continue to spend millions on piracy protection, but continue to lose millions more on lost revenues due to piracy.

As those who follow entertainment trends as well as advocates for the actors, directors, producers, creators and investors of film and television series, we need to better understand the nature and reporting of new media markets, which continue to grow, evolve and spark debates regarding the sometimes controversial studio accounting. With the general decline of hard-goods packaged media (DVD and Blu-Rays), studios are finding themselves forced to make up the lost revenues elsewhere. And, what better arena exists than the ever-growing, ever-evolving and ever-ambiguous “brave new media world.”

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Profit Participation Nostalgia...
By Ilan Haimoff (Partner, Green Hasson Janks)

I recently came across a great paper written by Mark Weinstein in January 1998 in the University of Chicago Journal of Legal Studies, entitled “Profit-Sharing Contracts in Hollywood: Evolution and Analysis.” If you are in the profit participation business, this is a must read!

What caught my eye was the discussion of the history of profit participation. Here are some highlights:

- **Gross Deals:** According to the paper, the first gross deals were the 1930 John Barrymore and Al Jolson contracts that paid a percentage of the gross revenues from their movies. Jolson’s was for a percentage of the excess over a fixed amount while Barrymore’s was for 10 percent of the gross from the first dollar. The paper also went on to discuss the 1939 James Cagney contract, covering 11 movies for $150,000 per movie plus 10 percent of the gross receipts over $1.5 million.

- **Net Deals:** According to the paper, the earliest contract that resembles the modern “net-profits” contracts is one between Warner Brothers and David Belasco in 1923. This contract gave Belasco a percentage of the “net profits.” This may be where the “distribution fee” concept may have started, as Warner Brothers was able to subtract the costs of making and distributing the movie, along with a distribution fee of five percent. Evidently, Belasco had audit rights. That’s how the participation audit business was born!

- **“Net-Profits” Contracts:** Similar to what we see today, the paper explains that this concept dates from 1950 when Jimmy Stewart’s agent, Lew Wasserman, negotiated a deal for the movie Winchester ’73 with Universal. According to the paper, at that time “Universal was in financial difficulty and could not afford Stewart's normal salary of $250,000. Instead, Stewart got no fixed salary but did get 50 percent of the ‘net profits.’ Net profits were contractually defined as gross receipts in excess of twice the negative cost.” Mel Sattler, who negotiated the contract on behalf of Universal, put it this way: “Universal accepted the proposal because it permitted the company to put substantially less at risk by reducing its immediate production costs.”

- **Other Highlights from the paper:** In the 1941 Hal Wallis contract with Warner, overhead is specifically included in the negative cost, but it is to be an amount determined by the Warner’s auditor, Price-Waterhouse. I didn’t realize how much power an accounting firm used to have!

While times have changed quite a bit since then, it is interesting to look back and see how it was born. Be sure to read the entire paper by clicking here.

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Ilan leads the Green Hasson Janks Entertainment and Media Practice, and his specialty includes profit participation audits on behalf of talent, investors, and co-producers at both the major and mini studios. He currently oversees participation audits at various studios, including 20th Century Fox, Sony, Starz, as well as other prominent studios. He is a co-author of Green Hasson Janks’ recent whitepaper, New Media Trends: Consolidating to Meet Consumer Demands.