

# 8. The financial performance of the principal suppliers of recorded music

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## Introduction

8.1. In this chapter we summarize the financial information we obtained from the principal companies involved in the supply of recorded music in the UK. These companies are:

- (a) the five major UK record companies-BMG, EMI, PolyGram, Sony and Warner (the majors);
- (b) four leading independents-MCA, Telstar, Pickwick and Beggars Banquet-and some of the smaller independent companies;
- (c) certain large retailers-W H Smith, Our Price, Virgin Retail, Kingfisher (including EUK) and HMV; and
- (d) the largest record clubs-Britannia, BCA and Reader's Digest.

## The five major recorded music companies

8.2. The majors (and MCA, the largest independent) are also the main participants in the international recorded music business. BMG, PolyGram, Sony and Warner are all subsidiaries of overseas companies. EMI's ultimate parent company is located in the UK, but its recorded music business in this country is controlled through the EMI Music headquarters (EMI Music HQ) which is located in New York.

8.3. The businesses of the majors in the UK consist of a number of diverse functions, already described in Chapter 5. Typically these companies finance new recordings and supply and distribute recorded music products in this country. They also license their rights in recordings to other companies both in the UK and overseas. Connected companies manufacture recorded music products or run substantial music publishing businesses. Some of the majors (EMI, Polygram and Sony) distribute some or all of their recordings

through separate self-accounting distribution businesses. In addition to the results of the recorded music companies, we obtained separate information on the results of their manufacturing affiliates in the UK.

8.4. All record companies refer to the money they spend on developing new recordings and on advances to artists as A&R (Artist and Repertoire) expenditure. When records are sold or royalty and licence income is received, the A&R costs that are recoupable from artists are either charged against the income arising on the sale of recorded music products or set off against the companies' gross royalty income receipts. Unrecouped or abortive A&R is written off or provided for in the companies' accounts as it is incurred<sup>1</sup> but some of the A&R (net of provisions) may be carried forward in the companies' balance sheets. As well as selling recordings which they have financed (own repertoire), the companies also sell recordings manufactured in the UK but licensed-in from other (usually connected overseas) companies (licensed-in repertoire).

8.5. The UK recorded music companies export very small amounts of finished recorded music products. In order to simplify the information provided, the companies have included these exports and their related costs and profits with the sales of recorded music products sold in the UK. In 1992/93 BMG's direct exports, as a percentage of gross sales, were 0.8 per cent; PolyGram's 3.5 per cent; and Sony's 1.7 per cent. Warner's exports were negligible. EMI's direct exports (excluding Virgin) were 1.9 per cent of net sales. In addition, some of EMI's sales to independent third party customers were exported overseas. For EMI, excluding Virgin, these exports were estimated at 6.8 per cent of gross UK sales of recorded music products.

8.6. The income of the recorded music companies consists of:

- (a) sales of own-repertoire records and records of artists of overseas affiliates;
- (b) royalties and licence fees from allowing these records to be used for broadcasting and public performances domestically; and
- (c) royalties and licence fees from the sales of own-repertoire records mostly by their foreign affiliates.

The main items of expenditure include:

- (d) A&R expenditure (dealt with in more detail from paragraph 8.21 onwards);
- (e) royalties to artists and holders of copyrights in the music for own-repertoire records;
- (f) licence fees to affiliates abroad for the use of their copyrights; and
- (g) the general expenses of manufacturing, distributing and promoting records domestically.

8.7. Each of the majors has provided us with information on its inter- and intra-group transfer pricing policies. In this chapter we refer only to those policies that bear most directly upon the results of recorded music companies, ie usually those that apply between the companies and their manufacturing affiliates.

8.8. To simplify our analysis of the results of the recorded music companies, we have divided their activities into three separate categories. These are:

- (a) their core business activities;
- (b) their non-core activities; and
- (c) their non-recorded music business activities.

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<sup>1</sup>In the tables in this chapter, unless indicated otherwise, both the amounts written off or provided for are shown or referred to together.

Where we deal with the companies' core and non-core activities together, we call these two categories combined the companies' total recorded music business.

8.9. In our core business category are the sale of recorded music in the UK and income from royalties and licence fees less A&R expenditure written off in the accounts. In the non-core activities are recorded music joint ventures; the distribution of recorded music labels other than the companies' own labels (which are part of the core business); joint venture labels in which the company is a participant; and other recorded music activities such as operating recording studios. The non-recorded music business category is any activity such as music publishing which is dealt with in the statutory accounts of the recorded music companies but which lies outside the core business and the non-core activities.

8.10. In their statutory accounts, three of the majors (BMG, EMI and PolyGram) include in turnover their net sales of recorded music products (and other products) and gross royalties and licence fees. Net sales are shown after the deduction of discounts and returns. The other two majors (Sony and Warner) only include net sales of recorded music products (and other products) as turnover. Royalty and licence fee income is dealt with as a separate item under other operating income. Out of the royalty and licence fee income (the gross income) received by the companies, there are amounts due to artists. In their statutory accounts Sony and Warner report this income as a net figure; with sums due to artists being set off against the gross income received. In this report we show royalty and licence fee income gross, with sums due to the artists included in costs. We have adopted this presentation so as to show the full amounts received by the companies and also to present these figures on a uniform basis. We report both net sales and gross royalties and licence fees together under revenue. For the core business we then go on to show the profit before interest and tax (PBIT) as a percentage of total revenue (return on revenue-ROR). Total revenue is the income arising from net sales and gross royalties and licence fees; and PBIT is the sum of the contributions from recorded music products and royalties and licence fees less the A&R written off.

8.11. The companies themselves told us that their preferred measures of profitability are calculated from their profit and loss accounts and the operating statements in their management accounts, as the companies' balance sheets show low or negative capital employed. Consequently return on capital employed (ROCE) calculated from the companies' financial and management accounts is not a relevant indicator of their overall performance. These low or negative figures are shown in Table 8.1 which summarizes the aggregate year-end capital employed of the five majors' recorded music businesses. The reason for these low figures is the very high level of creditors in relation to tangible fixed and current assets. These creditors include the amounts due to artists in respect of royalties. The balance sheets do not include any amounts that reflect the value of the companies' copyrights (see paragraphs 8.33 to 8.43).

TABLE 8.1 Capital employed in the recorded music businesses of the five majors, 1989 to 1993

	<i>£ million</i>				
	1989	1990	1991	1992	1993 <i>estimated</i>
<i>Tangible fixed assets</i>					
Land and buildings	12.6	13.9	13.4	23.8	22.2
Plant and machinery	13.0	16.8	15.0	14.0	17.7
Other	<u>8.4</u>	<u>10.9</u>	<u>10.2</u>	<u>19.4</u>	<u>17.8</u>
Total (A)	<u>34.0</u>	<u>41.6</u>	<u>38.7</u>	<u>57.2</u>	<u>57.7</u>
<i>Current assets</i>					
Investment in artists	46.6	63.5	74.7	105.5	100.1
Stock	11.8	12.0	10.8	10.7	9.0
Debtors	<u>251.0</u>	<u>229.9</u>	<u>192.4</u>	<u>239.3</u>	<u>202.1</u>
Total (B)	<u>309.4</u>	<u>305.4</u>	<u>277.9</u>	<u>355.5</u>	<u>311.2</u>
Less creditors (other than borrowings) (C)	<u>(351.3)</u>	<u>(330.9)</u>	<u>(345.7)</u>	<u>(527.7)</u>	<u>(432.6)</u>
Year-end capital employed (A+B - C)	<u>(7.9)</u>	<u>16.1</u>	<u>(29.1)</u>	<u>(115.0)</u>	<u>(63.7)</u>
Average capital employed*†	(7.9)	4.1	(6.5)	(76.8)‡	(89.4)

Source: MMC from companies' data.

\*For 1989, year-end only.

†Chrysalis and Virgin are included for the first time in 1992.

‡Average of opening and closing balance, £72.1 million, plus an adjustment for the Chrysalis and Virgin opening net balances amounting to £4.7 million.

Note: Amounts may not total exactly because of rounding.

8.12. In this section, where aggregate figures are shown for the majors, the years relate to those calendar years in which most of a company's financial year falls. All figures for 1993 are estimated, except for BMG which was able to provide us with actual figures for its year ending in 1993 in response to our request for information.

### **Aggregate results**

8.13. The aggregate results of the five major record companies' total recorded music business are set out in Table 8.2. This table shows that ROR has declined each year from 8.0 per cent in 1989 to 3.4 per cent in 1992. This is the outcome of an average annual increase in revenue of 12.4 per cent and an average annual decrease in PBIT of 16.0 per cent over the period. The companies estimate a recovery in 1993 to an ROR of 6.2 per cent with a PBIT almost doubled from 1992, and turnover increasing by 3.3 per cent in the same period.

TABLE 8.2 Aggregate results of the total recorded music businesses of the five major record companies, 1989 to 1993

	<i>£ million</i>				
	1989	1990	1991	1992	1993 <i>estimated</i>
Revenue:					
Net sales of records	382	441	455	471	498
Gross royalties	182	204	236	347	345
Other	<u>48</u>	<u>49</u>	<u>38</u>	<u>50</u>	<u>55</u>
Total (A)	612	695	729	868	898
PBIT (B)	49	41	33	29	56
Average capital employed*†	(8)	4	(7)	(77)	(89)
ROR (B/A) (%)	8.0	5.9	4.5	3.4	6.2

Source: MMC from companies' data.

\*For 1989, year-end only.

†See paragraph 8.11.

Note: Amounts may not total exactly because of rounding.

8.14. Set out in Table 8.3 are the aggregate results of the major record companies' core businesses from 1989 to 1993. Despite the overall growth in income, partly because of acquisitions, the aggregate PBIT of the five companies' core business has declined on average by 17 per cent annually up to 1992 but is forecast to more than double in 1993. The ROR has declined each year from 7.1 per cent in 1989 to 2.8 per cent in 1992 with an estimated 5.9 per cent in 1993. The results of the core business of each company from 1989 to 1993 are set out in Table 8.4.

TABLE 8.3 **Aggregate summarized results of the core recorded music businesses of the five major record companies, 1989 to 1993**

	<i>£ million</i>				
	1989	1990	1991	1992	1993 <i>estimated</i>
Revenue:					
Net sales of records	382	441	455	471	498
Gross royalties	<u>182</u>	<u>204</u>	<u>236</u>	<u>346</u>	<u>345</u>
Total (A)	564	645	691	817	843
PBIT (B)	40	31	28	23	49
Average capital employed*†	(10)	3	(6)	(74)	(91)
ROR (B/A) (%)	7.1	4.8	4.0	2.8	5.9

Source: MMC from companies' data.

\*For 1989, year-end only.

†See paragraph 8.11.

Note: Amounts may not total exactly because of rounding.

TABLE 8.4 **Aggregate results for the core recorded music business of each major, 1989 to 1993**

	<i>£ million</i>				
	1989	1990	1991	1992	1993 <i>estimated</i>
<i>Revenue (net sales plus gross royalties)</i>					
BMG	[				
EMI					
PolyGram					
Sony					
Warner					
Total					
<i>Figures omitted. See note on page iv.</i>					
<i>PBIT</i>					
BMG					
EMI					
PolyGram					
Sony					
Warner					
Total					]
<i>per cent</i>					
<i>ROR (PBIT/revenue)</i>					
BMG	[				
EMI					
PolyGram					
Sony					
Warner					
Total					]

Source: MMC from companies' data.

Note: Amounts may not total exactly because of rounding.

8.15. The aggregate results of the core businesses of the five majors for 1989 to 1993 are set out in greater detail in Table 8.5. The results of each company's core business is summarized in Appendix 8.1. In Table 8.5:

1. 'Gross sales of records' is the total of sales of records at published dealer prices in all formats in the UK.
2. 'Returns' is the value of records at published dealer prices returned to the record companies.
3. 'Discounts' are the deductions from published dealer prices allowed by the record companies to their customers.
4. 'Net sales of records' is the amount received by the record company for records sold after deducting returns and discounts.
5. 'Recording' is included as part of A&R cost. This is because recording costs are generally recoupable from artists' royalties. This aspect of A&R is dealt with more fully in paragraphs 8.21 to 8.32.
6. 'Manufacturing' is the purchase or manufacturing costs of the products (ie the records in all formats) and includes packaging, paper parts, duty etc.
7. 'Artists' royalties' are amounts payable to artists on the record companies' rosters arising in respect of sales of records in the UK, and are shown gross before any recoupments.
8. 'Mechanical royalties' are amounts payable to the MCPS, which collects such sums on behalf of music publishers (which own, control or administer the copyright in the music as distinct from the copyright in the recorded work).
9. 'Licence fees' are fees payable to third party and intercompany licensors who own, control or administer the copyright in the recorded work.
10. 'Distribution' is the cost of distributing product from warehouse to purchaser (retailer or wholesaler) and includes distribution fees and warehousing costs.
11. 'Marketing' includes costs of advertising, promotion, public relations, cost of free goods (whether or not intended for resale), staff costs and the non-recoupable cost of music videos (less any net profit in the UK from the sale of videos). The recoupable part of video costs is a part of gross A&R expenditure.
12. 'Selling, general and administrative' includes costs of the departments responsible for sales, finance, systems, personnel, administration, and legal and general management. It also includes bad debts and trade body subscriptions.
13. 'Gross royalties etc received' is income received by the record companies comprising licence fees for use of copyrights by affiliated companies overseas and third parties in the UK and abroad, including fees for track licensing and synchronization, and PPL and VPL fees.
14. 'Matching royalties and other costs' includes royalties payable to artists in respect of the use of copyrights for which royalties etc are received by the record companies, together with associated marketing and selling, general and administrative costs.
15. 'A&R written off' comprises A&R costs (which include advances to artists, recording costs, video costs, costs of A&R staff, management costs and related expenditure and tour support) not expected to be recouped, and written off to profit and loss account.

TABLE 8.5 **Aggregate detailed results of the core recorded music businesses of the five major record companies, 1989 to 1993**

	<i>£ million</i>				
	1989	1990	1991	1992	1993 <i>estimated</i>
1. Gross sales of records	465	543	564	594	622
2. Returns	(31)	(44)	(37)	(42)	(39)
3. Discounts	<u>(52)</u>	<u>(57)</u>	<u>(72)</u>	<u>(81)</u>	<u>(85)</u>
4. Net sales of records	382	441	455	471	498
Direct costs:					
5. Recording	-	-	-	-	-
6. Manufacturing	(88)	(108)	(108)	(113)	(114)
7. Artists' royalties	(41)	(46)	(51)	(54)	(61)
8. Mechanical royalties	(32)	(41)	(38)	(42)	(45)
9. Licence fees	(31)	(41)	(45)	(44)	(50)
Other	<u>(4)</u>	<u>(5)</u>	<u>(3)</u>	<u>(1)</u>	<u>(2)</u>
Total	(195)	(242)	(245)	(254)	(272)
Gross profit on sales of records	187	200	209	217	226
Indirect costs:					
10. Distribution	(21)	(27)	(28)	(28)	(30)
11. Marketing	(68)	(83)	(87)	(105)	(99)
12. Selling, general and administrative	(54)	(69)	(66)	(81)	(88)
Other	<u>(2)</u>	<u>1</u>	<u>(2)</u>	<u>(10)</u>	<u>(8)</u>
Total	(145)	(178)	(183)	(224)	(225)
Contribution from records before A&R costs (A)	42	22	26	(7)	1
Royalties and other fee income:					
13. Gross royalties etc received	182	204	236	346	345
14. Matching royalties and other costs	<u>(113)</u>	<u>(114)</u>	<u>(145)</u>	<u>(207)</u>	<u>(201)</u>
Net royalty income (B)	69	90	91	139	144
Contribution from records plus net royalty income (A+B)	111	112	117	132	145
15. A&R written off (C)	<u>(71)</u>	<u>(81)</u>	<u>(89)</u>	<u>(109)</u>	<u>(95)</u>
PBIT (A+B - C)	40	31	28	23	49

Source: MMC from companies' data.

Note: Amounts may not total exactly because of rounding.

8.16. The results in Table 8.5 are shown again in Table 8.6 with all items expressed as percentages of gross sales in each year. These percentages are used solely to facilitate a comparison of one item of income and expenditure with another. In particular, the figures for PBIT in this table, which are expressed as percentages of gross sales, should not be confused with the actual percentage returns on the combined net sales and gross royalties which are set out in Table 8.3.

8.17. Although discounts given to record retailers and wholesalers dropped in 1990 to 10.5 per cent from 11.2 per cent, they rose to 13.7 per cent in 1992 and are predicted to stay at that level in 1993. Manufacturing costs remained at around 19 per cent of gross sales from 1989 to 1992 and are predicted to fall slightly in 1993 to 18.3 per cent. Artists' royalties have grown steadily as a percentage of gross record sales since 1990 and both mechanical royalties and licence fees have grown since 1989 but not steadily over the period. Marketing costs have remained in the range between 15 and 16 per cent, except for 1992 when they rose to just under 18 per cent of gross sales. A&R cost write-offs showed similar characteristics, staying in a range of around 15 to 16 per cent of gross sales but reaching just over 18 per cent of gross sales in 1992.

8.18. An indication of the net overseas earnings of the five majors' core businesses can be obtained from item 13 in Table 8.5 (gross royalties etc received, which are largely received from outside the UK) less item 9 in Table 8.5 (cost of licence fees, which are largely paid overseas) and the payments to connected companies overseas shown in Table 8.13.

8.19. Summarizing these results over the period, the salient features are:

- (a) the increases, as percentages of gross sales, in discounts, artists' and mechanical royalties and licence fees paid out; and
- (b) the relative stability of manufacturing and marketing costs and A&R write-offs as a percentage of gross sales.

TABLE 8.6 **Aggregate detailed results of the core recorded music businesses of the five major record companies, 1989 to 1993**

	1989	1990	1991	1992	1993 <i>per cent</i> <i>estimated</i>
Gross sales of records	100.0	100.0	100.0	100.0	100.0
Returns	(6.7)	(8.1)	(6.6)	(7.0)	(6.3)
Discounts	(11.2)	(10.5)	(12.9)	(13.7)	(13.6)
Net sales of records	82.1	81.4	80.5	79.3	80.1
Direct costs:					
Recording	-	-	-	-	-
Manufacturing	(18.9)	(19.9)	(19.1)	(19.0)	(18.3)
Artists' royalties	(8.7)	(8.5)	(9.0)	(9.1)	(9.8)
Mechanical royalties	(6.8)	(7.6)	(6.8)	(7.1)	(7.3)
Licence fees	(6.6)	(7.6)	(8.0)	(7.5)	(8.0)
Other	(0.9)	(1.0)	(0.5)	(0.1)	(0.4)
Total	(41.9)	(44.6)	(43.4)	(42.8)	(43.8)
Gross profit on sales of records	40.2	36.8	37.1	36.5	36.3
Indirect costs:					
Distribution	(4.6)	(5.1)	(4.9)	(4.8)	(4.8)
Marketing	(14.7)	(15.3)	(15.3)	(17.7)	(15.9)
Selling, general and administrative	(11.6)	(12.7)	(11.7)	(13.5)	(14.1)
Other	(0.4)	0.3	(0.6)	(1.7)	(1.3)
Total	(31.3)	(32.8)	(32.5)	(37.7)	(36.2)
Contribution from records before A&R costs (A)	8.9	4.0	4.6	(1.2)	0.1
Royalties and other fee income:					
Gross royalties etc received	39.1	37.7	41.8	58.3	55.4
Matching royalties and other costs	(24.3)	(21.1)	(25.7)	(34.9)	(32.2)
Net royalty income (B)	14.9	16.6	16.1	23.4	23.2
A&R written off (C)	(15.2)	(14.9)	(15.8)	(18.3)	(15.4)
PBIT as a percentage of gross sales (A+B - C)	8.6	5.7	4.9	3.9	7.9

Source: MMC from companies' data.

Note: Percentages may not total exactly because of rounding.

8.20. The non-core income of the major companies is summarized in Table 8.7. Here there is no consistent pattern since 1989 and PBIT, although increasing by 12 per cent in 1990, declined by 50 per cent in 1991 and has grown slightly since then. Annual non-core revenue is less than 9 per cent of core revenue over the review period.

TABLE 8.7 **Aggregate results of the non-core recorded music businesses of the five major record companies, 1989 to 1993**

	1989	1990	1991	1992	1993 <i>£ million</i> <i>estimated</i>
Revenue (A)	48	49	38	50	56
PBIT (B)	9	10	5	6	6
Average capital employed*†	2	1	0	2	2
Return on revenue (B/A) (%)	18.5	20.2	14.0	12.1	11.7

Source: MMC from companies' data.

\*For 1989, year end only.

†See paragraph 8.11.

Note: Percentages may not correspond exactly to the figures shown because of rounding.

## ***The companies' A&R expenditure and its accounting treatment***

8.21. A&R expenditure is incurred to develop a record company's own repertoire, and can be divided into recoupable and non-recoupable parts. The extent to which expenditure is recoupable varies between artists, depending on the specific terms of their contracts, but the classification of expenditures between these two categories usually follows similar lines.

8.22. Non-recoupable expenditure consists mostly of the costs of the A&R department, such as salaries, management costs and related expenses, and the costs of the business affairs department.

8.23. Recoupable expenditure usually includes advances to artists (often the largest single cost), recording and (usually) half the video costs. In return for incurring this expenditure, the company retains the artist's share of royalties and licence fees until all this expenditure has been recovered. In many instances the artist's share of royalties and licence fees will be insufficient to cover recoupable A&R expenditure, and any shortfall has to be borne by the record company. In this way part of the company's gross A&R expenditure is paid by its artists through recoupment, but a larger proportion is finally met by the company. Terms and conditions of classical contracts are usually different; generally advances to artists are very low and recording costs may not be recoupable.

8.24. A&R expenditure covers a mixture of successful and unsuccessful projects. On those which are successful, all recoupable expenditure is recouped. On those which are unsuccessful, there will be recoupable A&R expenditure which is not in fact recouped. This unrecouped A&R expenditure and the company's non-recoupable expenditure together make up its net A&R expense.

8.25. A record which has not fully recouped its A&R expenditure may not necessarily be a loss-making project for the record company. The record company receives all proceeds from the sale of records, and after paying for the direct costs of manufacturing, marketing and distribution, retains the remaining contribution. It also benefits from its entitlement to any royalties and licence fees.

8.26. For recoupable expenditure the prospects of full recovery will be greater for an established artist than for one who is unknown. A substantial part of recoupable A&R is either written off or provided for as incurred. But some of the companies carry forward part of this expenditure which is then recouped or written off in subsequent years. The main reason for writing off A&R expenditure is because it is prudent to do so; and this practice accords with the relevant accounting standards in the UK and the USA, under which the amount recoverable from each artist is considered separately. The A&R costs that are carried forward are typically those expended on major successful artists, where there is the best prospect of recoupment from the royalties that will become due to them.

8.27. The A&R expenditure that is carried forward in the companies' balance sheets is normally called 'investment in artists' and classified as a current asset. The amount carried forward for each artist will be reduced or eliminated as records are sold and other income arises. Unrecouped amounts are written off once it becomes clear that they will not be recovered from future income.

8.28. Except for classical recordings, most recoupments from artists arise in the months immediately following a new release, with any remaining amounts (the recoupable tail) being collected over a much longer period. Advances paid in the year relate to activities in that year and in succeeding years; recoupments will relate to activities in that year and in preceding years. The pattern of sales (which is one element from which a part of the recoupments arise) is illustrated in Table 8.11 in the section on income and expenditure over time.

8.29. In each accounting period the A&R that is written off in the companies' profit and loss accounts is a combination of:

- (a) non-recoupable A&R; and
- (b) (i) recoupable A&R write-offs and provisions; less
- (ii) any recoupment of A&R costs that have been written off or provided for in prior periods.

8.30. Set out in Table 8.8 is the aggregate A&R expenditure for the five major record companies. As a proportion of A&R gross expenditure, advances comprised between 54 and 60 per cent over the period. The other major A&R cost component was recording and origination costs which consisted of between 19 and 32 per cent of gross expenditure. Between 50 and 56 per cent of gross A&R expenditure was written off annually. Recoupments from artists as a percentage of advances varied between 66 per cent (in 1990) and 93 per cent (estimated for 1993). In comparing royalty etc income and A&R expenditure, there is a degree of mismatching, in that the recoupments in a given year do not all relate to advances made in that year.

TABLE 8.8 Five major record companies: aggregate A&R expenditure and movements on A&R account, 1989 to 1993\*

	<i>£ million</i>				
	1989	1990	1991	1992	1993 <i>estimated</i>
Opening balances (net of provisions)	39	48	66	86†	107
Expenditure incurred	127	157	163	218	183
Recouped from artists	(46)	(58)	(64)	(85)	(93)
A&R borne by company (written off)*	<u>(71)</u>	<u>(81)</u>	<u>(89)</u>	<u>(112)</u>	<u>(96)</u>
Closing balances (net of provisions)‡	48	66	76†	107	101
<i>Expenditure incurred</i>					
Advances	66	88	95	128	99
Recording and origination costs	41	43	37	42	40
Video costs	6	7	7	10	9
Tour support	3	4	4	3	2
Staff	9	12	14	15	15
Others	<u>2</u>	<u>3</u>	<u>6</u>	<u>20</u>	<u>18</u>
Total	127	157	163	218	183
<i>A&amp;R borne by company (written off)*</i>					
Movement on provisions	(29)	(31)	(39)	(52)	(43)
Artists balances written off	(14)	(19)	(17)	(23)	(17)
Non-recoupable expenditure	<u>(28)</u>	<u>(31)</u>	<u>(33)</u>	<u>(37)</u>	<u>(36)</u>
Total	(71)	(81)	(89)	(112)	(96)

Source: MMC from companies' data.

\*The figures for A&R costs written off ('A&R borne by companies (written off)') in 1992 and 1993 are £3.4 million more and £0.7 million more respectively than the A&R costs written off shown in Table 8.5 and the tables relating to individual record companies. This is because two companies treated some items of A&R costs differently as between their A&R analysis and their summarized reported results.

†The difference between the 1991 closing balance and the 1992 opening balance relates to acquisitions.

‡Differences between the closing balances shown in this table and 'investments in artists' shown in Table 8.1 arise from differences in the results reported to us for each table by two companies.

Note: Amounts may not total exactly because of rounding.

8.31. The companies' sales of (a) own-repertoire records and (b) royalties and licence fees are joint sources of income (joint products) arising from new releases and reissues from the back catalogue. While the amounts recoupable from artists can be allocated to sales or to royalty and licence income, the companies do not apportion the A&R costs that are written off or provided for in their accounts between them; and there is no generally accepted accounting method for doing so. Though the financial performance of the companies from (a) the sale of records and (b) royalties and licence fees may be measured and considered separately, the financial results arising from these two income streams have at some point to be judged together after deducting the costs of A&R written off in the companies' accounts.

8.32. The companies' expenditure on A&R creates, maintains and develops their inventory of copyright in recorded works, the exploitation of which is their essential business. As already noted, the core business exploits copyrights in two ways, ie by:

- (a) making and selling records in the UK; and

- (b) licensing someone else either to make records overseas (usually an associated company) or to use the records in another way (eg for broadcasting).

This aspect of record company activity is described in Chapter 5. In accounting terms, the copyright inventory is an unrecorded intangible asset and its value is only recognized on the sale or flotation of a company or when the copyrights themselves are sold. It is, however, through undertaking the arrangements necessary for the recording, which entails expenditure on A&R, that the copyright in recorded music generally becomes the property of the company. By virtue of the contract between the artist and the record company A&R costs are agreed to be expended by the company. Thus, not only are A&R costs the costs of creating the master tape of a record, they are also the investment which creates and develops the company's inventory of copyrights.

### ***Alternative measures of profitability***

8.33. The financial performance of the major record companies, set out in the preceding sections of this chapter, is based on their financial and management accounts. These accounts are drawn up in accordance with accounting standards, which require the companies to take a prudent view of the recoverability of all A&R expenditure and to write most of it off as incurred rather than capitalize and amortize it.

8.34. No intangible assets reflecting their catalogues of copyrights are capitalized in the balance sheets of the companies, either at historical cost less amortization or at a valuation. The balance sheets (see Table 8.1) are characterized by very large debtors and creditors which result in the companies having either low or negative capital employed. As a result, ROCE based on the financial accounts is not a relevant indicator of the companies' overall performance.

8.35. The International Managers Forum (IMF) told us that in its opinion the true profitability of the record companies is understated in their published accounts because of their conservative methods of accounting for copyrights (see paragraph 10.57). The IMF's view is that the copyright catalogues of the record companies are their most valuable asset but neither their cost nor their value appear in the companies' balance sheets. Most of the costs relating to the creation and build-up of value of copyrights (such as advances, recording costs, advertising and promotion) are written off against profits in the year in which they are incurred, although the companies may continue to earn income from exploiting these copyrights for many years. The effect of the companies' conservative accounting policies is that their capital employed is understated by the value of their copyrights and their results are similarly understated by the amount of any increase in their value.

8.36. We believe that, from an economic viewpoint, the major record companies' catalogues of copyrights can be valuable assets and increases in the value of these assets contribute to profitability. Since increases in this value are not specifically accounted for in the reported accounting profits, we agree that the accounting profits may understate economic profitability. In order to examine this question more fully we engaged consultants, KPMG Peat Marwick, to advise us whether there was a way in which the companies' accounts could be adjusted to give us an insight into this.

8.37. It should be emphasized that 'profits' relating to the build-up of uncapitalized copyright value would only be realized on the sale of the business or of the copyrights themselves. No additional funds are available to make payments from these unrealized gains. The cash flows of the record companies remain unchanged from those shown in their audited accounts as they are not affected by unrealized gains and losses. If the catalogue value is not realized through the disposal of the catalogue, the values will materialize in due course through future record sales or licence income and the resulting cash flow will lead to the payment of royalties to artists and composers and will be reflected in the financial results.

8.38. Recognizing these limitations, we asked our consultants (KPMG Peat Marwick) to undertake a broadly-based desk exercise, with the aim of producing a report that would:

- (a) advise us on possible methods for valuing the economic profits and intangible assets in the form of copyrights not shown in the accounts; and
- (b) apply these methods to provide us with:

- (i) a rough gauge estimate of the underlying value that is currently not reflected in the balance sheets of the five major record companies;
- (ii) a rough gauge set of corresponding adjustments over time to each company's operating results; and
- (iii) calculations of the return on turnover and ROCE which reflect these adjustments, together with any qualifications on their usefulness as indicators of the underlying profitability of the companies.

8.39. Our consultants' report is reproduced in Appendix 8.2. We have excluded the individual companies' results and certain other material, as noted in the appendix.

8.40. The consultants concluded that the most appropriate way to value the business of the record companies in a 'desk-top' exercise was to apply a multiple to the previous year's turnover. To derive this multiple, 15 of the largest acquisitions in the music industry from 1986 to 1993 were reviewed. For each acquisition, the ratio of the purchase consideration to turnover was calculated; this ratio was then adjusted to allow for the bid premium included in the purchase consideration (25 per cent) and for trade marks and other factors (10 per cent). A simple average of these adjusted turnover multiples gave a figure of 1.20 as the appropriate multiple.

8.41. This multiple was then applied to the actual turnover of each of the majors for the most recent four years and to the forecast turnover for the current year to obtain the total economic value of their businesses. The change in this valuation from year to year, after adjustments for acquisitions and changes of financial year-end, was taken as the economic profit.

8.42. After setting out the difference between the financial PBIT<sup>1</sup> and the economic profit, our consultants calculated revised rates of return on revenues and capital employed. However, they advised us that the ROCE was not meaningful because the method of calculation involved a circularity (ie the capital employed grew in proportion to the profitability). In Table 8.9 we set out the revised performance of the five majors, including RORs.

TABLE 8.9 **Five major record companies: aggregated performance, 1991 to 1993**

	<i>£ million</i>			
	<i>1991</i>	<i>1992</i>	<i>1993</i>	<i>Average</i>
Revenues	728.9	868.2	897.9	831.7
Financial PBIT (Table 8.2)	32.9	29.3	55.9	39.4
Adjustment	<u>23.4</u>	<u>(13.9)</u>	<u>32.3</u>	<u>13.9</u>
Economic profit	<u>56.3</u>	<u>15.4</u>	<u>88.2</u>	<u>53.3</u>
	<i>per cent</i>			
	<i>1991</i>	<i>1992</i>	<i>1993</i>	<i>Average</i>
RORs				
Financial returns (Table 8.2)	4.5	3.4	6.2	4.7
Economic returns	7.7	1.8	9.8	6.4

Source: KPMG/MMC.

8.43. We asked the five majors for their views on this exercise and these are summarized from paragraph 12.120 onwards.

### ***Results by format***

8.44. In Table 8.10 we set out aggregate information for all the majors on individual formats. In their management accounts the majors do not generally apportion costs by format below gross margin. The

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<sup>1</sup>Taken from their audited accounts (see Table 8.2).

allocation of indirect costs to format was carried out by the companies specifically for our inquiry. The majority of the companies allocated the main part of their indirect costs (including marketing, and selling, general and administrative expenses) in proportion to the value of gross sales less returns or net sales. As the unit prices of CDs are higher than those of cassettes, the amounts allocated to cassettes would be higher and the amounts allocated to CDs would be lower if another basis (such as units sold) had been adopted consistently. A reconciliation of the results in Table 8.10 with the aggregate results for 1992 in Table 8.5 is set out in Appendix 8.3.

8.45. Nowadays singles usually produce losses for the companies, which is consistent with the companies' views of the single as a promotional format for the album and the artist. Of the other formats, vinyl is consistently the worst performer in terms of net margin per unit and CDs produce the highest net margin per unit.

TABLE 8.10 Aggregate results of the majors by format, 1992/93\*

						£'000
	<i>Singles all formats</i>	<i>Vinyl</i>	<i>Tape</i>	<i>CD</i>	<i>Other</i>	<i>Total</i>
Gross sales	74,281	13,646	153,061	305,289	9,129	555,406
Less discounts	(15,295)	(1,548)	(17,635)	(40,867)	(1,262)	(76,607)
returns	(5,197)	(2,039)	(12,655)	(17,675)	(527)	(38,093)
Net sales	53,789	10,059	122,771	246,747	7,340	440,706
Direct costs:						
Manufacturing	(25,408)	(2,159)	(20,291)	(55,651)	(2,240)	(105,749)
Other	(17,481)	(3,584)	(39,245)	(72,029)	(2,204)	(134,543)
Total	(42,889)	(5,743)	(59,536)	(127,680)	(4,444)	(240,292)
Gross margin	10,900	4,316	63,235	119,067	2,896	200,414
Indirect costs	(35,375)	(3,900)	(50,370)	(94,112)	(1,934)	(185,691)
Net margin†	(24,475)	416	12,865	24,955	962	14,723
					<i>per cent</i>	
Gross margin‡	20.3	42.9	51.5	48.3	§	§
Net margin‡	(45.5)	4.1	10.5	10.1	§	§
<i>Unit results</i>						
Net realized price per unit	1.44	4.36	4.02	5.86	§	§
Manufacturing costs per unit	0.68	0.93	0.66	1.32	§	§
Gross margin per unit	0.29	1.87	2.07	2.83	§	§
Net margin per unit	(0.66)	0.18	0.42	0.59	§	§

Source: MMC from company data.

\* (i) Results are summarized from the results of the following financial years for the companies: BMG to 30 June 1993, EMI to 31 March 1993, PolyGram to 31 December 1992, Sony to 31 March 1993 and Warner to 30 November 1992.

(ii) In the case of one company, these results exclude (a) special exports and (b) repertoire centre costs with no corresponding sales.

(iii) In the case of EMI, the aggregates do not include figures for Virgin or Chrysalis (see Appendix 8.1).

(iv) Sony was unable to provide us with separate data on vinyl. Sony's vinyl results are included with cassette.

† Net margin is before A&R write-offs and net royalty income.

‡ As a percentage of net sales.

§ Not calculated.

8.46. Based on the information in Tables 8.5 and 8.10, we have attempted below to build up the cost structure for a 'typical' full-price CD priced at retail at £12.99:

	%
Price to retail customer (£12.99)	100
of which:	
VAT at 17.5% represents	15
Retailers' gross margin	<u>30</u>
Leaving realized price to record company of	<u>55</u>
of which approximately:	
Manufacturing costs	10
Mechanical royalties and artists' royalties/licence fees	<u>15</u>
Total direct costs	<u>25</u>
Balance remaining	<u>30</u>

The record companies' non-direct costs, including unrecouped A&R, distribution, marketing and administrative costs, have to be covered out of the balance (30 per cent) plus net royalty income, mainly earned from overseas. After full allocation of costs and income, profits relating to any individual CD will vary enormously, with the bulk of recordings being in loss and a small number making large profits.

### ***Discounts and other allowances from record companies to their customers***

8.47. The record companies set a published dealer price for each record, but this differs from the actual net proceeds that are finally received from the wholesalers and retailers which are their customers. First, the dealer price may be reduced by various types of discount. Secondly, customers may be allowed to return for credit a proportion of the records which they have purchased. Thirdly, some retailers benefit from marketing expenditure of the record companies, including direct expenditure on joint marketing programmes. Finally, retailers benefit from supplies of free records, usually singles. In this section we examine how these discounts and allowances vary from one customer or group of customers to another.

8.48. We asked the five major record companies to analyse their sales for their most recently completed financial year by trade channel, and within each channel by major customer. Gross sales were to be shown at published dealer price with separate deductions for discounts and returns. The companies were also asked to identify any direct marketing or promotional costs attributable to each channel or major customer, including supplies of free records. Separate analyses were requested for albums and singles, because we had been told that singles were used as a means of promoting sales of albums and therefore attracted higher rates of discounts and other allowances. We also asked for unit information so that we could calculate average selling prices. We asked the companies to include not only the discounts and allowances specified in contracts with their customers but any additional allowances and expenditure given for promotional purposes. Detailed tables of discounts and other allowances have been included in Appendix 8.4. In the tables EUK has been treated as a wholesaler, although about 80 per cent of its purchases are resold to Woolworths.

8.49. The record companies have not been able to provide information on a completely uniform basis. It is therefore not possible to make comparisons between the discounts and other allowances given by one record company and another (by comparing columns in the tables in Appendix 8.4). However, the information for each record company is internally consistent so that it is broadly possible to see any differences between the business terms applied by each record company to its various customers.

### ***Discounts***

8.50. The various types of discount are described in paragraph 7.29. Discounts may take the form of reductions in unit prices or the supply of additional goods, for example ten for the price of nine. These free goods discounts have been treated as discounts in the tables and, where information was available, dealt with separately from issues of free records for promotional purposes (see paragraph 8.55).

8.51. Discounts granted on albums and singles for the companies' most recently completed financial year are set out in Tables 1 and 2 of Appendix 8.4. [ \* ] enjoys significantly higher discounts from most of its suppliers than the other major retailers for both albums and singles. The record companies usually give higher discounts on singles than on albums to all their customers. While the major retailers generally receive higher discounts on albums than the independent retailers, the position is reversed for singles where the independents generally receive much higher discounts than the majors. Wholesalers generally receive higher discounts than retailers on albums but not on singles.

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\*Detail omitted. See note on page iv.

## *Returns*

8.52. As well as returning faulty products and those which have been wrongly delivered, wholesalers and retailers are allowed to return unsold records up to an agreed proportion of their purchases, which reduces their risk of stockholding losses. These 'privilege' return allowances are described in paragraphs 7.33 to 7.35.

8.53. Returns of albums and singles are set out in Tables 3 and 4 of Appendix 8.4. Returns have been calculated as a percentage of sales at dealer price, so that they are stated in value rather than in volume terms. Returns of albums from wholesalers, particularly EUK, are significantly higher than those from retailers. Our Price returns a higher than average percentage of its purchases of albums compared with the other major retailers and for singles, for which it is the second largest retailer after Woolworths, it has by far the highest returns, significantly greater than its returns of albums. With the exception of Our Price, the returns of the major retailers are not out of line with those of the independents.

## *Promotional support*

8.54. Both record companies and retailers engage in promotional activity, much of it organized on a co-operative basis. The promotional activities of the retailers are described in paragraphs 6.35 to 6.41.

8.55. In Table 5 of Appendix 8.4 we set out the value of expenditure by the record companies on joint promotion schemes as a percentage of net sales. We have not prepared separate tables for singles and albums, since promotional expenditure cannot easily be allocated between them. The major retailers generally receive considerably more support than the independent retailers, with [\*] receiving significantly higher promotional support than the other major retailers.

## *Free issues*

8.56. Record companies generally give some free copies of singles to retailers for promotional purposes. Some retailers do not take free goods, but for others it is an important form of promotional support. In Table 6 of Appendix 8.4 we show the volumes of free singles as a percentage of all singles delivered. We also asked the record companies to value free issues at dealer prices less all normal discounts, and in Table 7 we show them as a percentage of net sales of singles and albums. The independent retailers are by far the largest beneficiaries of free singles, which are of particular benefit to them since, as Table 6.4 shows, independents accounted for 51.0 per cent of retail sales of singles in 1992, but only 22.7 per cent of albums. Finally, in Table 8 we have combined the promotional expenditure in Table 5 with the value of free issues in Table 7, to show the total value of all promotional support as a percentage of singles and albums. This table shows that the independent retailers receive much the same level of support as the major retailers, with [\*] still enjoying higher levels of support than the other major retailers.

## *Transaction costs*

8.57. Transaction and administrative costs vary widely between customers. A small retailer who uses telesales support, has visits from sales representatives and places small orders will be far more expensive to serve than a large wholesaler. Kingfisher estimated the cost savings to a record company of delivering to EUK rather than to individual retail outlets as equivalent to 6 to 7 per cent of dealer price. One of the record companies supplied figures to us in which it had treated these differential costs and savings as an adjustment to sales proceeds. Calculated in this way, its effective selling prices were lower for the independent retailers than for the large wholesalers, suggesting that the additional discounts received by the wholesalers do not fully cover the savings arising from dealing with them rather than with other channels.

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\*Details omitted. See note on page iv.

### *Overall levels of discounts*

8.58. We do not believe that it is possible to combine the values of these various forms of discount and other allowances in order to arrive at a single overall figure showing the effective rate of discount from published dealer prices enjoyed by each retailer. However, the figures in Appendix 8.4 do not indicate that any one retailer or group of retailers is consistently receiving better terms than the others.

### *Income and expenditure over time*

8.59. To illustrate the flows of income and expenditure over time on individual own-repertoire recordings, we asked the companies to provide us with detailed information on these recordings for a small number of albums and singles from 1990 onwards. This information was provided separately for a range of albums and singles and has given us an insight into the pattern of the income and costs of these recordings. But this material is difficult to summarize because one company was able only to provide us with information for calendar years, rather than the financial years requested, and for all the companies the albums and singles were released at different times in 1989, 1990 and 1991. The companies also attached certain qualifications to some of the data (eg the results were atypical or recoupable A&R costs could not be analysed to particular recordings). However, in Table 8.11 we summarize that data we obtained on net sales which conformed to our requirements. The number of sales is very small but it illustrates that the bulk occur in the period immediately following the release of these recordings.

TABLE 8.11 **Own-repertoire recorded music products in their first year and next two years following their release (Year 1=100)\***

	Year 1	Year 2	Year 3	Total	Total net sales of the sample £m
15 best-selling pop albums†	100.0	22.0	6.0	128.0	58.3
15 best-selling singles	100.0	0.8	0.0	100.8	5.5
5 moderately successful albums	100.0	1.5	0.7	102.2	2.2
5 unsuccessful albums	100.0	5.9	1.3	107.2	<u>0.9</u> 66.9

Source: MMC from the companies' data.

\*For each company we asked for the three best-selling pop albums and singles and one moderately successful album and one unsuccessful album.

†These results include one double album.

In the table we have not included the information we obtained on classical recordings because the numbers of such recordings sold was not significant. But the income from these recordings is spread over a longer period.

8.60. In Table 8.12 we show the sales in the first accounting year in which the best-selling recordings were released as a percentage of each company's net sales included in the 1990 net sales figure shown in Table 8.5. In relation to their total catalogues, Table 8.12 indicates the importance of their best-selling own-repertoire albums to the overall results of the companies.

TABLE 8.12 **Best-selling own-repertoire pop albums and singles as a percentage of 1990 net sales\***

	Company A	Company B	Company C†	Company D	Company E
Percentage of 1990 net sales:					
3 best-selling own-repertoire pop albums	19.8	13.0	10.3	7.4	6.8
3 best-selling own-repertoire pop singles	5.4	0.6	0.7	0.9	1.1

Source: MMC from the companies' data.

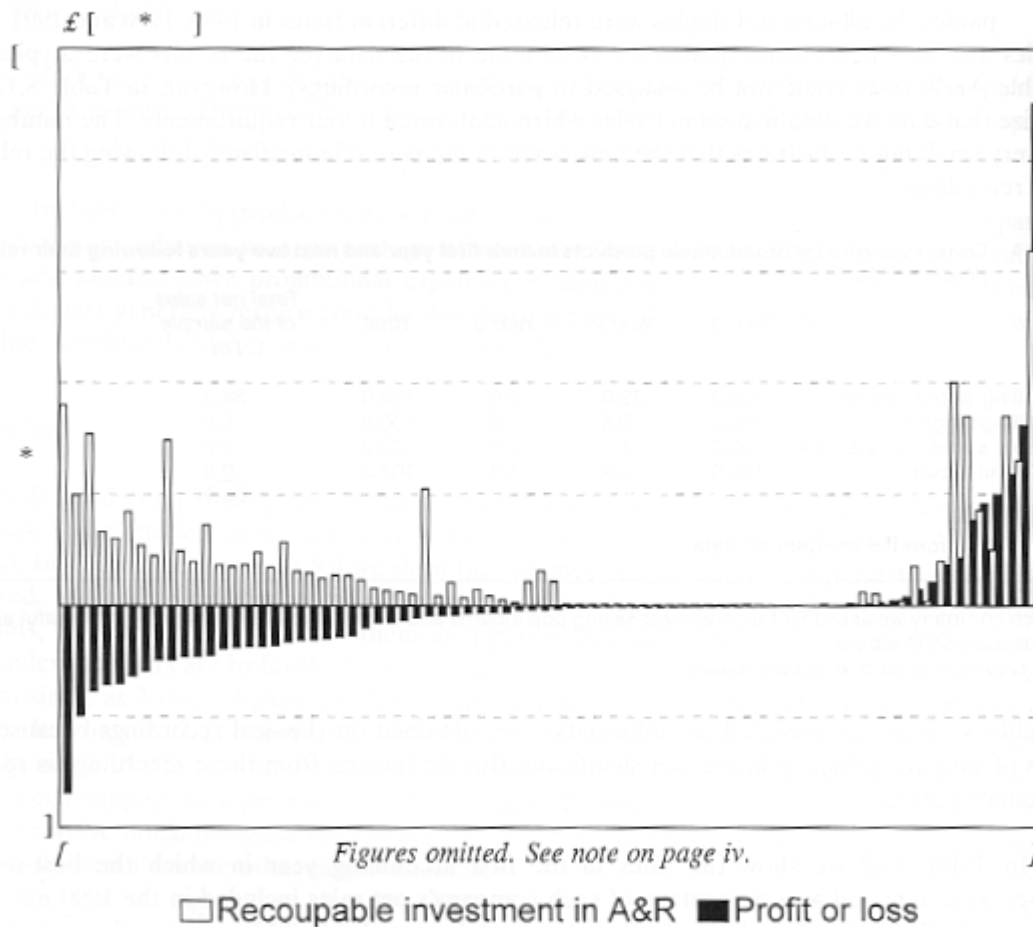
\*1990 net sales for each company are as included in the total of £441 million shown in Table 8.5. The basis of aggregation of individual company net sales is as set out in paragraph 8.12.

†This company's three best-selling pop albums includes a double album.

8.61. One company provided us with a far more extensive analysis of its own. This study tracked artists' income and expenditure flows (from 1985 to 1992) rather than individual recordings. We have extracted data relating to the [\*] artists signed from [\*] to [\*] in the study to show the recoupable A&R for each artist and the company's estimate of its profit and loss on the artist to [\*]. The results are set out in Figure 8.1. This shows that of the [\*] artists 16 were estimated to be profitable.<sup>1</sup> These profits arose after taking account of all income received after up to [\*] years for artists first signed in [\*], and going back each year, for up to [\*] years, for artists first signed in [\*]. Sums in excess of £[\*] million were spent on [\*] artists over the period; and this expenditure represented [\*] per cent of the total recoupable A&R. Of these nine artists, five were profitable and four were loss-making over this period.

FIGURE 8.1

Results for each of the [\*] artists signed by a major pop label between [\*] and [\*]



Source: MMC from company data.

Notes:

1. Cases are shown in ascending order of net profit/loss, ie the greatest loss is on the left-hand side and the greatest profit on the right.
2. Cases [\*] to [\*] each had a profit or loss of less than £15,000 and recoupable investment of less than £22,000.

\*Details omitted. See note on page iv.

<sup>1</sup>This is before taking into account the time value of money which would make some of the profitable artists unprofitable.

## ***Products and services bought in from connected companies and divisions***

8.62. In addition to royalty payments to connected companies overseas for licensed-in repertoire, all the majors' recorded music businesses buy in cassettes, CDs or products in other formats from connected companies or divisions. Also, in some cases, distribution is undertaken by connected self-accounting units. In Table 8.13 we summarize the majors' expenditure on bought-in products and services from connected companies and divisions in the UK and overseas, together with the profits (or losses) on this business reported to us by the principal connected companies and divisions in the UK. Also shown is all this expenditure as a percentage of the total costs of the recorded music businesses before A&R write-offs. In 1992, for example, this percentage was 23.5 per cent. For the connected business (£67.1 million) for which we obtained information the reported losses were £2.0 million.

TABLE 8.13 **Products and services bought in by the core businesses of the majors from connected companies and divisions, 1989 to 1993**

	<i>£ million</i>				
	1989	1990	1991	1992	1993 <i>estimated</i>
Connected businesses in the UK:					
Manufacturing	26.8	33.4	33.7	43.3	39.8
Distribution	19.4	26.3	25.1	23.8	25.6
Other	<u>1.2</u>	<u>1.1</u>	<u>1.1</u>	<u>1.5</u>	<u>1.3</u>
Total	47.4	60.8	59.9	68.6	66.7
Connected businesses outside the UK					
Manufacturing*	31.5	34.0	40.5	41.0	43.1
Other	<u>2.4</u>	<u>2.8</u>	<u>3.3</u>	<u>2.8</u>	<u>2.8</u>
Total	33.9	36.8	43.8	43.8	45.9
Total from all connected businesses	81.3	97.6	103.7	112.4	112.6
Recorded music business total expenditure before A&R write-offs†	309.8	382.3	428.3	478.5	496.9
Total from all connected companies and divisions as a percentage of the costs of recorded music business before A&R write-offs (%)	26.2	25.5	24.2	23.5	22.7
Total connected costs in respect of principal companies and divisions in the UK on which we have obtained profitability information:					
Manufacturing‡	25.6	33.4	33.7	43.3	39.8
Distribution§	<u>19.4</u>	<u>26.3</u>	<u>25.1</u>	<u>23.8</u>	<u>25.6</u>
Total	45.0	59.7	58.8	67.1	65.4
Profits/(losses) of the principal companies and divisions in the UK on which we have obtained profitability information:					
Manufacturing‡	0.3	0.3	0.6	1.1	0.6
Distribution§	<u>(3.5)</u>	<u>0.2</u>	<u>0.8</u>	<u>(3.1)</u>	<u>(1.0)</u>
Total	(3.2)	0.5	1.4	(2.0)	(0.4)

Source: MMC from companies' data.

\*One company was unable to supply figures for its transactions with connected companies for 1989 and 1990. All this company's transactions were for manufacturing outside the UK.

†From Table 8.5. But for 1989 and 1990 excludes costs for the company that was unable to provide us with the details of its transactions with connected companies in these two years.

‡One company connected to a major which supplies the major's recorded music business with CDs was unable to provide us with information for 1989.

§One major's connected distribution company receives fees for the products it distributes for the recorded music business. In its recorded music business results, the major reported its connected company's actual costs of distribution rather than the fees paid to it. Accordingly, neither profits nor losses arise in the figures reported to us for distribution through this division.

8.63. Additional information on the results of the principal connected companies and divisions in the UK, together with the basis of transfer pricing, is set out in Appendix 8.5.

### **Results of the four leading independents and the smaller independent companies**

8.64. We obtained financial information from the four leading major independents (MCA, Telstar, Pickwick and Beggars Banquet) for their last three completed financial years. Their core businesses showed varying results. For the two companies that made profits in each year (ranging from £2.8 million to £0.2 million), the PBIT on revenue ranged from 14.1 to 2.6 per cent. The third company reported losses in two of the three years; and the fourth losses in all three years. In the case of the fourth company, the main reason for these losses was that the company was building up its own roster of artists in the UK and the majority of the recordings that were released were not successful.

8.65. We asked just over 100 smaller independent companies to provide us with a brief summary of their financial results. The results of those companies that provided us with information showed no clear pattern. Reported profitability was varied, with both profits and losses being shown.

### **Financial results of the major retailers**

8.66. We requested financial information from the five largest retailers of recorded music (listed in Table 6.3) for their four most recent financial years. The information which we received from them is based on their management accounts, which have been reconciled to their statutory accounts. We also requested various analyses of sales and margins, and a calculation of average capital employed. In many of these analyses, costs, expenses and assets had to be apportioned between the companies' recorded music businesses and their other retail businesses. Some of these apportionments were taken from the management accounts of the companies but, more often, they were the results of special analyses carried out by the companies specifically for our inquiry.

8.67. We did not receive all the analyses which we had requested because the companies' information systems did not hold the necessary information. There was little information relating to unit sales, so that we are unable to calculate average selling prices. There was an increase in the information available towards the end of the four-year review period because of improvements to information systems, including the installation of EPOS terminals in some stores.

8.68. From each of these retailers we have obtained calculations of the overall gross profit, PBIT and, except for Kingfisher, ROCE of its recorded music business for the last four completed business years. We have also obtained calculations of gross profit by format from each of the retailers except W H Smith. This information is shown in detailed tables in Appendix 8.6.

### ***W H Smith***

8.69. In June 1993 W H Smith operated in England and Wales from 399 high street shops, 59 bookstalls (located at 47 stations) and 37 airport shops (located in 8 airports). Of these 495 outlets, 317 sold recorded music.

8.70. W H Smith's retail shops are operated as a division of W H Smith Ltd (a wholly-owned subsidiary of W H Smith Group plc) and the division (W H Smith Retail) does not have separate statutory accounts. It told us that in its management accounts, it calculates gross profit for each of its main merchandise groups, which include news, books, stationery and recorded music. Operating costs and head office costs are not allocated to merchandise groups in W H Smith's management accounts. However, it carried out a special exercise for us. Head office costs were allocated to its merchandise groups in proportion to turnover. Fixed assets were apportioned to reflect the amount of selling space actually occupied by recorded music in W H Smith branches, and stocks were taken from the management accounts. The results for recorded music from 1989 to 1993 are set out in Table 1 of Appendix 8.6.

8.71. W H Smith's information systems do not provide any analysis of sales, gross profit and operating expense by price category (full-price, mid-price and budget); similarly, there is no analysis by chart, catalogue, special promotions, etc. Also, it was the only one of the major retailers which was unable to provide us with an analysis of gross profit by format.

8.72. W H Smith Retail's sales and gross profits for each of its merchandise groups are shown in Table 8.14.

TABLE 8.14 **W H Smith Retail: sales and gross profits, 1993**

	Sales excl VAT £'000	Gross profit £'000	Gross profit %
Books	[		
News			
Stationery			
Recorded music	[	Figures omitted. See note on page iv.	29.6
Video	[		
Cards			
Other*		Figures omitted. See note on page iv.	
			]

Source: W H Smith.

\*Includes sound accessories, personal computing, calculators and typewriters, photography and games and toys.

The gross profit of 29.6 per cent for recorded music is almost [\*] percentage points below that for the whole of W H Smith Retail. Commenting on this, W H Smith told us that it did not see music as one of the big cash or profit contributors to its business. Its role was much more about adding to the character and feel of the whole W H Smith brand.

## ***Our Price***

8.73. Our Price, which was acquired by W H Smith in 1986, is a specialist chain operating 336 stores. It has the same financial year as its parent company but, as an independent operation, has its own system of management accounts. This differs from that of W H Smith Retail, and Our Price has been able to provide us with information on its gross profit by format, which is included in Table 3 of Appendix 8.6. Its financial results for the four years ended 31 May 1993 are set out in Table 2. [

*Details omitted. See note on page iv.*

] Recorded music has accounted for 87 to 90 per cent of Our Price's sales during each of the last four years.

8.74. Our Price told us about the power of the record companies in negotiating discounts. For example, after W H Smith bought Our Price in 1986, the major record companies, rather than giving increased discounts to reflect the combined volumes of the two businesses, had reduced the Our Price terms to those of the W H Smith business.

## ***Virgin Retail***

8.75. Virgin Retail sells recorded music through 21 megastores. W H Smith acquired 50 per cent of its share capital in September 1991 from Virgin Retail Group Ltd (Virgin Retail Group), and it has since been operated as a 'deadlock joint venture', with each parent company having equal representation on the Board of Directors. Virgin Retail's financial year was changed from 31 July to 31 May in 1992 and, as a result, the accounting period which ended on 31 May 1992 was a ten-month period. In 1988 Virgin Retail sold 74 of its smaller stores to Our Price.

8.76. The joint venture agreement contains a put option, giving Virgin Retail Group the right to require W H Smith to purchase all, but not some only, of its shares in and loan notes due from the joint venture

\*Figure omitted. See note on page iv.

after 31 May 1994; W H Smith has a call option exercisable after 31 May 1997. The agreement also contains a non-competition clause governing the number of Virgin Retail and Our Price outlets in 36 towns and how new retail sites in these towns should be allocated between Virgin Retail and Our Price.

8.77. Virgin Retail is managed separately from W H Smith's other businesses, so that the system of management accounts differs from those operated by W H Smith and Our Price. The financial results of Virgin Retail are set out in Table 4 of Appendix 8.6.

8.78. Sales and gross profit by format are set out in Table 5. Virgin Retail told us that there are no costs which vary disproportionately between formats. The other analyses of sales and gross profit which we had requested were not available. It does not record sales and costs by price category. Sales are analysed by music type, but the related cost of sales and unit information is not held.

8.79. On 2 March 1994 W H Smith announced that Virgin Retail's UK and Irish operations would be combined with those of Our Price. W H Smith would hold 75 per cent of the enlarged business and Virgin Retail Group would hold the remaining 25 per cent. Until regulatory approval was received, Our Price and Virgin Retail would continue to be managed as separate businesses.

## ***Kingfisher***

8.80. Kingfisher sells recorded music through 785 Woolworths stores in Great Britain and Northern Ireland. All of Woolworths' recorded music is sourced from EUK, another Kingfisher subsidiary, which was acquired in 1987 from EMI and PolyGram. Kingfisher also sells recorded music through its Titles Video subsidiary, but the amounts are very small and have not been included in the tables below nor in those in Appendix 8.6.

8.81. EUK is the largest wholesaler of recorded music, but the Woolworths business has consistently accounted for around 80 per cent of EUK's turnover. In 1993 EUK's non-Woolworths turnover was £28.1 million, so that TBD with a turnover of £[ \* ] is the largest independent wholesaler of recorded music in terms of third-party sales.

8.82. Woolworths divides its operations for management purposes into divisions, the largest of which is the Entertainment Division, comprising several departments. Some of these departments (records and cassettes; CDs; singles) are concerned with recorded music. The results of Woolworths for recorded music are shown for only three years in Table 6 of Appendix 8.6 because, for the year ended 31 January 1990, there is no separate analysis of sales and profitability by department, nor any calculation of the trading profit of the Entertainment Division. For the years ended 31 January 1991 and 1992 the allocation of store-related expenses between recorded music and other departments has been estimated by us.

8.83. Table 7 of Appendix 8.6 shows Woolworths' sales and gross profits by format. Sales and gross profit by format for EUK are set out in Table 8. EUK separates the sales of vinyl LPs from sales of cassettes in its management accounts; Woolworths no longer sells vinyl LPs.

8.84. The sales and gross profit of Woolworths' Entertainment Division for the year ended 31 January 1993 are set out in Table 8.15.

TABLE 8.15 **Woolworths: sales and gross profit of Entertainment Division, 1992/93**

	<i>Sales excl VAT £m</i>	<i>Gross profit £m</i>	<i>Gross profit %</i>
Recorded music	[		
Other entertainment		<i>Figures omitted.</i>	
Entertainment Division		<i>See note on page iv.</i>	]

Source: Kingfisher.

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\*Details omitted. See note on page iv.

8.85. Table 8.15 shows a gross profit accruing to Woolworths on recorded music which is significantly lower than that for other retailers. It does not include the further profit on these sales which arose within EUK. Kingfisher therefore prepared a consolidated profit and loss account for EUK's recorded music sold through Woolworths for the year to 31 January 1993, broken down by format. This analysis, which includes the sales, expenses and profits of both Woolworths and EUK, is included as Table 9 in Appendix 8.6 and shows gross profits for each format which are similar to those of other retailers, except that the gross profit on singles is reduced because Woolworths aims to have the lowest prices on chart products. A similar analysis showed that for products other than recorded music (mostly videos and games) the Entertainment Division had a gross profit of [ † ] per cent and a net profit of [ † ] per cent; these margins are a little better than those achieved on CDs and much higher than those on cassettes and singles.

8.86. Table 9 also shows a consolidated PBIT of £[ † ] on Woolworths' sales of £[ † ]. In addition EUK had a PBIT of £[ † ] from its business with third parties, so that the total PBIT of Kingfisher's recorded music business was £[ † ]. Kingfisher has not prepared a consolidated balance sheet for the recorded music businesses of EUK and Woolworths, so it is not possible to calculate its ROCE.

## ***HMV***

8.87. HMV, a division of THORN EMI Home Electronics (UK) Ltd, is a multiple retailer specializing in music. It has 94 stores with a total trading area of 393,000 square feet.

8.88. The results of HMV for the four financial years ending 31 March 1993 are set out in Table 10 of Appendix 8.6.

8.89. HMV told us that it recorded turnover by merchandise group, format and main product category, but that cost information was not recorded in this way and had been estimated on the basis of the margins at which the company sold different products and product categories. An estimated analysis of sales and gross profit by format for the year to 31 March 1993 is included as Table 11 in Appendix 8.6.

## ***Comparative performance of the retailers***

8.90. Because the retailers have different financial year ends, we have taken the results for their most recently completed year in the tables below. For W H Smith, Our Price and Virgin Retail the most recent financial year ended on 31 May 1993; for Kingfisher on 31 January 1993; and for HMV on 31 March 1993.

### ***Gross profit by format***

8.91. Table 8.16 shows the gross profit by format for all the major retailers except for W H Smith Retail, which was unable to provide us with this information.

TABLE 8.16 Major retailers: comparative gross profit by format, 1992/93

	<i>W H Smith</i>	<i>Our Price</i>	<i>Virgin Retail</i>	<i>Kingfisher*</i>	<i>per cent</i> <i>HMV</i>
Vinyl	[				
Cassettes					
CD					
Singles					
Total					]

Source: Retailers.

\*The gross profit for Kingfisher is the consolidated gross profit of Woolworths and EUK arising from Woolworths' sales after deduction of distribution costs.

†Details omitted. See note on page iv

For each retailer there is little variation in gross margin between formats. [  
*Details omitted. See note on page iv.*

]

### ***Profitability and ROCE***

8.92. Table 8.17 shows the sales, contribution and ROCE of the five major retailers for the financial year nearest 31 December 1992.

TABLE 8.17 **Major retailers: comparative sales, contribution and ROCE from recorded music, 1992/93**

	<i>W H Smith</i>	<i>Our Price</i>	<i>Virgin Retail</i>	<i>Kingfisher</i>	<i>HMV</i>	<i>£'000</i>
Sales excl VAT	[					613,315
Cost of goods sold						<u>410,401</u>
Gross profit						202,914
Direct costs						<u>25,105</u>
Contribution						<u>177,809</u>
						<i>Figures omitted. See note on page iv.</i>
Allocated overheads						
Store-related expenses						149,610
Head/regional office expenses						27,766
Marketing adjustment						<u>(4,910)</u>
PBIT						<u>5,343</u>
Average capital employed					]	
						<i>per cent</i>
Gross profit:sales	[					33.1
Contribution:sales						<i>Figures omitted. See note on page iv.29.0</i>
PBIT:sales						0.9
ROCE					]	N/A

Source: Retailers.

Kingfisher undertakes its own distribution and the cost of £[ \* ] (almost [ \* ]) has been included in cost of goods sold so that its results are comparable with those of the other retailers.

8.93. Overheads have had to be allocated to the recorded music business for each of the companies, and these varied from [  
*Details omitted. See note on page iv.*

]

### **Financial results of the major record clubs**

#### ***Britannia***

8.94. Britannia Music Company Ltd is part of the PolyGram International Group. It is by far the largest of the record clubs, and estimates that during the last five years it has increased its share of the total market for recorded music from 4 to 8 per cent.

8.95. Unlike the retailers, Britannia does not buy a finished product from the record companies at a discount from a dealer price. Instead, each item purchased has three separate elements of cost:

- (a) a 'manufacturing' cost on each item delivered;

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\*Details omitted. See note on page iv.

- (b) a royalty payable to the record company on each item sold; and
- (c) a mechanical royalty payable to the holder of the copyright in the music.

In most cases royalties are paid directly by Britannia to the appropriate record company or copyright owner quarterly in arrears, although, on occasions, advances are paid.

8.96. In Table 8.18 we set out the results of Britannia for the three years to 31 December 1992.

TABLE 8.18 **Britannia: sales, gross profit and PBIT from recorded music**

	£'000		
	Years ended 31 December		
	1990	1991	1992
Sales excl VAT	[		
Cost of sales			
Gross	<i>Figures omitted.</i>		
Indirect expenses	<i>See note on page iv.</i>		
PBIT	]		
	<i>per cent</i>		
Gross profit:sales	[ <i>Figures omitted.</i>		
PBIT:sales	<i>See note on page iv.</i> ]		

Source: Britannia.

8.97. [ *Details omitted. See note on page iv.* ]

### **Other record clubs**

8.98. Reader's Digest supplies only its own compilations which are sold in packages. A typical package consists of four double-play cassettes, six CDs or eight LPs. Reader's Digest licenses tracks from many record companies, majors and independents, as well as recording some repertoire itself. It uses independent studios to compile the sets from masters supplied by the record companies, and it manufactures with a range of suppliers including the majors and independent manufacturing companies. Its recordings all carry the Reader's Digest label.

8.99. Reader's Digest's management accounts for 1992 showed that recorded music accounted for £[ \* ] out of group sales of £[ \* ], on which there was a trading profit of £[ \* ].

8.100. BCA (formerly Book Club Associates) is a partnership between Reed International Books Ltd and Bertelsmann Books & Magazines Ltd. BCA purchases all its products from the record companies in the same way as Britannia. Its terms are at no time expressed as a discount from dealer price or any other price. BCA does not supply its own compilations.

8.101. The management accounts of BCA's music division show turnover for the year to 30 June 1993 of £[

*Details omitted. See note on page iv.*

] As a partnership, BCA neither files its audited accounts at Companies House nor does it otherwise publish them.

\*Details omitted. See note on page iv.