The Brief Career of Carly Hennessy
(A Look at the Economics of Pop Music)

Billboard Magazine, April 7, 2001: Carly Hennessy, "I'm Gonna Blow Your Mind": "Fresh from his work on Rod Stewart's latest album, producer/one-time New Radical Gregg Alexander lends his songwriting/production skills to the other side of the demographic spectrum with teen newcomer Carly Hennessy. … this track is infused with such rapturous spirit; "I'm Gonna Blow Your Mind (Really Want to Kiss You) is a playful, affection-filled romp; … accentuated by a rollicking up-tempo beat, organic instrumentation and the impressive, playful vocals of Dublin native Hennessy; … the most promising debut track we've heard this year". CT (Billboard, April 7, 2001).

These were the initial review comments in early 2001 for the song "I'm Gonna Blow Your Mind" by newcomer Carly Hennessy[1]. To promote her first release, MCA Records spent $250,000 on a promotional video, $200,000 for independent promoters, $100,000 on "imaging" costs for Ms. Hennessy and $150,000 for a four-week promotional tour.

Carly Hennessy signed a recording contract with MCA (a subsidiary of the French company Vivendi Universal) in 1999. In Ireland, she had enjoyed success as a child singer (releasing a Christmas album at age 10) and actress (performing all over Europe in "Les Miserables" at age 13). At age 16, Ms. Hennessy dropped out of high school and came to Los Angeles with her father. Her newly recorded demo disc caught the ear of an executive at MCA Records who was looking to capitalize on the then current trend toward younger pop artists such as Britney Spears and 'N Sync. MCA originally planned to start Ms. Hennessy in the pop market and subsequently develop her into a more adult sound along the lines of Celine Dion.

Carly signed a six-album contract with MCA. Up front she received a $100,000 cash advance against the first album, $5,000 per month in living expenses and the use of a car. The label would own the music and advance all of the promotion and recording costs.

For Ms. Hennessy to earn more, the studio would first have to recover the advances and living expenses, all recording costs and one-half of any video production costs. Under these terms, album sales of 500,000 and 700,000 were needed before MCA would break even.

Above the break-even level, recording artists typically earn royalties at the industry standard of 15 percent of sales. Out of that 15 percent, artists must absorb additional costs for various promoters, managers and other company fees. Under the best of circumstances, Ms. Hennessy could expect to make $.80 to $1.00 per album.

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[1]To hear "I'm Gonna Blow Your Mind" and watch the video, go to: http://www.mcarecords.com/ Use the site's "Artist Search" to locate Carly Hennessy. The site requires you to join; however, it's free. You'll need to enter a user name, password and email address to get access. To play "Mind" you'll need to have audio capabilities (e.g. Real Player or Music Match) on your computer (both software downloads are free). To see the video, you'll need video capability (e.g. Internet Explorer or other video software).

The first album was completed by the end of 1999. However, neither she nor the company was happy with the results. Everyone felt that it was too adult sounding and too serious for the targeted teen market. However, the MCA people still believed in the ultimate success of Ms. Hennessy's recording career. In early 2000, they hired new producers and writers to rerecord the album from the beginning. By the end of the year, however, the new album was still not completed.

At this point, feeling the pressure of having already committed two years and a lot of money to Carly, MCA decided to release her first single. In early 2001, the song "I'm Gonna Blow Your Mind" was released. Despite some limited, positive reactions from the press and the radio industry, the song didn't get much air time. Typical industry impressions were along the lines of "too mature for pop radio", "too pop-sounding for adult top 40" and "… it just didn't have that sound that seemed like it would kick in". (Ordoñez). The promotional video was dropped after a lackluster test run on Nickelodeon. Sales of the title were very disappointing.

Standard terms for first contracts in the recording industry lock new artists into a minimum number of albums. This prevents the artist from signing with any other label regardless of their success. However, it doesn't prevent the label from "dropping" the artist at any time by ceasing to produce and promote the artist's music (Ordoñez). Only after proving themselves in the marketplace can artists dictate better terms. In fact, after some successful releases, it's customary for artists to renegotiate their contracts to more favorable terms.

The recording industry claims that only about 5 percent of albums ever reach profitability. For example, in 2001, of the 6,455 new titles released by the top five music labels, only 112 titles sold over 500,000 copies; only 60 titles sold over 1 million copies [Source: SoundScan]. Record labels depend on a few very big hits to absorb the costs of all releases. Therefore, labels feel justified in tying new and unproven artists to a minimum number of releases.

With the production schedule for Carly's first album falling ever further behind, a new, more veteran manager was hired in early 2001. A release date of November 13, 2001 was set for the album with both spending and production speeded up to meet the deadline. These additional production costs of $650,000 brought MCA's total investment in the album to about $1 million which is considered high for a first effort. However, everyone involved thought that the upcoming album, "Ultimate High", had the makings of a hit.[2]

To overcome Ms. Hennessy's limited name recognition with the public, MCA committed additional resources in a hurried-up promotional campaign for the album. As part of the promotion, a single from the album, "Beautiful You" was released late in 2001.

Billboard Magazine, October, 29, 2001: Carly Hennessy, "Beautiful You": "Carly Hennessy got off to a promising start with her launch single "I'm Gonna Blow Your Mind". Unfortunately, she got lost in radio's marked turn away from youthful pop, and the song went largely unnoticed. …this equally compelling follow-up … 'Beautiful You' is a buoyant outing, spirited and optimistic with an adhesive chorus fully capable of locking itself tightly in the memory. A spray of guitars and some "nah, nah, nahs" throughout give it added gusto. These guys have done their jobs; now, MCA, it's up to you to make sure radio gets the message." CT (Billboard, October, 29, 2001). .

Despite some favorable reviews like this one from Billboard, and MCA's spending of almost $500,000 on promotion for "Beautiful You", it got even less air time than "Mind". Hopes for a concert tour by Ms. Hennessy were abandoned. To date, MCA had invested almost $2.2 million on Ms. Hennessy since 1999.

For a variety of reasons, this was not a very favorable climate for new artists to be attempting a breakthrough. In the pop music industry (unlike rock music) successful songs need to be instant hits since they are given little time to "grow" into a success. This puts tremendous pressure on pre-release and early promotional efforts for the title and the artist. For songs to be successful, they need radio air time. Deregulation of radio station ownership had left the industry dominated by a few big players with a focus on profits. Local stations were under pressure to only play those songs that seemed like immediate hits leaving little time for songs to "catch on". Air time for new artists was at a premium.

Large discount retailers (e.g. Wal-Mart) are the fastest growing segment of retail music sales. Unlike traditional music stores, discounters stock a large volume of only a limited number of titles. They stock huge inventories of successful, proven artists but aren't willing to take a chance on new, unproven artists. In this environment, record companies have a harder time getting new and untested titles on the shelves.

World-wide music sales (the U. S. accounts for two-thirds) had been in decline since 1996 and continued dropping another five percent in 2001. The movement from vinyl records to CDs had sparked a sales boom that had all but ended by the mid-1990s and no similar sales-generating trend had taken its place. But, perhaps most importantly, pop music had been unable to find new, hugely-popular artists who could continually sell multi-millions of albums. In 2001, for the first time since 1966, no album sold over five million copies (Goldsmith and Ordonez). Even Britney Spears' latest album only sold one-third as many copies as her first album three years earlier (Nielsen SoundScan)!

Into this market, MCA released Carly Hennessy's single "Beautiful You". Together, her first two singles ("Mind" and "Beautiful You") only sold about 17,000 copies.

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[2]You can sample tracks from "Ultimate High" including "Beautiful You" by going to: www.mcarecords.com Locate Carly Hennessy under the "Artist Search" menu. Click on "Ultimate High".

Billboard Magazine (August 3, 2002): Hennessy's High: With a successful career as a child actor/ model already under her belt, Irish teenager Carly Hennessy now turns her attention to music. Her MCA debut, "Ultimate High", features the A-list songwriting and production talents of the New Radicals´ Gregg Alexander and Danielle Brisebois. The lead single is "I'm Gonna Blow Your Mind". Nick Kelly Billboard (August 3, 2002).

At last, the album "Ultimate High" was released in late 2001. Billboard's review pointedly talks more about the production and writing team and the artist's past successes rather than her success or promise as a singer. As it turned out, this review was accurately prophetic of the market's reaction to the album.

Following the failure of her first two singles, limited air time and lukewarm press, retailers stayed away from the album. Only about 10,000 copies were even ordered. The album generated sales of less than $5,000 (about 400 copies) in its first three months (MusicReviewer.com). To some production executives at MCA, it appeared that Ms. Hennessy's music wasn't rejected by the public; it just never "made it to the public".

After almost three years, MCA had invested $2.2 million in developing and promoting Carly Hennessy. As a last effort, MCA released "I'm Gonna Blow Your Mind" in Europe in early 2002 in hopes of promoting her in a more favorable market. The album, "Ultimate High", would be released there later.

Meanwhile, Ms. Hennessy vacated her apartment in Los Angeles, turned in her car and moved back to Ireland where she is currently getting ready for the European promotional tour for the album. She's still hopeful that it takes more than one album for artists to find a place in popular music.

Discussion Questions

1. In light of trends in the popular music industry over the past few years, briefly discuss the likelihood of any new artist generating at least a "break-even" level of sales for a debut album.

2. In your opinion, at what point during the three-year period of her contract (1999-2002) could MCA executives reliably predict the success or failure of Ms. Hennessy's recording career. Justify your answer.

3. MCA Records is a subsidiary of Vivendi Universal SA. At their Web site, locate the most recent set of financial statements. Scan Footnote No. 1 for a description of their revenue and expense recognition policies related to their music holdings.

4. Put yourself in the role of the controller for MCA. Prepare a report recommending the proper accounting for the revenues and expenses related to the Carly Hennessy project over the years 1999 – 2002. In your report, be specific as to when the sales revenue from all three releases should be recognized and when all related costs should be recognized. In your report, you can make any reasonable assumptions necessary to make your recommendations complete. Please identify any assumptions that you make.

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The Brief Career of Carly Hennessy
(A Study of the Economics of Pop Music)

Teaching Notes

Summary and Introduction: This is a case study about the basic premise underlying accrual accounting; namely the matching concept. The setting for the case will be familiar to most college students. The accounting issue is how recording studios account for production and promotion costs for albums of new and untested recording artists. Students decide whether such costs should be expensed as incurred or deferred and allocated to future periods as well as deciding when there isn't likely to be a "future" period for allocation. The accounting issue, revenue versus capital expenditures, is basic enough that accounting principles students can realistically discuss it with some level of understanding.

As background to the accounting issues, students get an introduction to the pop music industry through a brief look at three years in the recording life of a sixteen-year old newcomer artist. A brief look at recording contracts, production and promotion pressures, and the music distribution system are all summarized. (Students can listen to several songs and see the artist's promotional video on the Web as part of the background information.)

Students will discover that most new releases never approach even a break-even volume of sales. In an accounting context, this makes the likelihood of future revenues extremely unlikely. This removes, for the most part, any chance of future matching of revenues and expenses. In developing their recommendations, students access a corporate Web site, locate corporate accounting policies regarding music promotion and production costs, visit some GAAP rules for the music industry and discover a practical application of some basic financial accounting theory.

Question 1

Question: In light of trends in popular music industry over the past few years, briefly discuss the likelihood of any new artist generating at least a break even level of sales for a debut album.

Instructor's Notes: Students should conclude from the background material in the case that it is extremely unlikely that any one new artist will be a "success". In fact, based on the sales figures for new titles in 2001, it is considerably unlikely that new releases would even make a profit. Less than 2 percent (112 / 6455) even reached break-even.

The focus here is to get students to think about the concept of materiality (as a prelude to Question 4) as it relates to expected future recoverability of deferred costs. It really isn't necessary that students assign an exact probability to this question as long as they realize that in this industry, profitability only comes to a very few big-name artists. Most albums never even recover the upfront promotion and production costs or cash advances to the artists.

Question 2

Question: In your opinion, at what point during the three-year period of her contract (1999-2002) could MCA executives reliably predict the success or failure of Ms. Hennessy's recording career? Justify your answer.

Instructor's Notes: This question is intended to get students to concentrate on the timing of events and when, perhaps, the future viability of a project becomes doubtful. This is a warm-up exercise to Question 4 where students will be asked to make the same judgment in applying GAAP.

To properly discuss this issue, students will need to sort out the chronology of events. Perhaps the class as a group can draw a timeline to put all important events in context. Here is a brief summary:

- Mid 1999 – Carly signs six-album contract
- December 1999 – First album completed; results aren't very encouraging
- Early 2000 – New producer and writers hired to rerecord the entire album
- December 2000 – Rerecorded album not completed
- Early 2001 – The single "I'm Gonna Blow Your Mind" (from the upcoming album) released in U. S.; New production manager hired for the album
- Mid 2001 – The single "Beautiful You" (from the album) released in U. S.
- November 2001 – The album "Ultimate High" released in U.S.
- Early 2002 – The single "I'm Gonna Blow Your Mind" released in Europe

Based on the case discussion, it seems clear that both the artist and the label still considered Carly Hennessy a potential success at end of 1999. Even though everyone was disappointed in the first album, at that point it was still considered a production and positioning problem, not an artist problem.

By the end of 2000, the seeds of doubt should have been emerging. Although Carly had still not been tested in the market, the long recording and production problems suggested that perhaps she didn't really fit into any of the potential markets. However, absent any market results, the studio optimists at MCA still considered her a viable artist and worth the continued investment of MCA's resources.

In mid 2001, it was becoming obvious that Carly Hennessy was perhaps not going to be a success in U. S. pop music. Extremely slow sales of the first single in the spring were followed by equally slow sales of the second single in the fall. Even though the rerecorded album was finally completed in November, it was all but ignored by both retailers and radio stations. All doubts about future success were put to rest by the end of 2001.

Question 3

Question: MCA Records is a subsidiary of Vivendi Universal SA. At their website, locate the most recent set of financial statements. Scan Footnote No. 1 to locate their accounting policies for revenue and expense recognition related to their music holdings.

Instructor's Notes: Instructors might give the Vivendi Universal URL to students or let them locate it through a Web search.
http://www.vivendiuniversal.com/vu2/en/_home/home.cfm
To find their most recent annual report at the site:

- Click on: Shareholders
- Click on: 2001 Annual Report Form 20-F

On page 127 of the 2001 Form 20-F – Notes to Consolidated Financial Statements is Note 1 which describes their accounting policies.

Note 1 – Description of Business and Summary of Significant Accounting Policies
Revenues and Costs - Music:

> Revenues from the sale of recorded music, net of a provision for estimated returns and allowances, are recognized upon shipment to third parties. Advances to established recording artists and direct costs associated with the creation of record masters are capitalized and are charged to expense as the related royalties are earned, or when the amounts are determined to be unrecoverable. The advances are expensed when past performance or current popularity does not provide a sound basis for estimating that the advance will be recovered from future royalties.

In connection with the Vivendi's accounting policies, instructors may want to spend a few minutes deciding the appropriate GAAP standards in this area. SFAS No. 50 – Financial Reporting in the Record and Music Industry gives the authoritative guidance. (Relevant portions of the standard are in the appendix to the Teaching Notes.) At this point it might be obvious that the wording of Vivendi's policies is taken directly from SFAS No. 50.

[Later in Vivendi's Footnote No. 1 is the following description of their accounting for acquired music assets. This might be introduced to the class as a contrast to the previous discussion of their policies related to internally-developed music assets.

Other intangible assets:

> Vivendi universal has significant acquired other intangible assets, including music catalogs, artists contracts, music and audiovisual publishing assets, film and television libraries, international television networks, editorial resources and plates, distribution networks, customer relationships, copyrights and trademarks, among others. Acquired music catalogs, artists' contracts and music publishing assets are amortized over periods ranging from 14 to 20 years. Most other intangibles are amortized over a four-year period, on a straight line basis.

Question 4

Question: Put yourself in the role of the controller for MCA. Prepare a report recommending the proper accounting for the revenues and expenses related to the Carly Hennessy project over the years 1999-2002. In your report, cite corporate accounting policies and be specific as to when the album revenue and related costs should be recognized. Make any reasonable allocation assumptions necessary to complete your recommendations.

Instructor's Notes: The instructor will have to steer many students toward the relevant accounting theory and how it relates to this situation. Briefly, Vivendi's accounting policies are real-life applications of the basic revenue and expense recognition concepts.

Revenue should be recognized when it's realized (realizable) and earned. For most merchandisers, this occurs when the product is shipped. This is Vivendi's revenue recognition policy.

Expenses should be recognized when incurred which is in the period that the cost contributes to revenue generation. This is the matching principle underlying accrual accounting. Practically, the conceptual framework gives three guidelines for when to recognize expenses: direct matching with revenue, proportional allocation and immediate recognition in the current period. Vivendi's policy for recording costs and artist advances approaches the expense/revenue matching dilemma by deferring such costs until either a) the related royalty revenue is earned or b) the costs are determined to be unrecoverable.

Having identified the key events in 1999 -2001 in Question 2, studied Vivendi's accounting policies and reviewed the relevant financial accounting theory, students should be ready to make some concrete recommendations to MCA.

Since Vivendi's policy is to capitalize production costs and advances, ,most students will likely recommend that all costs for 1999 be capitalized and some students will recommend similar treatment for the costs incurred in 2000. As discussed earlier, there is still some possibility at the end of 2000 that Ms. Hennessy will still have a successful release in the future. Note that at the end of 2000, there were still no revenues attributable to Ms. Hennessy's recordings.

By the end of 2001, most students should be recommending that all costs be expensed. Two justifications might be made here. First, since MCA had virtually given up on her in the U. S. market, only in 2001 would there ever be any revenue to match the expenses against. Secondly, since future recoverability of any deferred costs was highly unlikely at this point, even absent any revenue, their policy is to write off deferred costs "…when past performance or current popularity does not provide a sound basis for estimating that the advance will be recovered from future royalties". (Reference to SFAS No. 50 would be appropriate here since Vivendi is following, to the letter, GAAP principles in the recording industry.)
If accounting for research and development (R & D) costs is part of the accounting principles course, this is a good time to revisit those issues. With some prodding,

students should see the similarity of the accounting practices in the music industry to the GAAP rules for R & D expenditures (SFAS No. 2). In both cases, the low likelihood of future revenues suggests immediate write-off of costs. In R & D, GAAP mandates immediate expensing which prevents any deferrals. In the recording industry, while deferral is certainly an option, the low likelihood of future recording success for artists in general would also suggest immediate expensing of promotion and production costs.

Instructors might also bring up the concepts of conservatism (immediate expensing) and materiality ($2.2 million is probably not material to Vivendi Universal or even MCA Records).

Additional Issues

Throwing good money after bad? In the discussions with students, the question will come up as to why MCA persisted with this project long after future did not look promising for her? MCA's president, Jay Boberg, originally heard and signed Carly Hennessy to her recording contract with MCA. Partly to save face and keep some new artists in the MCA "pipeline", Mr. Boberg undoubtedly felt pressure to make her a success (see: Ordoñez, Jennifer: "Behind the Music…"). In addition, the business strategies for Vivendi's music units specifically targets investing in new releases and new talents.

[Business strategies for Vivendi Universal's Music Units:
• **Local / Global:** optimize the balance and diversity between local music and global hit production, to keep growing market share both on a worldwide and local basis
• **New releases / Catalogs:** optimize the balance between new releases and back catalogs to meet consumers' needs and tastes
• **Artists & Repertoire and New labels:** keep investing in A & R to detect and develop new talents, as well as support emerging and promising labels
• **Fight piracy** by developing technology, by legal/legislative efforts and by developing commercial alternatives
• **Online Music:** capitalize on UMG's extensive music library and VU's expertise in online technology (MP3.com) to derive new revenue streams from online music subscription service press*play*™, the JV with Sony Music Entertainment, Inc., as well as other internet sites (MusicNet, FarmClub, GetMusic,etc.

(Source: http://finance.vivendiuniversal.com/finance/strategy/businessunits.cfm#04)]

Appendices – Teaching Notes

Statement of Financial Accounting Concepts No. 6 – Elements of Financial Statements

> Paragraphs 145 – 149: Accrual accounting uses accrual, deferral and allocation procedures whose goal is to relate revenues, expenses, gains, and losses to periods to reflect an entity's performance instead of merely listing its cash receipts than outlays. Thus, recognition of revenues, expenses, gains and losses and related increments or decrements in assets and liabilities-including matching of cost and

revenues, allocation and amortization-is the essence of using accrual accounting to measure performance of entities. The goal of accrual accounting is to account in the periods in which they occur for the effects of an entity of transactions and other events and circumstances, to the extent that those financial effects are recognizable and measurable.

Some expenses can be directly matched with related revenues as part of the same transaction. Other types of expenses cannot be directly related to particular revenues but are incurred to obtain benefits that are exhausted. Other types of assets yield their benefits to entities over several periods. In these cases expenses resulting from their use are normally allocated to the periods over their estimated useful lives in a systematic and rational allocation procedure.

Statement of Financial Accounting Standards No. 50 – Financial Reporting in the Record and Music Industry

(This statement extracts the specialized accounting principles and practices for AICPA Statement of Position 76-1, Accounting Practices in the Record and Music Industry and establishes standard of financial accounting and reporting for licensors and licensees in the record and music industry. …. It also establishes accounting standards for artist compensation cost and cost of record masters.)

Artist compensation cost

Paragraph 10. The amount of royalties earned by artists, as adjusted for anticipated returns, shall be charged to expense of the period in which the sale of the record takes place. An advance royalty paid to an artist shall be reported as an asset if the past performance and current popularity of the artist to whom the advance is made provide a sound basis for estimating that the amount of the advance will be recoverable from future royalties to be earned by the artist. Advances shall be charged to expense as subsequent royalties are earned by the artist. Any portion of advances that subsequently appear not to be fully recoverable from future royalties to be earned by the artist shall be charged to expense during the period in which the loss becomes evident. Advance royalties shall be classified as current and noncurrent assets, as appropriate.

Cost of record masters

Paragraph 11. The portion of the cost of a record master borne by the record Company shall be reported as an asset if the past performance and current popularity the artist provides a sound basis for estimating that the cost will be recovered from future sales. Otherwise, that cost shall be charged to expense. The amount recognized as an asset shall be amortized over the estimated life of the recorded performance using a method that reasonably relates the amount to the net revenue expected to be realized.

Paragraph 12. The portion of the cost of a record master recoverable from the artist's royalties shall be accounted for as advance loyalty, as discussed in paragraph 10.

Glossary

Advance Royalty – An amount paid to music publishers, record producers, songwriters, or other artists in advance of their earning royalties from record or music sales. Such an amount is based on contractual terms and is generally nonrefundable.

Record Master – The master tape resulting from the performance of the artist. It is used to produce molds for commercial record production and other tapes for use of making cartridges, cassettes, and reel tapes. The costs of producing a record master include a) the cost of musical talent (musicians, vocal background, and arrangements); b) the cost of the technical talent for engineering, directing, and mixing; c) costs for the use of the equipment to record and produce the master; and d) studio facility charges. Under the standard type of artist contract, the record company bears a portion of the costs and recovers a portion of the cost from the artist out of designated royalties. However, either party may bear all or most of the cost.

Royalties – Amounts paid to record producers, songwriters, or other artist for their participation in making records and to music publishers for their copyright interest in music. Amounts for artists are determined by the terms of personal service contracts negotiated between artist and record companies and usually are determined based upon a percentage of sales activity and license fee income, adjusted for estimated sales returns.

Statement of Financial Accounting Standards No. 2 – Research and Development Costs

Accounting for Research and Development Costs

Paragraph 12. All research and development costs encompassed by the statement shall be charged to expense when incurred.

Appendix B – Basis for Conclusions

Uncertainty of future benefits

Paragraph 39. There is normally a high degree of uncertainty about the future benefits of individual research and development projects, although the element of uncertainty may diminish as a project progresses. Estimates of the rate of success of research and development projects vary markedly-depending in part on how narrowly one defines a project and how one defines success-but all such estimates indicate a high failure rate. For example, one study of a number of industries found an average of less than 2 percent of new product ideas and less than 15 percent of product development projects were commercially successful.