SWP 30/89 BRAND ACCOUNTING: MYTH OR REALITY ?

SRI SRIKANTHAN, KEITH WARD and RICHARD NEAL
Cranfield School of Management
Cranfield University
Cranfield
Bedford MK43 0AL
United Kingdom

Tel: +44 (0)1234 751122
Fax: +44 (0)1234 781806

Brand Accounting: Myth or Reality?

by Sri Srikanthan, Keith Ward and Richard Neal of the Marketing Accounting Research Centre at Cranfield School of Management

"It is surely better to try for imprecise reality than settle for precise fiction". This was The Lex Column's reaction (Financial Times, November 23 1988) to Ranks Hovis McDougall's move to capitalise the value of its own and acquired brands in its published financial statements. Is brand accounting here to stay, or have recent events been acts of commercial expediency committed by a few major companies?

The financial world has over the past few months witnessed an increased awareness of the value of brand names and other marketing assets, which in many cases were previously unrecognised. Grand Metropolitan acquired Heublein in 1987 when it paid a premium of £560m for the brands including Smirnoff. This premium was not recognised on the balance sheet of the acquiring company. More recently Nestle's takeover of Rowntree highlighted what a strong brand portfolio can be worth and what can happen if this value is unrealised by the owning company.

The financial press has recently publicised the cases of Grand Metropolitan, which has capitalised some of its recently acquired brands, and Ranks Hovis McDougall (RHM). Their actions have coincided with the recognition by the Accounting Standards Committee of the deficiencies of SSAPs 22 and 23, which deal with the accounting treatment of goodwill and of mergers and acquisitions.

Levitt (1983), when writing about competitive strategy and competitive advantage, stated that consumers were not as interested in the core product as they were in the benefits, or the 'product surround', that came with the product. Decisions concerned with investment in these intangibles - customer service (pre and post-purchase), product image, branding - have therefore become as crucial, if not more so, than decisions concerned with the core product itself.

There are several factors that can explain why the intangible elements of the package are becoming increasingly important. In dynamic, mature markets a technological edge is a rarity; there are few cost or product advantages to be gained (the experience curve has flattened out): the result is that the market is full of fairly homogeneous products. And so companies must turn to the intangible elements such as the brand name or customer servicing to gain and/or hold loyal customers, and so create a competitive advantage: they compete by differentiating the product surround.

At the same time consumers have become more sophisticated and demanding of manufacturers and retailers. They too realise the similarities in product design and capability, and so they tend to base their purchasing decisions more on the intangible factors. Companies that are marketing orientated have increasingly realised this and spend more on brand development and maintenance activities aimed at creating an awareness of the brand with the customer.

The marketing manager's adage that products, not brands, have life-cycles is more true today than it has ever been, especially in dynamic industries such as personal computing where the products have very short lives. In order to preserve and increase market share when new models are launched, a high degree of brand loyalty is needed. This loyalty must be on-going and carried forward with the advances made in the product, and this requires continual investment in the marketing intangibles. Marketing managers and now also other managers believe that this brand loyalty has substantial, if not the greatest, future value to the business. The expenditure on brand development should be seen as a capital expense, and the asset created should be recognised in the financial statements of the company.

This product/brand concept can be illustrated by using a simple matrix (see figure 1). Looking at the brand/product strategy of an organisation, typically products tend to start their life-cycle in quadrant A where they enter a market because of a perceived product or technological advantage. The major asset at this stage is the organisation's technical expertise as represented in the tangible assets on the balance sheet. Such product orientated companies thus have a technological superiority and are able to deliver a superior product to the customer. The product has low brand image and, with limited competition, customers' buying decisions are based upon the tangible characteristics of the product. As the product develops the natural movement for a successful product is to enter quadrant B by increasing brand awareness while maintaining the product differentiation. As a market leader in this quadrant the organisation is faced with increasing competition as other companies with similar product qualities enter the market, thus driving the leader's product into quadrants C or D. Organisations which do not invest heavily to differentiate their brands find their products quickly regressing into quadrant D, where they become commodity products.

The structure of competitive forces has evolved over the years, so that today the majority of companies find their products situated in quadrant C, where, in order to maintain competitive advantage, the company must invest to maintain and develop brand differentiation: the brand has taken over as the major asset of the organisation.

Now that marketing investment is so important it is essential to have accounting systems that have developed from the traditional product orientated systems into ones that are marketing orientated and that will measure the performance of an organisation's investment in brand differentiation. The objective of an organisation whose market leadership has been eroded should be to keep its product in quadrant C by continually investing in brand differentiation. But with the aid of marketing asset accounting systems, the management can decide whether it is wise to continue to invest enough on brand differentiation to keep the product in C, or whether it would be more advisable to let the product slip into quadrant D and to transfer the brand investment and customer loyalty to a new product. The launch of a completely new product will push the company back to quadrant A (i.e. high product but low brand differentiation) in spite of the fact that brand investment is maintained as before. This is due to a combination of revised consumer expectations and the greater technological and marketing expertise and innovation needed by the producer to stay ahead of the competition once again.

The time it takes for an organisation's product/brand strategy to complete the four stages will match the traditional measurement of the product's life-cycle. Mainframe computer companies have, for example, aimed for a high level of product differentiation and as a result they have found that their products have very short life-cycles. By contrast, the Mars bar, which is over 50 years old and still going strong, has been characterised by high brand differentiation.

It is over twenty years since Dean (1966) suggested that "advertising belongs in the capital budget", implying that marketing involves making long-term investment decisions not merely allocating expenditure for the current year. This would seem logical because expenditure today might generate revenue over a number of time periods. But conventional accounting periods do not necessarily correspond to the time period during which an advertising campaign, say, produces its full increment of sales. On the other hand, longer accounting periods combine the results of many spending decisions on marketing, concealing over and under-spending. Conventional accounting practice again precludes the measurement of the profit responsiveness of a particular marketing investment decision (Feder 1965). The effect in many cases is that companies spend a substantial part of their marketing budget without an awareness of the implications of that expenditure.

Marketing investment decisions involve estimating how much revenue will be generated in future years from marketing spending now, so effectively putting a value on the advertising expenditure, brand, customer service or whatever. These values should be incorporated in the budget so that marketing effectiveness can be judged at future points in time. Then, if companies evaluate marketing investment for internal decision-making, there is no reason why this investment should not be shown as an asset in the published accounts.

The fact is that few companies actually show such assets in their financial statements, and even less use marketing asset accounting systems for managerial control. This is because a company's financial statements are an indication of past performance, and the company, particularly if it is based in the western world, is traditionally restrained under a short-term outlook as all is geared to producing results for the year end financial statements. Treating marketing expenditure as an investment would break this maxim by anticipating gains yet to be realised. It is therefore evident that accounting information systems are needed which:

(a) enable managers to make internal marketing capital investment decisions, to monitor the investment and to evaluate performance;

and (b) recognise the true value of marketing assets in the published financial statements.

The short-term restraints of the principles of accountancy are one of the many reasons why in the past the marketing and accounting functions have not cooperated to implement the accounting systems outlined above, or in fact *any* marketing accounting systems, within their organisations. The managerial style of accountants has been the dominating influence within companies. This is because a company's performance is ultimately judged on its year end profit or loss figure; and so the organisation is geared towards this narrow end: costs must be identified and regulated at every level, and accounted for in the period of incurrence.

However the marketing function cannot easily be accommodated within this paradigm. Marketeers are by nature and necessity an innovative breed: managerial desire for material and continual results cramps their style. Anyhow the control of the marketing department is not straightforward as marketing deals with intangible factors, such as customer perceptions and brand loyalty, which are not easily identifiable.

In today's highly competitive business environment, an integrated marketing accounting approach is crucial if a company is to survive and compete effectively. The marketing function requires accurate information, relevant to its needs, to be able to identify profitable products and markets, to establish the factors that might create a competitive advantage and to decide what degree of product and brand differentiation is required.

To shift the paradigm requires give on both sides; but this has been slow to happen. While many organisations are externally well equipped to satisfy the customer, there has been little change within the corporate body: costing systems are still geared towards serving a production orientated set-up, not a marketing one. The accountants are reluctant to accept brands and advertising and promotional expenditure as assets of marketing; and the marketeers rely on initiative rather than financial guidance to construct the firm's marketing strategy.

The attitude of the accountancy bodies, who have refused to accept that there is no longer a place for a rigid, short-term structure in business, has been a hindrance. For several years now even the bastions of the traditional business values, the banks, have realised the need for change, and are now far more responsive to the needs of their customers. Take for example the financial institution's acceptance of News International's valuation in 1983 and its subsequent revaluations of its publishing rights. This has provided additional security, which has enabled Rupert Murdoch's organisation to increase its borrowing while maintaining its apparent, published gearing at lower levels.

Brands and other marketing assets are so valuable to a company because they are more directly related to the company's most important asset, the customer, than more tangible assets, such as plant and machinery and working capital. There is little point in a company owning the most advanced item of machinery to manufacture products if the customer will not purchase them. It is the role of the marketing personnel to ascertain whether the products will be acceptable to customers, or to persuade them that they *should* accept the product. Once a product has been accepted, this acceptance, or how the consumer perceives the product, has a value to the company which should be recognised.

Today's leading brands are so powerful because they have been so heavily invested in, that it is sometimes cheaper for a company to purchase an established brand, even with tangible assets included in the package, than it is for that company to create one itself. That is why there has been so much merger and take-over activity in recent years, especially in the food and beverages industry, where the acquisition of a brand or portfolio of brands has been the key motive behind the investment decision. And brands that are recognised in Europe provide a firm market foundation from which to launch a programme of expansion in anticipation of the single market in 1992.

The importance of brands is not however just confined to fast moving consumer goods industries. The high street banks have only in the last four or five years begun to establish warm, friendly corporate images, and to create different product packages with a brand or logo that is designed to appeal to, and be recognised by, a specific market sector at which the product has been targetted.

The communication gap between the marketing and accounting functions has in the past resulted in marketing managers making 'investment' decisions with no financial guidance, and then have to start from 'zero sum base' in the following year because their expenditure was written off. The current moves in marketing asset accounting would seem to indicate that the two functions are now cooperating more to value marketing intangibles, because they see the significance of these assets.

In view of the obvious importance brands have for an organisation, there should no longer be any reluctance to account for them. Legally speaking, intangible assets, if they are separately identifiable as concessions, patents, licences, trademarks or other similar rights or assets (in other words, not goodwill as a collective asset), can be shown as assets on the balance sheet, whether acquired or created. However SSAP 22 'Accounting for Goodwill', which, along with other standards, is regarded as mandatory within the accountancy profession, does take a more stringent line. Brands which are acquired in a take-over situation may be carried on the acquiring company's books, although the recommended practice is to write them off so as to be consistent with the treatment of created brands which under no circumstances may be capitalised.

The reason given in SSAP 22 for allowing acquired brands, but not created brands, to be capitalised, is that the value attached to acquired brands is the result of a definitive market transaction. This is considered by accountants to be a satisfactory measurement because it is capable of objective and consistent appraisal.

But is market value consistent and objective? Is not market value dependent on such unpredictable and intangible factors as investor confidence and attitude to risk? Value will fluctuate widely according to internal and external circumstances. Any amount attributed to intangible assets is unique to the valuer and to the specific point in time at which it was measured. So it is unlikely that two valuations will be the same. The case of Rowntree has shown how the market valuation of a company with strong brands may not always reflect the perceived value given to it by a potential acquirer, and that no-one has yet developed a sophisticated, universally acceptable technique for valuing brands, purchased or otherwise. The actions of RHM, in particular, to value all its brands would seem to signify a willingness by company accountants and auditors not to adhere strictly to the accounting standards anymore.

Perhaps a more understandable explanation for SSAP 22 not allowing the capitalisation of created brands, and in general assets with intangible characteristics, can be found by considering the episode in Rolls-Royce's history leading up to the company's liquidation in 1971.

The problems for Rolls-Royce began back in 1962, when the accounts for that year were prepared on different accounting bases from those used in previous years. The company was having difficulty in reporting a profit because of heavy research and development costs. So the decision was made to carry forward in the balance sheet part of this expenditure; the previous practice had been to write it off in the profit and loss account as incurred. The amount carried forward as an asset was "the value of research and development recoverable from sales resulting from existing aero-engine orders".

While the accountants concerned may have been adopting the 'matching' (or 'accruals') concept, with hindsight it is apparent that their actions were not prudent, particularly when the RB.211 programme was in full swing in the late 1960s and it became apparent that the costs of research and development and the matching revenues could not be estimated with any degree of accuracy or certainty. This was mainly because no prior research into the RB.211 had been carried out, and therefore there was no knowledge of the likely costs or benefits.

The financial implications of this change in accounting policy are clearly highlighted by the Rolls-

Royce accounts for 1967 (Ashton 1983), which showed a trading profit after interest of £17.5m; the company spent £9.6m on research and development , but of this only £5.7m was charged to the profit and loss account; £4.2m tax was provided for. That left funds of £3.7m in a year during which dividends of £6.1m were paid, so borrowing had to be increased. When the apparent asset values were found not to be cash producing in the short-term, and as more and more funds were poured into the RB.211 programme, the company found itself in substantial and eventually irreversible financial difficulty.

The accountancy profession's reaction was to blame Rolls Royce's recognition of intangible assets for its liquidation, when in reality the main reason was poor financial management.

There is nevertheless uncertainty attached to matching research and development costs and revenues and this problem can be applied to marketing assets as well. As was seen with Rolls Royce, a company that puts a value on intangible assets could face severe financial problems if this value is not realised in future accounting periods. The argument is that asset values should only be carried forward "where there is a clearly demonstrable and reasonably measurable future period of benefit" (Spiller 1977). Companies like Grand Metropolitan and RHM believe that their brands meet these criteria, and indeed go as far as to say that the future benefits will continue indefinitely. To the prudent accountant thinking back on the fate of Double Diamond, Woodbine, Park Drive, that statement may seem a little rash, but Grand Metropolitan and RHM must know with reasonable certainty what the future is expected to hold for their brands to enable their management to justify the marketing investment or expenditure needed to support the brands.

Companies should strive to establish management accounting systems for brands and other marketing assets. This will enable the use of long-term decision tools and performance measurements such as net present value or internal rate of return which are more relevant to marketing decision-making than the traditional, short-term ratios based on earnings. This will help managers to continue to narrow the communication gap, and to consider the implications of investment in brands for the organisation's marketing and corporate strategy. Once this is achieved, even though it is difficult to make an externally usable valuation of intangible assets with which accountants, the City, the shareholders and the directors all agree, companies should not stop trying, as Lex implies.

While companies are waiting to establish marketing accounting systems, if they are worried about being undervalued on the stock market, it is worth noting that a valuation of brands does not directly affect market capitalisation. Market capitalisation reflects the value of the shares attributed by the shareholders, and it is their perception of the company's worth which will affect the share value.

Brand accounting *is* here to stay. Grand Metropolitan and RHM, who started the ball rolling, undoubtedly had a number of motives for capitalising their brands. Perhaps, they wanted to show a truer indication of their value to make themselves less vulnerable to take-over than their rivals; perhaps, they wanted to lower their gearing and maintain their reserves; and perhaps, they wanted to gain a psychological advantage over their competitors. But the fact is several other companies have been waiting for someone brave enough to make a move, and now that has happened, one can expect a wave of activity from organisations with strong brand portfolios. It would be unfair, therefore, to suggest that Grand Metropolitan and RHM have committed commercial expediency.

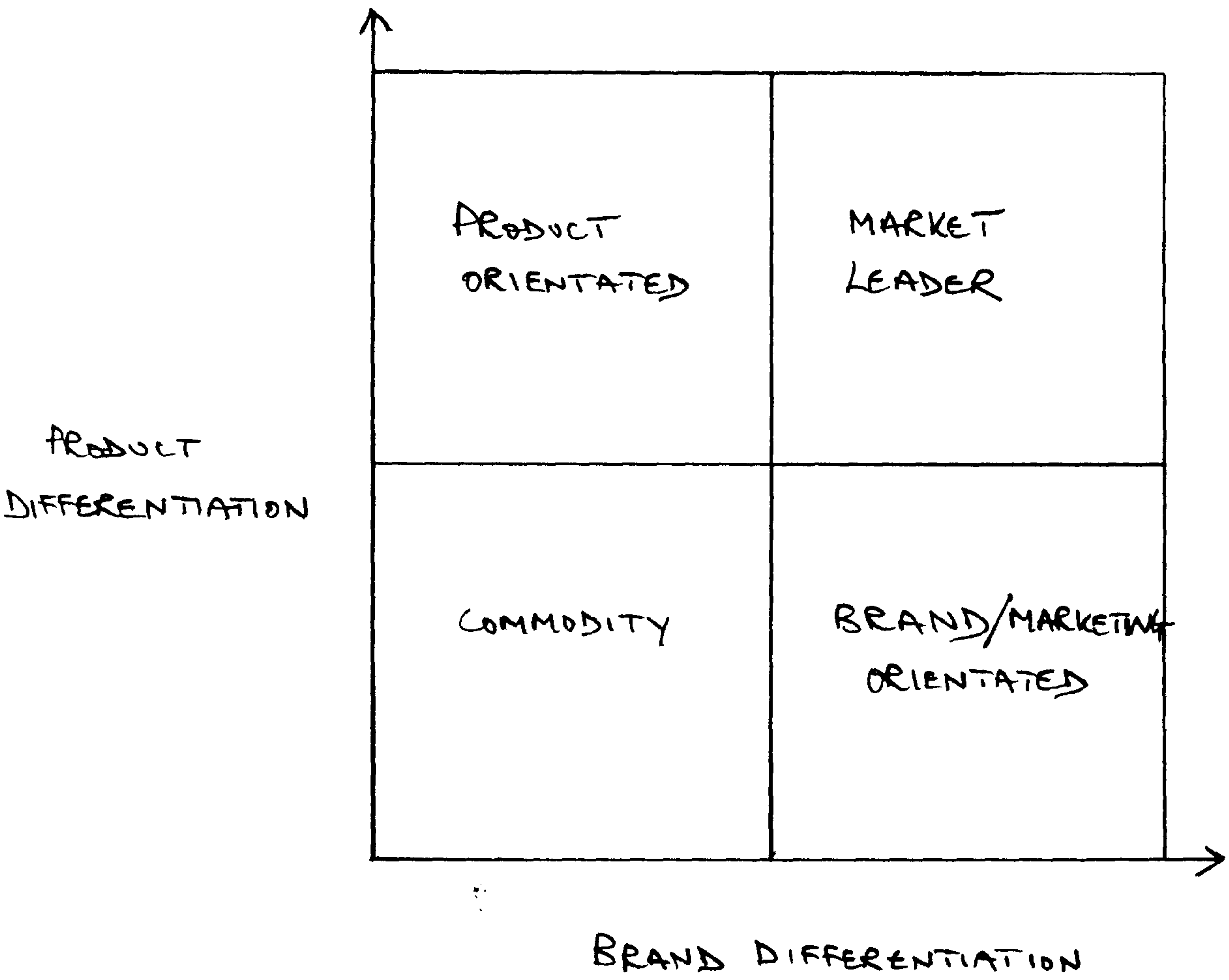
There is though a great need for research to be carried out to pull together the thoughts and actions of accountants and their companies on accounting for brands and other marketing assets. Without any such research so many approaches will be adopted by companies wishing to account for their brands that it will become extremely difficult for the Accounting Standards Committee to continue to regulate the accountancy profession. In the space of a few months, one company has capitalised its recently acquired brands, another all its brands and two others have recapitalised previously written-off goodwill to lower their gearing ratios.

Some sort of order must come out of this mayhem. For this to happen companies must look carefully at the role marketing assets and marketing accounting systems can play in aiding managerial decision-making and control; and the Accounting Standards Committee must act decisively and quickly to bring companies back into line, by recognising the importance of brands and by allowing companies to show the true value of all their assets either as a note to, or actually on, the balance sheet.

The Marketing Accounting Research Centre at Cranfield School of Management is currently surveying accountants' attitudes towards marketing asset accounting and the use of marketing assets as decision-making tools. Details from the authors at MARC, Cranfield School of Management, Bedford, MK43 0AL. Tele: (0234) 751122.

APPENDIX A

Figure 1: Brand/Product Differentiation Matrix



APPENDIX B

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