CGMA

CGMA MANAGEMENT CASE STUDY FEBRUARY 2020 EXAM ANSWERS

Variant 1

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Section 1

Value chain

At present, the primary activities in the value chain associated with the back catalogue are limited and very straightforward. The digital sales require little more than limited marketing to support their popularity and a limited amount of infrastructure, primarily in terms of processing receipts from sales and royalties and the payment of royalties to artists. Sales on CD involve a physical product, but that is not much more complicated because the manufacturing of CDs is outsourced to a third party and so the only additional activities are the logistics associated with procurement from the manufacturing company and the logistics associated with managing the resulting inventory.

The most immediate concern in terms of Trevel's primary activities is the need to market the new range of vinyl recordings. The company cannot take it for granted that the continuing popularity of the digital copies will translate to sales of vinyl. In the first instance, Trevel will have to invest in market research with a view to identify the target market and the albums that are likely to prove popular in this format. The company will also have to develop a marketing strategy that promotes the vinyl format, without undermining the digital recordings that will continue to be the company's primary source of revenue.

The vinyl recordings will also impose a significant strain on Trevel's logistics, both inbound and outbound. It will be necessary to make decisions about batch sizes and storage. It would not be cost-effective to print small batches frequently, but there is also a cost associated with storage and managing inventory, even if that is outsourced to a third party.

If Trevel orders too many albums then it may become uneconomic to store them until they can be sold, which could lead to them being scrapped or sold at a discount.

In terms of support activities, the release of the back catalogue on vinyl would require consideration of the technology associated with creating analogue records. Much, if not all, of Trevel’s back catalogue, will have been recorded using digital equipment and on digital media. It may require some development work to create satisfactory vinyl copies that would satisfy customer when played back on turntables. Trevel would have to ensure that it had access to the necessary technology and expertise and that the recordings at its disposal are suitable.

Business logic

The factors that make vinyl unappealing appears to be the driving force behind the growing demand for this format. Customers seem to enjoy the feeling of handling records and playing them on analogue turntables. The demand for vinyl has already been demonstrated by other labels and so it would be illogical for Trevel to disregard this revenue source without at least evaluating its potential for the company. Anna’s recommendation appears to have been driven by the fact that there is already a demand for this format and so it should be made available rather than permitting competitors to benefit from that revenue stream.

The proposal is not to replace digital sales with vinyl. Vinyl is an emerging market segment that is likely to supplement digital sales rather than replace them. The potential customers for vinyl copies of Trevel’s back catalogue of albums will probably own those recordings in a digital format or have access through streaming sites. They probably wish to buy a further copy on vinyl and so the new format will enable Trevel to augment its sales.

Vinyl records could be marketed and sold as a premium product. Customers are prepared to invest in special equipment to play records. The profit margin could be higher on vinyl than on digital recordings. Customers appear to value features such as the cardboard sleeves, with high-quality printing of text and artwork, which would enable Trevel to sell these records as “special editions”. If that strategy works then the additional cost of making and managing vinyl records will be more than offset by the inflated selling price.

Trevel’s present strategy of selling digital copies does not appear to be particularly effective, with declining revenues and profits. The music market does not appear to be willing to spend money on digital copies, at least to the same extent as before, but there is at least a segment that is prepared to buy more vinyl. From a purely marketing point of view, it could make sense to replace digital copies with vinyl because that is where the demand is.

Section 2

External factors
The availability of record turntables should be considered. If music lovers cannot buy turntables, then they will have little need for vinyl records. The Board should investigate the number of manufacturers and retailers who can provide these devices and ensure that they appear to be profitable.

The demographic of the vinyl-buying public should be investigated in order to establish its exposure to economic change. It has been suggested that many buyers are in their late 20s and early 30s, which is a stage in life when people often have mortgages and family commitments. An increase in mortgage rates could, therefore, have an impact on disposable incomes and that could seriously harm their ability to spend on luxuries such as music.

The attitudes of retailers should be considered and the likely availability of retail space. Vinyl records are large and fragile and not ideally suited to online sales.

Will retailers make sufficient profit from these recordings to make it viable for them to set aside floor space for Trevel and the other labels?

The availability of factories and that of raw materials should be considered. If the supply chain is disrupted, then customers may lose interest in vinyl and that could prove expensive. Trevel should consider how many manufacturers are available to manufacture good quality records and how many suppliers are there for raw materials.

The possibility of this new segment attracting the environmental lobby should be considered. Vinyl records will have a much larger carbon footprint and will consume plastic and paper in their manufacture. Trevel might use focus groups to investigate how customers might respond to arguments that vinyl is less sustainable than downloading or streaming music.

Project management issues

The first issue is the initiation of the project. Trevel's Board has decided, in principle, that it wishes to produce a series of vinyl recordings, but there are further decisions that have to be made. For example, the resources that will be required will have to be identified and obtained. In this case, Trevel must confirm that the project is feasible before it goes further. Apart from the technical issues arising from creating the records, it will also compete with other record companies. The risks associated with this project will also have to be defined. For example, the fact that demand for vinyl is increasing at present does not mean that this will remain the case.

Next, the project will have to be planned. Trevel will have to appoint a project manager, who will require an appropriate background. That will be complicated in this case because it is unclear whether the focus of the project should be the marketing aspects of launching the new format, the engineering aspects of creating the records themselves or the manufacturing aspects of mass-producing the records. This will be a significant decision because the project manager's focus could affect the overall success of the project, given the need to bring together those key areas.

The execution of the project will require careful consideration because it will require coordination of marketing, manufacturing and distribution. Trevel will have to be ready to promote these recordings to ensure that maximum publicity is obtained from the launch. It will also be vital that adequate inventories of records are available and that commitments to retailers are met. This is a new direction for Trevel and so the Board will have to ensure that all relevant departments are coordinated and ready to support the project team.

Controlling the project will be complicated because the project team may have to change as various aspects of the project are completed. For example, once the processes for converting Trevel's digital files to vinyl have been finalised then there may not be an ongoing need for audio engineering to be part of the team. The Board will also have to pay close attention to signs of dysfunctional behaviour by project team members who are keen to make a reputation from this new direction.

The closure will require consideration of the switch from implementation to ongoing operations. If the market for vinyl records becomes established, then it will no longer be a separate project but will simply become a product line. That will require care in deciding when the project team should be returned to their normal roles or integrated into the management team. That change may have to be handled with some sensitivity if managers have been seconded to the project and colleagues promoted on an acting basis to fill in for them.

Section 3

Pricing

The records themselves should be thought of as premium products. Customers appear to be keen to own the music on this medium because of the aesthetic pleasure associated with handling vinyl records and reading record sleeves. The fact that these recordings are already on Trevel's back catalogue suggests that customers will generally have access to digital copies and so are prepared to pay extra for a further copy on vinyl. They have demonstrated that commitment to vinyl by investing in the necessary equipment to play it. All of those factors suggest that pricing will be relatively inelastic and so Trevel could consider a market skimming strategy in the first instance.

This medium appears to have attracted the music-buying public's attention. It is generally believed that music sounds better when played from vinyl, even though tests suggest that listeners cannot distinguish vinyl from digital in blind tests. The market is prepared to believe in the quality of this product and will be receptive to claims that Trevel has added value by, say, "optimising" the original recordings so that the resulting records can be said to offer excellent sound quality. The fact that listeners choose to believe that they can hear the improved quality of vinyl when compared to digital sources supports the suggestion that skimming is justified.

There is already an observable market in vinyl because other labels are selling music in this format and so it would make sense for Trevel to take established selling prices into consideration when setting initial prices. It would be logical to avoid overpricing releases in comparison to other labels, unless Trevel is adding value in such other way, such as adding previously unreleased tracks to the album. Even so, if Trevel focusses on "classic" albums for its initial release then the customer may be prepared to pay a small premium over typical retail prices to have a particularly important record in their collections.

Ratios

The most immediate change is that we would expect Trevel's return on capital employed to increase. Operating profit will increase because we will be selling a new line at a profit, with no meaningful increase in the capital employed. Any increase in ROCE is to be welcomed as an improvement because the company will be seen to be generating an additional return from the investment that has been made in it.

Trevel's asset turnover will also increase. The new line will increase revenue, without the need for any additional investment in PPE. That increase will be viewed as an improvement because it will indicate that Trevel is using its asset base more efficiently in generating business.

Trevel's gross profit percentage will change. If we assume that the margin on sales of vinyl is greater than on digital sales because vinyl is a premium product, then the addition of high margin sales will increase the gross profit percentage. Changes in gross profit percentage can be difficult to interpret, but this change should be viewed as an improvement because the company has been struggling with poor profitability and so the shareholders will be pleased to see that the percentage has increased.

Trevel's current ratio will be affected because, in the first instance, inventories of records will increase, with a matching decrease in cash. After all, payment to Steampress is due on delivery. That will have no net impact on the current ratio because the two figures will offset one another. The quick ratio will, however, decline, which will make Trevel appear to be less liquid. Also, the reduction in the bank could raise further concerns about liquidity.

The inventory turnover ratio will almost certainly increase. If Trevel invests heavily in vinyl, then the proportionate increase in inventory will be far more significant than the increase in cost of revenues and so the number of days will increase significantly. Naïve readers may assume that this is an indication of inefficiency on the part of Trevel's management, while more astute readers may recognise that it is difficult to determine a meaningful figure for this ratio without a split between cost of revenues from digital downloads and streaming, versus CD sales and now vinyl.

Section 4

Goodwill

IFRS 3 *Business combinations* states that goodwill is determined after recognising and measuring the identifiable assets acquired and liabilities assumed in the acquisition. That may be complicated by the fact that Trevel may be trading with Steampress already and so some of the assets acquired may have been acquired through some previous and separate transaction. Trevel will have to keep careful records of the business it does with Steampress during the negotiations leading up to the final acquisition of the company.

Steampress owns significant quantities of sophisticated and specialised production machinery. That will have to be valued at its fair value, Trevel will have to consider how the nature of the business and its technology will affect the fair value. It may be that the equipment has very little sale value unless it is being used to press vinyl records, in which case the identifiable assets will be understated and the goodwill figure overstated.

IFRS 13 *Fair value measurement* permits fair values to be determined based on their “highest and best use”**.** That makes it possible to take account of the present value of the assets if used to generate cash surpluses over the remainder of their useful lives or Trevel’s ability to sell the assets on the open market. Given the specialised nature of the assets, those values would be potentially difficult to determine.

Steampress owns significant intellectual property in the form of patents that should be taken into account in determining the goodwill. These might be difficult to value because of their specialised nature and because of the lack of an observable market. It would, however, be potentially misleading to exclude the assets from the goodwill calculation because they were undoubtedly a significant reason for Trevel’s acquisition of Steampress.

The valuation of liabilities may be complicated by the fact that some assets are leased. The value of the leases will have to be evaluated in terms of future cash flows and expectations of their fair values. It may not be appropriate to reflect the book value of the liabilities as shown in Steampress’ financial statements. Trevel will also have to consider whether there are any unrecorded provisions or other liabilities that should be taken into account in calculating goodwill.

Investment centre

The fact that the company has attracted sufficient business as to be overtrading suggests that it does not require any additional investment in manufacturing equipment. It should not be necessary for Steampress to make significant additions to PPE once it becomes part of the Trevel Group. Requiring any such investments to be authorised by the Board should not be a problem.

Steampress may have invested too heavily in PPE, to begin with and so may have been guilty of overspending on its asset base, suggesting that some restraint could be in order.

If Steampress is expected to work within the Trevel Group by mastering and manufacturing vinyl records, then it should be managed in such a way that it is coordinated with the other subsidiaries. Steampress will be providing Trevel with services rather than seeking out separate business opportunities and operating independently. If that is the case, then it may be more appropriate to establish Steampress as a cost centre within the group rather than an investment centre.

Steampress should, perhaps, focus on the need to manage costs and revenues in the first instance. Permission could then be sought from Trevel's Board in the event that Steampress' management team can justify additional investment. Apart from anything else, this is a new venture for Trevel and it may be helpful to encourage senior management to pay close attention to its operations.

The danger is that imposing restrictions on Steampress could prove demoralising for the company's management and its technical staff. The overtrading that has led to cash flow problems could be seen as a symbol of the company's success in attracting record labels who wish Steampress to process their vinyl. If the managers are not permitted to manage the company to their satisfaction then they may be tempted to resign, which could leave Trevel with a shortage of skilled staff to operate the equipment to its potential. Steampress could be permitted to continue as an investment centre, but with some oversight from Trevel's Board so that any spending is understood and discussed in advance.