CGMA MANAGEMENT CASE STUDY FEBRUARY 2020 EXAM ANSWERS

Variant 3

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Section 1

Negotiating compensation

Trevel is negotiating with the members of a small folk group, who may believe that Trevel can afford to pay a substantial amount simply to bring matters to a speedy conclusion. Trevel's Board is likely to feel that it would be unacceptable to pay more than is justified because that would be a waste of the shareholder's money. The different perspectives will complicate the negotiation. Public relations will further complicate matters. The folk group could also take account of the fact that Trevel will not wish to be seen to be breaching copyright and bullying a small group of musicians from a poor country.

The folk group could apply the sanction of telling Trevel to stop using its copyright material in the background of Bentana's song, which could prove disruptive. That would then require the track to be withdrawn until it could be remixed with the offending sample removed. If the musicians took this approach then it could cost Trevel a great deal in terms of lost revenues, including the need to recall any digital downloads that have been sold.

The fact that Trevel's engineers deny the accusation that the sample was stolen in this way is a further complication. Ultimately, it may be necessary to argue in court as to whether a breach has occurred. The fact that the music sounds the same to an untrained ear does not mean that a theft has occurred. It may be necessary to have evidence from expert witnesses as to the extent of the alleged similarity and the cost of responding to the accusation may be greater than the cost of paying even an inflated compensation.

Need for provision

The need for a provision should be considered in terms of the requirements of IAS 37 *Provisions, contingent liabilities and contingent assets*. A provision will be required if Trevel has incurred a liability of uncertain timing or amount, which may be the case. Trevel has released a music track that includes content that may breach copyright, so the question of whether a liability has been incurred depends on whether the claim against Trevel can be substantiated.

To be recognised, IAS 37 requires that it is probable that Trevel will suffer an outflow and that the outflow can be estimated reliably. Trevel denies the claim, although that need not be sufficient to prevent a court from finding that copyright has been breached. So there is uncertainty. The compensation for this breach is also open to negotiation because nothing has been agreed with the folk group who claim to have been copied, so there is no reliable estimate.

As things stand, there is no possibility of a provision in Trevel's financial statements because there is too much doubt about the amount payable. That will only change if Trevel makes an offer that is likely to be accepted, in which case the offer would become a constructive obligation and so would be deemed payable. In the absence of such clarification, the claim would be reflected in the notes to Trevel's financial statements as a contingent liability.

Charges to responsibility centres

It makes sense for the A&R Department to bear the cost of creating any new album, including studio costs, backing musicians' fees and the cost of samples because those are costs that can be controlled by A&R. The compensation claim is not controllable. It may be that Trevel's producer was misled over the source of the piece of music or that the melody was written by someone who accidentally created a copy of the folk group's original. Charging the cost of settling the claim to A&R's budget would be misleading and could demotivate the management team by creating the impression that they are being held responsible for some wrongdoing.

The Legal Department has a little more control over the cost of settling the claim, which might create an argument for charging the cost to them. Legal could, however, counter that it was not responsible for the circumstances that led to the need to make this settlement and so they could claim that they had little control over the cost. This is a more complicated argument than that relating to A&R because the Legal Department has a clear responsibility to ensure that everyone involved in the creation of music is aware of the principles of copyright and the need to respect the ownership of intellectual property.

This case might create a very difficult precedent for the Finance Department. It is to be hoped that successful legal claims against the company will be so rare that they should not be budgeted or incorporated into the routine costing system. If that is the case then the costs should be recorded in a manner that recognises the loss to Trevel as a whole, but that also avoided allocating undeserved blame. It may be appropriate to recognise the settlement as a "Head Office" cost so that all managers are aware of the need to take care.

Section 2

NPV of software

It will be difficult to estimate the cash flows that the software will generate because it is unclear how we will benefit from using the software. In theory, the software might prevent a repeat of events such as the allegation that we breached copyright, but the huge fuss that we created when we were accused indicates that it is not a normal or frequent occurrence for us to be accused in that manner. If we buy the software then we should be able to reduce the risk of a recurrence, so that we can buy the rights to any music that we wish to use. It would also prevent anyone else from using the software against us because we would have sole rights. Unfortunately, there are likely to be other packages developed to do a similar job and those will be available to other users and so any competitive advantage that we obtain is likely to be restricted to the short term.

The cash flows arising from the software's ability to generate "new" music from combining existing music would also be difficult to predict. Recording artists may be uncomfortable with music that has been composed by a computer algorithm and so the software will not always lead to reduced royalty costs. Trevel is a record label with access to skilled musicians. Replacing composers with software may lead to a loss of talent, helping competing labels to produce superior music. A human composer can create music that stirs specific emotions and that is likely to be beyond the capability of this software. For example, it may be possible to compose some background music for a movie soundtrack, but it is unlikely that it would be possible to specify that it should be an acceptable background to, say, a car chase.

The threat of competing versions of this software further complicates the determination of NPV. The F$12 million investment will be a sunk cost if a superior version of the software is launched by a competing vendor. That may lead to the investment being written off to benefit from the superior capabilities of a newer package. The required rate of return on this investment will have to take the possibility of further investment into account. It seems likely that Trevel would derive more benefit from a licence to use the new software.

Business model

Trevel's existing business model emphasises creativity and being at the forefront of innovative trends in the music industry. This software appears to be designed to copy existing music and to adapt it so that it is sufficiently different to avoid accusations of breach of copyright. The extent to which the software supports the existing business model depends on the extent to which it can generate music that appeals to the market. It may be that popular music lends itself to this process and that the software will support the business model. The question is whether the music that is generated is enjoyable to listen to. It would be necessary to experiment to establish whether it is or not.

Trevel does not have a particular interest at present in creating music for adverts or movie soundtracks and that does not seem particularly consistent with the idea of developing innovative new music. Background music in film and television is not intended to divert the listener's attention from the story or the product being advertised. Presumably, some companies exist to serve this market and so Trevel would be competing against specialists in this field. Trevel's ability to compete would rely on the effectiveness of an unproven piece of software. Breaking into this market could prove to be a significant distraction from pursuing and implementing the strategy that has worked well in the past.

Trevel's business model also encompasses the generation of revenue from its back catalogue. It appears that the software could assist Trevel in recommending music that might be suitable for movie or television soundtracks. Apart from the royalties that such a service might help generate, any increase in the exposure of tracks from the back catalogue could boost their popularity amongst consumers. Given the size of Trevel's back catalogue, it would be difficult to recommend from across the whole range of music that is available for this purpose. In this case, the service would essentially be a supplement to the existing business model rather than a new model in itself.

Section 3

Goodwill

IFRS 3 *Business combinations* require that the identifiable assets should be valued at their fair value, with the total of those fair values being taken into account when setting the value for goodwill. The assets recognised in Softsono's latest statement of financial position comprise IT equipment and office furniture, shown at book value. Determining the fair value of those assets will be complicated by the fact that the book value of IT equipment could easily exceed its fair value because the book value reflects the estimated useful life of the equipment. A PC could be expected to be perfectly serviceable for, say, ten years even though it could be regarded as obsolete and have very little market value. The lack of resale value could also make it difficult to observe fair values.

The Soundpattirn software will also create challenges with regard to market value. This is a unique item of software that has not yet been brought to market. That means that any valuation based on future cash flows will rely on forecasts and estimates. The fact that the software has not yet been released means that there can be no guarantee that it will attract significant revenues. At best, Softsono will only be able to offer market research to support claims about the software's value. The fact that the software has not been released also creates concerns that it might not be fully tested for bugs and other problems. The fact that Trevel is insisting that the founder remain as chief programmer heightens those concerns. It may be necessary to place little or no value on the software, which could lead to most of the F$60 million payment being applied to goodwill.

Debt v equity

Regardless of how the acquisition is funded, the purchase of Softsono will increase the Group's net assets by F$60 million. That will be reflected in an increase of the same amount in either debt or equity.

The Group's gearing is presently 1,377.3/(1,377.3+2,358.3) = 37%, which is a relatively high amount. If the company uses debt then gearing will increase to 1,437.3/(1,437.3+2,158.3) = 38%, which is not a huge increase, but it could push the group closer to, or even over, any gearing limits agreed with existing lenders. Conversely, the use of equity would lead to a slight decrease to 1,377.3/(1,377.3+2,418.3) = 36%, which would be a slightly reassuring decrease.

The nature of the proposed investment is also significant because the F$60 million is to be invested in high-risk software that may not prove to be a commercial success. If Trevel's new subsidiary fails then the goodwill may have to be written off through an impairment adjustment, which will reduce both group assets and equity, making any increase in gearing all the more significant.

Increasing debt will also increase finance costs, which would have no direct impact on operating profit and so ROCE would be unaffected. That would not, however, alter the fact that the additional finance costs would reduce the profit for the year, which is already declining because of the contraction of the music market.

Managing costs

Softsono was founded to enable a team of programmers to collaborate on the creation of an ambitious piece of software. The programmers have not yet had to consider the need to manage operating costs and make a profit. The company's only activity has been development and testing of software, so it would appear that they all come from a programming background and may struggle with the idea that they will have to start earning a profit rather than simply writing code. The subsidiary staff may resist attempts by Trevel to set budgets and to restrict costs once the company becomes a part of the Group. The management of Trevel will also struggle because they have little experience of the management of a software company and so it will be difficult to know what a realistic budget for costs would be.

The fact that the Soundpattirn software is approaching completion could lead to a need to reduce the number of programmers, but that could involve redundancies, which might be resisted by the management team. The founder may resist attempts to cut staffing in that area because of a sense of loyalty to people who have been with the company almost since the start. Trevel may be faced with claims that programming staff are necessary to maintain and improve the software. The founder may also claim to have further ideas for new products that ought to be developed, thereby making it even more difficult to reduce and manage staff costs.

Section 4

Pricing strategy

The most realistic strategy would be to offer a penetration pricing approach, setting a relatively low price to attract customers immediately after launch. In the short term, increased sales volume will generate significant publicity, which will promote further sales. The first wave of buyers will use these tunes on their social media posts and their mobile phones and that will encourage others to buy copies so that they can create personalised tunes of their own. The low price can be set for a limited period. Customers may be more inclined to buy if they feel that they are being offered a bargain that will expire after, say, a month.

One big advantage in building a customer base through an initial penetration pricing strategy is that Trevel can launch an upgraded version of the software after several months. Existing customers can be offered the opportunity to create enhanced versions of their tunes at a discounted cost. Over time, Trevel will generate a significant quantity of revenue from customers who buy successive upgrades. The marginal cost of marketing upgrades will be minimal because registered users will provide Trevel with their email addresses and so they can be contacted directly. The initial release of the software could even exclude some desirable features so that there is a designated upgrade path.

Project lead

Strategy and operations should be involved because this is a completely new direction for Trevel. The implementation of the new strategy of creating and selling software will require careful planning that is well integrated with the overall business model of creating music and generating revenue from it. The Department should have managers who are experienced in considering the implications of different business strategies and in advising on their successful implementation. This department is responsible for operations, including technology, within Trevel and so it would be a suitable department to take overall responsibility for leadership. Doing so would focus the project on overall implementation.

Marketing and Business Development should be represented on the project team. The whole point of this project is to create a new product that will be sold alongside Trevel's traditional product range. Marketing will be crucial to make the project a commercial success. The Marketing Department should be responsible for defining the key market need that the software will address and in developing a selling proposition. Involving Marketing in this capacity will ensure that all communications to the market are consistent and that any synergies with the sale of music are identified and exploited.

The Finance Department will have to be represented to ensure that the project is properly funded and implemented with due regard for plans and budgets. The launch will require expenditure or advertising and promotional activities and those will have to be budgeted to ensure that Trevel obtains proper value for money. The ongoing implementation will also have to be studied to ensure that the software business is being managed properly and any need for corrective action is understood and addressed.

Transfer price

The nature of internal trade will have to be determined. Softsono will not have a product unless it makes use of a resource provided by Trevel. The software takes a brief extract from an existing music track and adapts it in line with customers' tastes to create a unique snatch of music. In that case, it could be argued that value is being obtained from the back catalogue, even though it could be argued that Softsono is creating a unique snatch of music. The concern that the service is restricted to Trevel's back catalogue to avoid complaints of copyright infringement from other record labels, could reinforce the argument that value is being derived from the use of the original music.

Determining the amount of the payment is complicated by the fact that the opportunity costs are difficult to evaluate if, indeed, there are opportunity costs. Softsono's sales are dependent on having access to music that can be adapted, so the opportunity cost of refusing access is either the total loss of sales or the amounts that would be charged if the rights to use music were purchased from competing labels. The opportunity cost to Trevel's existing subsidiaries may be zero because applying the software to a track will not involve any additional cost. There could, however, be an argument that hearing snatches of music from popular tracks will lead to listeners becoming bored with those tracks and so Softsono might have to make a payment that compensates for potential loss of revenues.

There does not appear to be an optimal pricing basis. It seems likely that the transfer price will have to be determined by negotiation or through the imposition of a pricing mechanism by Trevel's Board, which would be potentially simpler than relying on market forces.