CGMA MANAGEMENT CASE STUDY FEBRUARY 2020 EXAM ANSWERS

Variant 2

These answers have been provided by CIMA for information purposes only. The answers created are indicative of a response that could be given by a good candidate. They are not to be considered exhaustive, and other appropriate relevant responses would receive credit.

CIMA will not accept challenges to these answers on the basis of academic judgement.

Section 1

Conflict over the business model

If managers disagree over the implementation of the business model then they may operate in a manner that is suboptimal for the business as a whole. The decisions taken by different department heads could lead to a lack of coordination and wasted resources. For example, if Marketing spends heavily on the promotion of the back catalogue then A&R might be left with insufficient to develop the acts that have been signed recently.

The disagreement suggests that senior management has failed to set a clear direction for the company and so different departments are following their separate agendas. For example, the question about whether the strategic priority should be developing new artists or expanding revenues from the back catalogue is an important one that should have been addressed by Trevel's Board. If the Board cannot communicate a clear strategy then it will lose its ability to govern the company and that could lead to declining revenues.

If different departmental heads disagree over the implementation of the business model then they will waste time in disputes and arguments with one another. The fact that there is no clear direction from a clear and unambiguous business model will mean that there is no consistent basis against which to measure decisions and so disagreements will lead back to the business model. If different managers are working with different ideas of the direction that Trevel should be taking then they may find it impossible to reach a workable compromise that is in the company's overall best interest.

It may be, though, that the business model should always be under review, with managers making it clear when the believe that changes are necessary and their concerns and recommendations kept under review by the Board. Trevel's business environment is constantly changing, with new styles of music, different technologies for accessing and listening to albums and so on. It is unacceptable to argue that the business model should remain fixed when the market is constantly adapting and it is only through emerging disagreements over the model that things will adapt .

Balanced scorecard

Marketing and Business Development encompasses a broad range of different activities, but they are all related to the overall objective of generating revenue from the recruitment and development of artists and the marketing of the recordings that they create. These activities may compete for resources in the short-term, but they share the overall goal of maximising revenues from the creation and promotion of music. A balanced scorecard would reduce the emphasis on short-term decision making, which might encourage a more long-term perspective on the management of the marketing spend. A balanced scorecard for Marketing and Business Development would chart performance on four perspectives, only one of which would be specifically financial. That would, however, enable senior management to track progress for the other three perspectives, in the context of the marketing spend.

The creation of a balanced scorecard would enable Trevel's Board, in particular Anna Kari, to consider the direction that it wished the company to take with regard to Marketing and Business Development. The Board could then set targets for the customer, internal business processes and learning and growth perspectives and could consider whether achieving those targets would require additional funds to be budgeted. The Board could then consider whether its intended direction would be unduly expensive for the group to fund when compared to the potential benefits, in which case a less ambitious set of targets could be developed.

A balanced scorecard could also start with the budget targets that are already in place and the immediate plans and targets for the other perspectives. The Board could then consider whether the targets reflect an acceptable outcome for the money that is being spent. It may then be possible to consider whether better planning could yield greater efficiencies and enable the company to obtain better value for a planned spend.

A balanced scorecard will not, in itself, optimise the marketing spend. Indeed, the fact that it reports performance across a range of perspectives and targets could lead to a loss of focus on cost. While it would be undesirable to focus on cost to the exclusion of all other factors, the balanced scorecard involves the measurement of profit in terms of several different dimensions and so there could be a sense in which nothing is optimised. Improving performance in terms of, say, the customer perspective could easily lead to a need to spend more on marketing. Similarly, analysing the non-financial perspectives could lead to additional outlays on one area, such as learning and growth, being paid for by excessive savings on, say, business perspective.

Section 2

Back catalogue

The fact that Belboa is being acquired means that Trevel will have to value the company's identifiable assets in accordance with IFRS 3 *Business combinations*. The prospective subsidiary's back catalogue is potentially valuable intangible asset that will have to be valued. Trevel will attach a value to all of the recordings in Belboa's back catalogue, with no regard for how Belboa acquired them, whether through acquisition or recording them under contract. The initial valuation will be based on the fair value of the tracks, with an estimate being based on the revenues that the tracks could be expected to create.

Immediately after the acquisition, Belboa's back catalogue will be included in Group intangible assets at cost, with an accumulated amortisation to date of zero. That cost will be written off over the expected useful lives of the tracks, which will take account of historical earnings and the likelihood that any track is likely to have a finite commercial life. The fact that Belboa assumed a life of ten years does not mean that Trevel should amortise these assets over that same period. The possibility of impairment should also be considered every year, particularly in respect of albums released by artists who have gone out of favour.

Interpretation

The valuation will have no direct impact on the Trevel Group's net assets. The fair value of the consideration paid for Belboa will be split between identifiable assets and goodwill on the acquisition and so the higher the value attributed to the back catalogue the smaller the goodwill. In theory, that means that some ratios will be unaffected by the valuation. For example, both debt and equity will be the same and so the gearing ratio will be unaffected. The problem is that investors may regard goodwill as a rather soft asset that has no realisable value and so they might restate the consolidated statement of financial position to attach a value of zero. The lower the value attached to intangibles, the greater the impact of any such adjustment.

The valuation will also affect the annual amortisation charge, which will have an impact on profit and profitability ratios. The higher the valuation, the lower the operating profit and so the smaller the return on capital employed and gross profit percentage. The higher the value attributed to the asset the greater the risk of a sizeable impairment adjustment, which would also reduce the profitability ratios and would introduce some volatility into reported earnings.

The valuation could also have an impact on efficiency ratios, most particularly the asset turnover ratio. Increasing the value of non-current assets will decrease the revenue per F$ of assets and so Trevel will appear to be less efficient.

The fact that the value attributed to the back catalogue is a matter of conjecture will mean that better-educated readers will take the nature of the assets into account when calculating ratios. For example, the amortisation figure might be added back, to draw a meaningful comparison with a recording company that has only internally-generated intangibles, which would not be reflected in its financial statements.

Product lifecycle

The biggest problem is that the lifecycle of any given piece of music could last from a very short period to many years. In the worst possible case, a recording may not attract much interest from the market and it may never generate a meaningful amount of revenue. At the other extreme, a piece of music may continue to be popular for many years, possibly decades.

The popularity of a piece of music can be restored without a great deal of warning and without necessarily being managed by the recording company. For example, a movie company might select a particular piece to serve as the soundtrack of an iconic scene and that could lead to an almost forgotten piece becoming popular again. Trevel cannot do a great deal to exploit such opportunities, other than to offer movie makers as much help as possible in supporting their use of Trevel's back catalogue.

Changing technology has an impact on how the lifecycle works. When music was sold on physical media, there would come a point where most potential buyers of an album already had a copy and would not require another. Now that digital streaming is becoming increasingly common, Trevel will now receive a royalty of a few F$ Cents every time a track is played, which is a major positive development. On the other hand, when Trevel releases a new album, listeners may focus on the singles and a few popular tracks and pay little attention to the rest. That could mean that much of the back catalogue will consist of tracks that have rarely been played and that yield very little revenue.

Section 3

Project

Trevel's Board would have to start by defining the objectives of the project so that the project team had a clear understanding of what is being asked of them. The objectives should include a statement of the desired outcome so that the endpoint can be understood and identified. That will be complicated in this case because Trevel and Belboa are already using their back catalogues to generate revenues and so the Board will have to clarify exactly what the project will entail and how it will benefit the Trevel Group.

A project team should be established to ensure that all relevant business disciplines are applied in the management of the launch. The team should be led by a designated team leader whose background reflects the area in which the project should focus. In this case, that is likely to be marketing because the Group already has the products in place and the relaunch is essentially about revisiting the approach that is taken to marketing that music. The team should include some members from Belboa, who may have ideas or business contacts that would enable them to offer advice about the marketing of the particular styles of music that are being acquired.

The project team should be given various deadlines and interim supporting dates so that they are encouraged to work towards a designated endpoint. The Board should review progress, with the intention that the relaunch will be completed and then the ongoing exploitation of the back catalogue will become an element of ongoing operations.

Digital sources

This is a task that could use big data analytics to great effect because there are a great many data sources available to Trevel and it would be potentially useful to bring those together . These sources include historical revenues from albums and individual tracks, the frequency with which music is played on the radio and comments of social media. Ideally, Trevel would wish to determine whether there are relationships that might be exploited to good effect in deciding what music to promote. For example, is there any evidence of the effectiveness of past marketing efforts? Does promotional activity boost the sales of the albums or artists that are being promoted, or might it encourage sales of the style of music that they represent?

Big data analytics might also help Trevel to identify music that has the potential to sell well because of an underlying interest expressed on social media. For example, if there are frequent requests for the name of a piece of music that is the background to a television advert then Trevel should check whether it owns the rights to that music in its back catalogue and promote it in the hope that it will sell well.

Trevel should conduct a separate analysis of Belboa's revenues using these techniques because the company has built a significant back catalogue. That may be due to successful marketing rather than simply skill in the recruitment of artists and the recording process. Trevel should explore the approach that Belboa has taken to directing its marketing activities, including how it has collected and interpreted statistics.

Transfer prices

Ideally, transfer prices should reflect the opportunity costs associated with internal transfers, so that internal trading is optimised. There is no real opportunity cost to Belboa in having any given piece of music streamed by Trevel's Marketing and Promotions Department. The music itself has been recorded and the commercial lives of the digital recordings are limited only to the extent of the popularity of the music.

Trevel's streaming companies could argue that the only real cost to Belboa of generating revenue from a track is the royalty that has to be paid to the artist when a track is downloaded or streamed. In the unlikely event that Belboa agreed to such a small price, that could lead to a preference for promoting the streaming of Belboa's back catalogue rather than Trevel's . Any such distortion of promotional activities could create problems with current artists who also have back catalogue albums because they might be concerned that Trevel is not working to maximise their revenues.

Given the popularity of Belboa's strong back catalogue, its management team might be tempted to argue that Trevel needs to do very little to promote music that is already, in a sense, selling itself through its ongoing popularity. That could lead to arguments that Trevel should pay a premium for Belboa's music, which could further encourage dysfunctional behaviour.

Section 4

Impairment

The impairment adjustment will reduce operating profits for the year. That decrease will amount to F$200 million for Belboa's back catalogue and F$397.4 million for Trevel's . That adjustment will also reduce Group equity, which complicates the determination of the impact on ROCE because both the numerator and the denominator are being reduced. Historically, the Trevel Group's operating profit has been smaller than its capital employed, so the proportionate decrease in return will be greater than that on capital employed and so ROCE will probably decrease.

The impairment adjustment will decrease equity but will not affect non-current liabilities, so the overall impact on gearing will be to increase the percentage.

Thus, the overall effect will be to make the Trevel Group appear both less profitable and riskier.

Paradoxically, in future years, the impairment adjustment will reduce the amortisation charges on intangibles and so operating profits will increase. That may lead to a slight recovery in ROCE because increasing operating profit and equity by the same amount will lead to a greater proportionate increase in the numerator. The increased operating profit should also help to restore equity without affecting debt, although it is unlikely to do so by enough to have a marked impact on gearing.

Communication concerning losses

The starting point would be to talk to the artists' agents in the first instance. The agents are supposed to be the artists' commercial advisers and so they should be better equipped to understand the impact of an impairment adjustment and to explain that to their clients.

It should be made clear to the artists that the impairment adjustment does not alter the fact that Trevel's business model involves creating music and marketing it to generate revenues. Trevel will continue to make every attempt to generate revenues from its back catalogue and so artists should be reassured that the company will do its best to maximise their royalties in the future.

It should be made clear that the impairment adjustment is an accounting entry that will not affect the artists directly. Trevel is simply taking a cautious view of asset values because of a single disappointing marketing campaign and so the artists should not become unduly concerned.

We should explain that the music industry as a whole has been experiencing problems and that artists should not become dissatisfied by Trevel . The Trevel Group remains a significant part of the music business and so its artists should be encouraged to maintain their support and to focus on creating music that will continue to attract revenues from fans.

Future promotions of back catalogue

It could be argued that this is a potentially isolated incident and that Trevel has chosen the wrong albums to promote or has failed to promote them effectively. Logically, Trevel should aim to learn as much as it can about this failed relaunch to determine whether there were mistakes that could be avoided in the future.

It could be that the concept of “Forgotten Memories” misses the point of a back catalogue and that some music will be unlikely to recover its initial appeal. Back catalogues contain a mixture of classic albums that will continue to generate revenue with little or no active promotion and other music that people do not choose to listen to. It will always be tempting to attempt to broaden the appeal of the entire back catalogue, but this failure may suggest that that is an unrealistic goal. Consumers may simply wish to listen to a mixture of new releases and established favourites and so any promotion of the back catalogue might be best directed at reinforcing the popularity of classic albums.

The disappointing result may also imply that changes to how the music is consumed has altered the potential for earning revenue from the back catalogue. The growth of subscription to streaming sites means that music lovers can listen to new releases at no additional cost. In the short to medium term, they might not be interested in listening to older music, at least until the novelty of streaming anything they wish has worn off.