

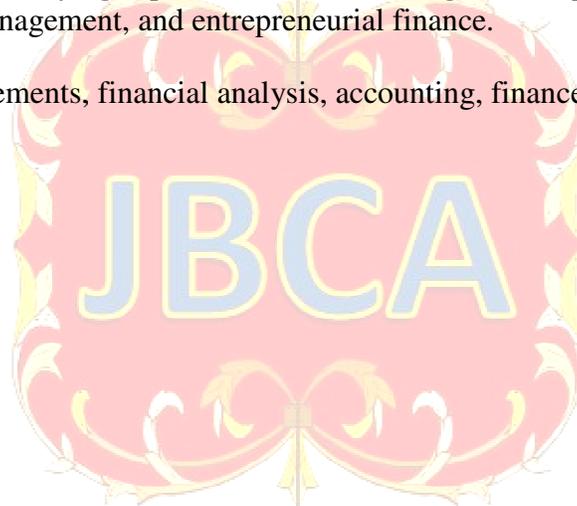
Baton Rouge Music Studios: a case analysis

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Abstract

This case requires students to analyze the financial position of a small business on the verge of closing. This case is very flexible; how much of the solution should be given to the students is a function of the amount of time the instructor wants to devote to the case and the learning objectives to be achieved. This is also an opportunity to encourage students to employ sensitivity analysis via a spreadsheet. If time is at a premium, all of the preliminary financials can be provided, with the students only focusing on analysis of the statements and/or recommendations regarding continued operation of the venture. This case, with its core business content and subject matter, is likely to be of interest to sophomore and junior level business students. It can be used in varying capacities in the following classes: principles of accounting, principles of financial management, and entrepreneurial finance.

Keywords: financial statements, financial analysis, accounting, finance



PURPOSE OF THE CASE

This case is designed to introduce students to the operational difficulties experienced by a small business. Many issues would not be present if the firm were publicly-held, with audited financial statements and a secondary market for its securities. The firm being analyzed is a music school, an entrepreneurial venture of a professional musician. The case is also designed as an initial presentation of financial statements, allowing students to search for ways to increase revenue and decrease expenses, while still remaining viable. This is also an opportunity to encourage students to employ sensitivity analysis via a spreadsheet. By changing the value of one variable, students will be able to determine the effect on profitability. Students in accounting and/or finance classes may find the content challenging, yet enjoyable. However, the case is very flexible. All of the financials can be provided to students in an entrepreneurship or introductory management class, only making recommendations regarding continued operation of the business, without detailed knowledge of accounting or finance.

THE COMPANY

Baton Rouge Music Studios, LLC (hereafter, BRMS) is a “business dedicated to creating, developing, and implementing educational and performance based programs to Baton Rouge area youth” (Baton Rouge Music Studios website, 2011). Through private lesson offerings, students learn musical theory and technique. Unique group oriented programs enhance the student’s learning experience; “instructors model motivation and communication techniques that provide students with the skills necessary to work with other musicians in a constructive, critical manner” (Baton Rouge Music Studios website, 2011).

BRMS was founded in 2006 by Doug Gay, a professional touring and studio musician. Between 2009 and 2011, Doug played drums for Tab Benoit, a Grammy©-nominated Louisiana Blues artist. Gay used \$25,000 of savings to invest in computers and high-tech recording equipment. Income Doug earned as part of Benoit’s band was used to offset BRMS expenses. Doug’s wife, Courtney, remained at the studio while he toured. Prior to touring, Doug was the band director at a local high school and would tend to the studio after school dismissed. Growing weary of life on the road (250 days a year), Doug quit the Tab Benoit Band in May of 2011. However, the income earned as a touring musician helped to keep the studio afloat. After several months of poor financial performance, it was time to focus on business. The studio is open 5 days a week, 4 p.m. – 8 p.m. and is closed for all major holidays. The reception desk, which accepts payment from students and answers telephones, is maintained by Doug, Courtney, and the instructors at BRMS.

TEACHING PHILOSOPHY

The faculty at BRMS is comprised of professional musicians and educators. Besides Doug, there are seven instructors, teaching drums, guitar, bass, piano, voice, brass, and woodwinds. Each instructor executes what Doug has dubbed “purpose driven lessons.” Traditionally, there are two schools of thought in regard to private music lessons. The first technique is used by many professional contemporary musicians. They use a laid-back approach to teach students parts of recognizable songs; sometimes, several students informally “jam” with other students. Unfortunately, there are no public performances or recitals. The second

approach uses a rigid curriculum. Progression through a series of instructional books is used to structure each lesson. Once or twice a year, students perform for family and friends via recitals; however, students rarely play alongside others. Students at BRMS not only receive a sound musical education in technique and theory, but also have the opportunity to learn how to play with other students. Students are prepared for several performance opportunities per year in rock and roll concert settings, such as at malls, auditoriums, and local festivals. Doug's philosophy is that "music should be a tool that helps a student with self-discipline and accountability; but, music should also be fun" (Baton Rouge Music Studios website, 2011). Doug believes BRMS uses the best methods (and the most enjoyable ways) to teach these skills.

PROGRAMS

BRMS offers several programs. The following is a description of these programs and fee schedules:

Private instruction

BRMS offers both ½- hour and 1-hour private music lessons. Lessons are held on the same day and time each week during the course of a month. Fees for private lessons are \$110 per month for ½-hour lessons, \$200 per month for 1-hour lessons (the market rate for private music instruction in this community). Fees are paid via cash or check. Once signed up for lessons, clients must give a 30-day notice of withdrawal in order to stop the invoicing process. Private lessons are scheduled with the front desk (scheduled time will depend on instructor and student availability).

Rocklab

For beginner guitar and bass players, economical group classes called RockLab are available. Students, aged 6-11, have the opportunity to learn together under the leadership of a qualified group instructor. RockLab classes are one hour in length per week, and are scheduled according to student availability. The RockLab program is a five month program and is offered two times per year. The cost of RockLab is \$110 per month for 5 months, plus a \$50 rehearsal fee.

Young band nation

Young Band Nation (YBN) offers intermediate skill level students the opportunity to learn, rehearse, and perform together as a band. No more than six students, usually those with similar musical skill and interest, are grouped to form a young band (each young band usually includes at least the following: lead singer, drummer, lead guitarist, and bass guitarist.) Young Band Nation is offered three times a year – spring (January, February, March, and April), summer (June and July) and fall (September, October, November, and December). Each semester has a different theme. Recent themes have included "Songs of the 80s," "The British Invasion," and "Write an Original Song." Each semester has a syllabus and itinerary which gives the students and parents a clear timeline. Band lineups may change from semester to semester. Therefore, it gives the students the potential opportunity to play with many different

students throughout the year. Band members meet at the studio once per week, for two hours. Students in YBN have a mid-semester, as well as, an end-of-semester performance. The current cost of YBN per student is \$100 per month. Students enrolled in the YBN program must also be simultaneously enrolled in private lessons at BRMS, which is not included in the fee structure for YBN (i.e., private lessons are an additional cost.) The content of YBN is exclusively under the supervision of Doug Gay.

Punch card/gift card system

This program allows clients to pre-purchase lessons. Clients must call 48 hours in advance to schedule a lesson. After completion of a lesson, the cost (\$30 per half hour, \$55 per hour) is deducted from the card's remaining balance. Cards are available in denominations of \$30 and up.

One hit wonder

For adults and children unable to make a long term time and/or financial commitment to private lessons, BRMS offers the "one hit wonder" program. Clients must call 72 hours in advance to schedule a "one hit" lesson. The cost is \$30 per half hour, \$55 per hour.

PHYSICAL LOCATION

BRMS is housed in 2500 square feet of Class A office space in the southern part of the community, just south of the Louisiana State University (LSU) campus. Other tenants include doctors, attorneys, and insurance agencies. Most students enrolled in BRMS programs live in the general area. Doug has signed a month-to-month gross lease at the rate of \$3,650 per month. Eight parking spots are included.

ADVERTISING

BRMS has relied primarily on word-of-mouth to promote its programs. Community performances by Young Band Nation students also serve as advertising for the programs offered by the studio. Several local television stations, as well as, the LSU student newspaper, have covered BRMS. Doug promotes his programs at several "fairs" held around town publicizing programs available for children. Social media marketing (Facebook, Twitter, etc.) has been pursued. BRMS is likely to attract new students through this avenue, since most teens are tech-savvy. Doug has always felt that a formal marketing plan for the studio would be his secret weapon to tap if times got tough; but, he is hesitant to pay for one.

CHALLENGES

BRMS has encountered numerous challenges over the last few months. Revenue is unstable during the course of the calendar year. For instance, participation in summer programs is usually low. Meanwhile, expenses during this portion of the year remain roughly the same. Monthly profit and loss statements for March and June 2011 are presented in Tables 1 and 2 (Appendix); a balance sheet is presented in Table 3(Appendix). However, BRMS' landlord

insists that demand is keen from other present tenants, and rent will be increased by 15% in 2012. To keep the studio operational, Doug and Courtney have borrowed \$5,000 from family members (without interest) and do not take salaries; however, they are committed to remaining open. Future dreams for the studio include: CD and promotional packages for members of Young Band Nation as they begin to record their original music; live streaming performances for family and friends to see students perform in real time; in-house venue for Young Band performances and workshops; and, a full suite of rehearsal spaces open to the Baton Rouge music community (by the hour or by the month rentals).

QUESTIONS

1. Do BRMS' financial statements conform to generally accepted accounting principles (GAAP)? If not, what alterations are necessary to the income statements and/or balance sheet in order to achieve compliance?
2. Formulate a pro forma income statement for 2012, assuming that no changes are made in the present program.
3. Suggest ways in which BRMS can increase its revenue.
4. How can BRMS reduce its expenses?
5. Provide two years of pro formal financial statements using your suggestions from questions 3 and 4. All assumptions used to derive these statements should be noted.

TEACHING NOTES

1. The financials are unaudited statements; they do not conform to GAAP. Actually, adjustments need to be made prior to beginning the analysis and answers will vary. The income statement solution provided in Table 4 (Appendix) assumes that the March statement is typical for 75% of the fiscal year, while June represents 25% (with the exception of RockLab and YBN, each currently run for 10 months). It is also assumed that the Tab Benoit income is earned only through May of 2011. However, this should provide an annual view of the firm's current financial picture. It is an interesting exercise to tell students that there is something missing from the income statement (depreciation expense for the studio's equipment); it allows students to enhance their knowledge of basic financial statement structure. In terms of the balance sheet, the \$25,000 invested in the equipment (5 year MACRS assets) 6 years ago will be worth zero in terms of book value. The goodwill account appears in order for the accounts to balance. Furthermore, the loans from family members may appear on the balance sheet; but, since they are without interest, they do not impact the income statement. The adjusted balance sheet is presented in Table 5 (Appendix).
2. A typical answer is presented in Table 6 (Appendix). Students should include the following in their presentations: (1) elimination of the Tab Benoit income stream, (2) increase in rent, and (3) zero depreciation expense.
3. In terms of revenue generation, there are several areas that could be addressed by students:
 - The instability of student fees in the summer months is related to such things as family vacations, summer school and other activities. Some students are unwilling or unable to commit to an ongoing 2-3 month program during this time.

An alternative revenue generating program would involve 1-2 week intensive band camps, available to students of different skill levels, instruments, and ages. The program could even be offered to adults, marketed as a rock and roll dream camp, with a performance at a local restaurant or coffeehouse as the program finale.

- The generation of revenue only occurs for four hours each day, Monday through Friday; however, the space is leased for 24 hours per day, seven days a week. Doug should investigate offering private music lessons or group lessons for preschoolers and their mothers/fathers/caregivers, as well as, to children who are homeschooled. Programs such KinderMusik© and Music and Me© have been very successful. Local daycares and school before care/after care programs should be approached; programs could be tailored to the needs of the client.
 - Since the price point for private lessons is at the market rate, an increase would likely drive away students. However, the current rate of \$100 per month for Young Band Nation students is too low, especially when compared to the amount of time each student spends at the studio in conjunction with the program. It is reasonable to believe that the program could continue to succeed at a rate of \$150 per month. Also, the semester lengths should be standardized in order to generate income over the entire calendar year: Spring – January, February, March, April, and May; Summer – June, July, and August; Fall – September, October, November, and December.
 - Doug should consider investing in a consultation with an attorney familiar with copyrights and franchising agreements. Since Doug’s ideas regarding music education are novel, the market may be ripe to establish his programs in other communities.
 - Institution of a new payment policy is necessary. All ongoing lesson programs (private lessons, RockLab, YBN, as well as, any new programs) should be paid through direct draft, eliminating any collection issues.
4. A couple of expenses are too large for a business of this size and drag down the studio’s profitability:
- The studio is overpaying for rent. It does not need Class A office space. Retail space in a strip shopping center that is centrally located would offer a larger footprint and more parking at a lower rate. Furthermore, the landlord is likely to build out the space to the tenant’s needs. The dream of housing rehearsal space, available for rent to the community, may be possible with a change in location. Currently, market rates for retail space in this area of the Baton Rouge community run between \$10 and \$20 per square foot per year. Many rents are negotiable. Other improvements, such as an in-house performance venue and recording studio will have to wait.
 - Payroll expenses for instructors at the studio are astronomical. By the looks of the statements provided, the expenses barely cover the revenue generated by these instructors. It is likely that the studio’s other programs have been subsidizing private lessons (and can hardly afford to). The studio treats these instructors as employees, rather than independent contractors. Thus, BRMS has been responsible for benefits, Social Security payroll taxes and

Federal/state withholding. BRMS should avoid a knee jerk reaction such as elimination of private lessons, dismissal of current instructors, and/or eradication of all instructor benefits. Such a move would have a disastrous effect. Private lessons serve as a feeder for all of the other programs offered by the studio. Dismissal of beloved teachers would likely drive away many students. Elimination of benefits would force the resignation of many instructors. The solution may be to reduce the amount of benefits to current instructors and to ease in new instructors and treat them as independent contractors, thereby substantially lowering payroll expense.

5. Answers will vary. This is also an opportunity to encourage students to employ sensitivity analysis via a spreadsheet. By changing the value of one variable, students will be able to determine the effect on net income. The statements provided in Table 7 (Appendix) assume the following:
- A slight up-tick in demand for private lessons, as well as, RockLab and “other” programs.
 - The YBN program increases its fee to \$150/month; 2012: 50 students for spring and fall semesters, 25 students in summer; 2013: 65 students for spring and fall semesters, 35 students in summer.
 - New morning program for toddlers - children attend once per week for 1 month, program run every month, \$100 per month, 2 sessions per day; 2012: 5 children per session; 2013: 10 children per session.
 - New summer program for children - \$150 per child, 10 children per session; 2012: 8 sessions over course of summer; 2013: 16 sessions over course of summer.
 - New summer program for adults - \$200 per adult, 5 adults per session; 2012: 4 sessions over course of summer; 2013: 8 sessions over course of summer.
 - The assumption is made that BRMS moves to 4,000 square feet at \$15 per square foot per year. This move increases the studio’s footprint and eliminates the need to rent storage space and provides more room for the studio’s new programs (as well as, set the stage for rental of rehearsal space to local musicians). Utilities will increase.
 - Direct debit for student fees increases cash flow and eradicates bank overdraft fees.
 - The firm seems woefully underinsured; an increase in this expense is needed. Encourage students to research policies and premiums.
 - Formerly, payroll represented between 85 and 90% of operating income. By reducing the amount of benefits to current instructors and easing in new instructors treated as independent contractors, a decrease in payroll of 25% is expected in 2012 and 30% in 2013.
 - Minimal advertising investment in select local publications, \$1,000 per year.
- Sustained profitability allows the firm to eventually eliminate debt and invest in new equipment. Answers will vary depending on student assumptions.

REFERENCE

Baton Rouge Music Studios. www.brmusicstudios.com. 2011.

APPENDIX

Table 1

Baton Rouge Music Studios, LLC
 Consolidated Statement of Income
 For the Period March 1, 2011 to March 31, 2011
 Operating Income

Income from Lessons		
Private Lessons		\$13,280
RockLab		330
Young Band Nation		5,200
Other		0
Total income from lessons		<u>\$18,810</u>
Tab Benoit income		<u>\$ 2,600</u>
Total Operating Income		\$21,410
Expenses		
Payroll expenses		\$16,287
Computer, internet		150
Rent		3,650
Storage		221
Office supplies		400
Cell phones		260
Electricity		150
Phone – land line		150
Water		31
Insurance		150
Bank service charges		388
Total Expenses		<u>\$21,837</u>
Net Income		<u>\$ (427)</u>

Table 2

Baton Rouge Music Studios, LLC
 Consolidated Statement of Income
 For the Period June 1, 2011 to June 30, 2011
 Operating Income

Income from Lessons	
Private Lessons	\$11,060
RockLab	330
Young Band Nation	1,600
Other (punch cards, One Hit Wonder)	<u>285</u>
Total Operating Income	\$13,275
Expenses	
Payroll expenses	\$12,590
Computer, internet	200
Rent	3,650
Storage	221
Office supplies	600
Cell phones	260
Electricity	400
Phone – land line	150
Water	31
Insurance	150
Bank service charges	<u>0</u>
Total Expenses	\$18,252
Net Income	<u>\$ (4,977)</u>

Table 3
 Baton Rouge Music Studios, LLC
 Consolidated Balance Sheet
 June 30, 2011

Assets	
Cash	\$3,000
Accounts receivable	2,000
Total current assets	\$5,000
Net fixed assets	\$25,000
Total assets	\$30,000
Liabilities and Equity	
Accounts payable	\$1,200
Accruals	3,000
Total debt	\$4,200
Common stock	\$25,000
Retained earnings	800
Total liabilities and equity	\$30,000

Table 4

Baton Rouge Music Studios, LLC
 Consolidated Statement of Income - Adjusted
 For the Period January 1, 2011 to December 31, 2011
 Operating Income

Income from Lessons	
Private Lessons	\$152,700
RockLab	3,300
Young Band Nation	44,800
Other	<u>855</u>
Total income from lessons	\$201,655
Tab Benoit income	<u>\$ 13,000</u>
Total Operating Income	\$214,655
Expenses	
Payroll expenses	\$184,353
Computer, internet	1,950
Rent	43,800
Storage	2,652
Office supplies	5,400
Cell phones	3,120
Electricity	2,550
Phone – land line	1,800
Water	372
Insurance	1,800
Bank service charges	3,492
Depreciation	<u>1,500</u>
Total Expenses	\$252,789
Net Income	<u>\$ (38,134)</u>



Table 5
Baton Rouge Music Studios, LLC
Consolidated Balance Sheet - Adjusted
June 30, 2011

Assets	
Cash	\$3,000
Accounts receivable	2,000
Total current assets	\$5,000
Net fixed assets	0
Goodwill	30,000
Total assets	\$35,000
Liabilities and Equity	
Accounts payable	\$1,200
Accruals	3,000
Long term debt	5,000
Total debt	\$9,200
Common stock	\$25,000
Retained earnings	800
Total liabilities and equity	\$35,000



Table 6

Baton Rouge Music Studios, LLC
 Pro Forma Consolidated Statement of Income
 For the Period January 1, 2012 to December 31, 2012
 Operating Income

Income from Lessons	
Private Lessons	\$152,700
RockLab	3,300
Young Band Nation	44,800
Other	<u>855</u>
Total operating income	\$201,655
Expenses	
Payroll expenses	\$184,353
Computer, internet	1,950
Rent	50,370
Storage	2,652
Office supplies	5,400
Cell phones	3,120
Electricity	2,550
Phone – land line	1,800
Water	372
Insurance	1,800
Bank service charges	<u>3,492</u>
Total Expenses	\$257,859
Net Income	<u>\$ (56,204)</u>

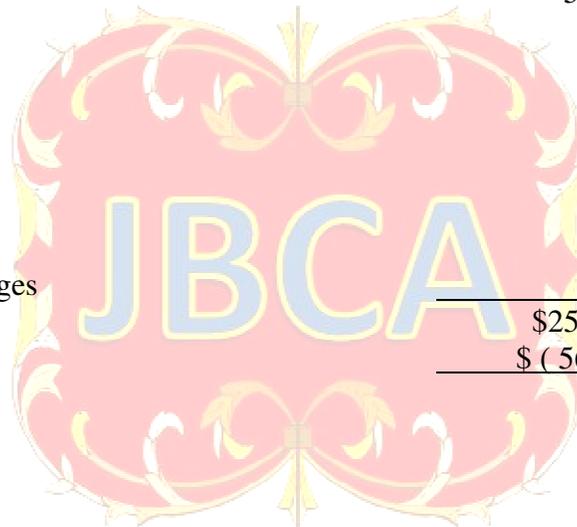


Table 7

Baton Rouge Music Studios, LLC
 Pro forma Consolidated Statements of Income
 For the years 2012 and 2013

	2012	2013
Operating Income		
Income from Lessons		
Private Lessons	\$160,000	\$175,000
RockLab	4,500	6,000
Young Band Nation	78,750	103,500
Morning program for toddlers	12,000	24,000
summer program – children	12,000	24,000
Summer program – adults	4,000	8,000
Other	2,000	4,000
Total operating income	<u>\$273,250</u>	<u>\$344,500</u>
Expenses		
Payroll expenses	\$180,345	\$212,212
Computer, internet	2,500	3,000
Rent	60,000	60,000
Office supplies	7,000	8,000
Cell phones	3,120	3,120
Electricity	5,000	5,000
Phone – land line	1,800	1,800
Water	500	500
Insurance	5,000	5,000
Advertising	1,000	1,000
Depreciation	700	4,120
Total Expenses	<u>266,265</u>	<u>299,632</u>
Net Income	<u>\$6,985</u>	<u>\$44,868</u>