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SWP 19/90 STRATEGIC BRAND ACCOUNTING

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**Summary Report of Cranfield Marketing Accounting Research Centre Workshop, 24
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Cranfield School of Management Working Paper

"Strategic Brand Accounting"

Summary Report of Marketing Accounting Research Centre Workshop, May 24, 1989

Written by Keith Ward, Sri Srikanthan and Richard Neal

Abstract

The Marketing Accounting Research Centre (MARC) had been working on accounting for brand values for some time when this whole area blew up following the Nestle takeover of Rowntree in July 1988. The main issue with this takeover was that Nestle had paid substantially in excess of the book value of Rowntree because it had seen the long-term value, not represented in the balance sheet, of Rowntree's brands. Hence the subsequent debate in UK financial circles has been about whether brands and other intangible assets have a role on the balance sheet, and what implications this has for market values of companies, and the apparent inadequacies of current accounting regulations regarding the acquisition of companies with valuable intangible assets.

There is a more crucial issue, MARC believes however, which has not received much attention; that is, do organisations have the right accounting systems to value their brands internally and therefore make strategic decisions that will enhance the long-term value of the business? Without a true understanding of the strategic significance of brand investment and the importance to decision-makers of properly accounting for it, the financial community's arguing about financial reporting requirements is irrelevant.

The aim of this workshop was therefore to have open and constructive discussion on brand management issues and the ways in which proper brand accounting systems can improve the decision-making process within the organisation, leading to the achievement of long-term, value-enhancing objectives.

All those who attended the workshop were agreed that the real value of brand information was for internal use in improving the effectiveness of marketing decisions. However it was also acknowledged that the argument and confusion over the role of the balance sheet and intangible assets in relation to this had to be resolved.

The delegates were carefully selected because of their close involvement in the brand accounting debate and their obvious interest in the subject's strategic management issues. Those present at the workshop were:

Speakers:

Keith Ward, Chairman, MARC, Cranfield School of Management

Sri Srikanthan, Director, MARC

Richard Neal, Research Officer, MARC

Leslie de Chernatony, Lecturer in Marketing

Cranfield School of Management

Peter Holgate, Senior Technical Manager, Deloitte Haskins & Sells

Delegates:

Ken Black, Finance Manager, Cadbury

Peter Cartmell, Group Financial Controller, Cadbury Schweppes

Chris Parratt, Grand Metropolitan

Peter Clayton, Group Financial Controller, Trusthouse Forte

Jeffrey Oram, Lecturer in Marketing, Henley - The Management College

John Murphy, Chairman, Interbrand

Martin Moorhouse, Group Chief Accountant, Ranks Hovis McDougall

John Dowey, The School of Management, Imperial College

There were six presentations made during the day. After the Chairman, Keith Ward, had introduced the proceedings, outlining the programme and its aims, Leslie de Chernatony gave a perspective on the meaning and perceived values of a brand and its role in strategy.

Sri Srikanthan discussed some of the problems of measuring business success and the inappropriateness of these traditional measures for judging marketing performance. Methods of evaluating an investment in a brand asset were then discussed.

It was then the turn of our guest speaker, Peter Holgate, to reflect on the "brands on the balance sheet" debate and to suggest where things might go from here.

Richard Neal then presented the findings of MARC's empirical research based on interviews with senior finance and marketing managers. The issues raised included developing a brand image and controlling investment in the brand; and the different perceptions that corporate and divisional managers had about the role of brand accounting systems.

The final presentation was made by Keith Ward. He suggested how brand valuations could be applied to investment appraisal and control, measuring managerial performance and carrying out competitive analysis.

Introduction: Keith Ward.

The chairman gave a brief resume of the brand accounting debate which, he explained, had been concentrated on published financial statements. The main issues that had been covered were the question of whether companies should include own developed brands as well as acquired brands on the balance sheet; should acquired brands be shown at cost or valuation; and should brand assets be depreciated.

The Cranfield view of brand accounting differs somewhat from the main thrust of the debate in that MARC believes that brand valuation is a critical element of corporate and marketing strategic decision-making. Thus internally used brand values are even more important than externally published data. This area of brand accounting had not received the same emphasis and so it formed the main focus of discussion during the day.

For the purposes of brand management a separation of the brand from the product is required. Also marketing strategies and expenditures should differentiate maintenance and development activities for individual brands. This requires a clear understanding of brand attributes and the ways in which the brand's value can be enhanced.

As a consequence of this view MARC believes that there are four key requirements for the effective management of brands:

- 1). The need for a clear definition of brands and their role in corporate strategy.
- 2). The need to justify investment in brands in a similarly rigorous way to other long-term capital items.
- 3). The need to control expenditure on brands, both investment (development) and maintenance activities.

4). The need to understand the role of published financial statements and the external communication of brand information.

Understanding the brand and its role in corporate strategy: Leslie de Chernatony.

There exists much confusion about the interpretation of the term "brand" which can lead to ineffective branding strategies. The speaker reviewed the evolution and rationale for manufacturer brands and distributor brands in the grocery retail sector. Four interpretations of brand assets have been put forward by theorists:

1). Brand as a differentiating device. However companies cannot compete on a name alone: the brand must have a unique benefit which satisfies real consumer needs. Therefore although designing a name or a symbol is an important aspect of branding it is only one of the many elements that lead to successful brands.

2). Brands as shorthand devices for consumers. Consumers are unable to remember and differentiate all the attributes of a particular product before making a purchase decision, but through the brand they can easily recall certain attributes. However this interpretation still does not enable the marketing manager to decide which particular attributes of the brand should be developed and strongly associated with the brand's name.

3). Brand as a promise of consistent quality, a guarantee. The brand name is used as the device to enable recognition of a company's product and to then associate this with a specific quality level. This view very narrowly emphasises quality or consistency as the added value aspect of brands, yet added value can encompass many alternatives. This interpretation is applicable to only certain types of brands.

4). Brand as a means of projecting self-image. The brand provides the product with a personality. The brand is then chosen according to how it fits in with the consumer's self concept at that time. To be of value, the brand as a symbolic device must communicate its meaning and value to consumers. Advertising therefore plays a crucial role. This fourth interpretation may have value in certain product fields, but it is not universally applicable. There are instances where functional characteristics are more important than symbolic communication.

Leslie de Chernatony concluded that no one of these interpretations was universally applicable. Together with Gil McWilliam of Imperial College, he has developed a matrix: brands can be characterised by two dimensions, representationality and functionality. Knowing a brand's position on the representationality/functionality matrix should help to develop effective brand strategies. For example, if a brand is highly functional, the company should invest in developing and maintaining the product to maintain superiority. A highly representational brand will need a lot of promotional support. Pricing strategy will also depend on the brand's position on the matrix: consumers will pay a premium price for a highly functional and highly representational brand.

Most of the delegates could clearly associate with this matrix; indeed it was felt that sophisticated 'perceptual mapping' models were widely used by marketing managers for understanding brands.

"The Strategic Implications of Clarifying How Marketers Interpret Brands" by Leslie de Chernatony and Gil McWilliam is available in the Cranfield School of Management Working Paper Series as SWP 39/89.

Accounting for brands: Sri Srikanthan

Sri Srikanthan tackled the problem of measuring the success of brands. Profitability and return on investment (ROI) measures are inappropriate for measuring success of brands. Profit as traditionally calculated is net of costs that yield future benefits (advertising, promotions and other development expenditure). ROI is susceptible to differing accounting interpretations regarding the measurement of income and investment. By using ROI, one can only judge performance up to the present point of time and not over the whole life of the project. This is because historic costs rather than present values are used. Present values are more relevant because they deal with the future, when the effects of the decision take place. Discounted cash flow (DCF) techniques use present values as decision drivers.

Evaluating brand investment is like evaluating an investment in any other asset: one needs to identify the likely future cash flows to be generated by the asset, its life and a suitable risk adjusted discount rate.

Only the cash flows that are attributable to the brand are of interest, and not those attributable to other asset investments, such as the plant and machinery needed to manufacture the product that is behind the brand image or the distribution network through which the product/brand is delivered to the customer or consumer.

It was agreed among the delegates that identifying the cash flows and a discount rate would not cause many problems. However identifying the life of the investment would. This is because, MARC felt, that managers fail to separate the brand and the product and do not realise that each has its own life.

The Interbrand/Ranks Hovis McDougall approach to brand valuation was discussed. This method relies on the interpretation of the brand's strength and its market position, which roughly corresponds to identifying the life of the brand. However a clear understanding of brand attributes and ways in which the brand adds value to the business is vital; and although sophisticated

techniques such as 'perceptual mapping' were widely used by marketing managers for understanding brands, this information is not being applied to financial evaluation.

Many recognised the high level of subjectivity in evaluating the life of the brand, but nevertheless it was agreed that the management commitment required in this process would be of significant value to the business.

MARC believes that the life of the brand can be split into two stages: development and maintenance. Management should then be able to decide the level of expected performance in each stage and the measurements most appropriate for judging this performance. For example, at the development stage where cash flows are likely to be negative, market share might be a more suitable measure of performance.

A major competitive advantage can be gained by looking at the long-term value of market share. Enhancing cash flows from brand investment, it was agreed, was therefore the main criteria for achieving success.

Brands on the balance sheet - the way forward: Peter Holgate

Peter Holgate discussed the origins of the practice of putting brands on the balance sheet and the accounting regulations regarding the treatment of goodwill and intangibles. The corporate motives behind such actions were also discussed, but the speaker argued that the objective of communicating the existence of brands and the quality of the earnings stream from brands could be represented in the chairman's report, and so would avoid the argument over whether to show created as well as acquired assets and whether these assets should be depreciated. The selectivity and incompleteness of capitalising only a company's strongest brands was also questioned.

Next the methods of valuation were discussed. Basically assets can be valued at historical cost or current cost (there are three methods for current cost: replacement cost, realisable value and present value). All four methods have their problems. The problem with historical cost is deciding what should be the basis of measurement. The lack of a market makes current valuation on the basis of purchase price or sale proceeds difficult, and when using present values the brand cash flows must be separated from the other assets.

The debate over whether to include brand values in published financial statements was set to continue, some delegates argued. It was felt that Australian businessmen such as Robert Holmes a Court had gained significant competitive advantages because of the greater flexibility regarding the accounting treatment of intangibles in Australia. The Australians had exploited this situation and used brand capitalisations as security against which to borrow from their comparatively risk accepting financial institutions and set about acquiring companies in Europe.

With the valuation of intangible assets specifically in mind, a number of other methods had emerged including:

- 1). The amount spent on advertising and product development. This is hard to identify and it could result in an expensive flop being given a high valuation.

2). Replacement cost. However there tends not to be any real market for intangibles. Moreover it is not clear whether replacement cost means the cost of recreating a brand or of buying one already created by someone else.

3). The market value of the brand. Again, there may be no real market.

4). Marginal or premium pricing. This appears attractive in theory, but hard to implement. One needs to consider for how long the brand is likely to generate cash flows, what premium (additional revenue) should be assumed, what volume will be obtained and what discount rate should be used.

5). Discounted value of future profits. This has doubtful validity, because discounting profits values all the assets used in production and sale of the goods rather than just the brand assets. We are interested in brand cash flows.

6). The Interbrand method. The key factor in determining the value of the brand is its profitability over time. Only the elements of profitability resulting from the brand's identity are included, but the ultimate figure is based on a three year weighted average of past earnings and so is dubious for this reason.

7) Capitalised royalty income. Royalty is a proxy for premium pricing, what someone else is willing to pay. However this assumes the brand is about pricing rather than volume; and in some cases the value of a brand may be more to do with extra volume than premium pricing.

Peter Holgate believes that, because none of the above methods is precise, it is advisable to calculate brand values under a number of methods to see what relationship the results bear to each other.

Brand accounting survey findings: Richard Neal

The main conclusions of a survey of managerial attitudes to accounting for brands was presented at the workshop. Below is a more detailed analysis of the findings.

The findings were based on interviews with senior finance and marketing managers at the corporate and divisional levels of a number of multinational organisations in the food and beverages, drugs and publishing industries.

It was recognised in all the organisations surveyed that the use of the brand to differentiate the product from the competition was a major source of competitive advantage today. This result was not surprising however in view of the organisations that were selected.

Four key variables were identified in developing a brand image: product, price, packaging and advertising. The first two could be said to correspond to the functional characteristics of the brand as described by Leslie de Chernatony, while the latter two were representative attributes.

The balance of these variables has different implications for controlling investment in the brand. With product and price the objectives must be to maintain consistent product quality but minimise costs and maximise profit. The impact of a change in price on the consumer will be quick, so the time scales under which the manager must operate are shorter.

With packaging and advertising as the key components one is dealing with more intangible characteristics, and with it taking longer to achieve a desired level of awareness with the customer, the time scales and therefore the life of the investment are longer.

Two distinct perspectives emerged regarding the significance of brand accounting. These were from the corporate perspective and from the divisional perspective.

Generally speaking the two perspectives that emerged were thus:

(a) The corporate perspective argued for the capitalisation of brand values on the balance sheet. It appeared that this was an acceptable way of accounting for growth by acquisition without damaging the balance sheet.

(b) The view of divisional managers was somewhat different to that of their corporate counterparts. They essentially saw brand values as aids to managerial decision-making, for performance evaluation and control of brand investment. This allowed the managers to focus on creating competitive advantage in the market place. The balance sheet was irrelevant for these purposes: cash flows were more important.

At the corporate level, the capitalisation of acquired brands to avoid the writing off of goodwill to reserves was a universally agreed financial benefit of brand accounting; that is the Grand Metropolitan approach, which, to all intents and purposes, was to recapitalise the £560m goodwill previously written off after the Heublein acquisition in 1987. The reserves would then be protected at future acquisitions. The company admitted that the primary purpose of this exercise was to solve a balance sheet problem which had arisen because of GrandMet's activities on the acquisition field. There had therefore been no incentive to capitalise created brands.

The protection of reserves was considered particularly important in publishing acquisitions where about 90% of the purchase price represented goodwill, or the value of publishing titles.

A constant reduction in reserves also puts a restriction on the payment of dividends. The level of payment of dividends is limited to the value of net assets minus share capital plus undistributable reserves (s264 Companies Act 1985).

The other major benefit given for the capitalisation of intangible assets was the lowering of the gearing level and the possible increase in the borrowing capacity of the business that an increase in the asset base would bring. This argument was though dismissed by some because bankers were

considered more sophisticated than just to rely on published information for making lending decisions.

Hanson's approach of getting its shareholders to veto an increase in borrowing capacity after including previously written-off goodwill in its gearing calculation was found to be a suitable alternative.

Although an organisation's short-term financial position could be improved by putting brand values on the balance sheet, there was also a major drawback: marketing expenditure, if treated as an investment and capitalised, was no longer tax allowable; and if anything was a certainty in the world of business and finance, it was that companies "would do anything within their power to minimise tax payments", confessed one senior finance executive.

While managers at the corporate level were clearly concerned with the impact of financial transactions and financial reporting on the capital markets, the strategic implications of good brand accounting information were acknowledged by those managers with responsibility for the management of brands, namely divisional managers.

One division of a major multinational organisation that was visited was developing more sophisticated systems for evaluating marketing investment by using a discounted cash flow model. The company was then able to develop long-term plans against which the more short-term objectives set at corporate level had to be balanced.

Control of the brand was far more difficult, this company said, although the importance of the quality of advertising and distribution were recognised as critical success factors. Analysing brand cash flows in the short-term was considered not to be a problem, but over the longer term it proved more difficult, perhaps because of a lack of understanding of product and brand life-cycles and a failure to differentiate between the two.

The development of a good brand accounting system for aiding strategic decision-making and brand planning was recognised as being of vital importance, allowing companies to place an emphasis on investment in and performance of key brands. One company admitted that it had "missed good opportunities in the past to develop new brands and invest in existing, underdeveloped brands because of a lack of good accounting information".

The existence of two distinct interests in brand information and brand accounting systems - one as a way with dealing with the inadequacies of the financial reporting of *acquisitions*; and the other as a means of making better decisions about the *organic* development and maintenance of brand investment - could clearly lead to areas of conflict. This issue was raised at the workshop. Would growth by acquisition be preferable to organic growth because, by capitalising the acquired assets, there is a way of accounting for this growth without damaging the company's short-term financial position? While it was accepted that corporate and divisional management may perceive the role of brand accounting systems differently, strategic decisions are not made on the basis of what will happen to the group's financial reports, although what happens in the short-term is still important. It does not matter how good the long-term picture looks, the short-term still has to be negotiated.

Despite this response, the influence of financial reporting requirements on management decisions and the provision of management accounting information is evident and this is an area which the author is currently investigating.

One other issue which was discussed during the interviews was the future of the Accounting Standards Committee (ASC). There was general disillusionment with the ASC and its response to the brand accounting debate. There were calls for a full-time, fully paid committee to be set up that was able to keep in touch with the reality of accounting for a large organisation in a competitive environment, and which could also react quickly to requests for guidance on problematic subjects like accounting for brands.

Valuing the brand and applying brand valuations: Keith Ward

Keith Ward clarified the role of the balance sheet as a reconciliation statement, reconciling the profit and loss account and the funds flow statement. It was not a valuation statement. To use the balance sheet as a valuation statement would require casting aside the prudence concept and saying that the value of a business is the net present value of the future cash flows from the business (i.e. includes future profit streams) or the net realisable value of the assets if the business was broken up. The market value of the business should reflect the relevant valuation basis for the business.

The key problems are communication and credibility. Companies must communicate their long-term brand strategies clearly to the City so that the analysts can judge the likely success of this strategy on the basis of short-term performance indicators.

Investment appraisal and control

The first application of brand valuations is investment appraisal and control. In justifying long-term capital investment one needs to allow for the risk level and the time value of money, and also recognise the low rate of return and long life of brands. Also it must be realised that many investments in tangible assets hinge for their financial justification on the success of brand strategies. DCF techniques, because they account for these factors, are therefore more appropriate than ROI measures.

Performance measurement

Brand values are driven by relative external total long-term economic performance. However brand performance is often used as a relative internal controllable short-term managerial performance measurement. These two measures are not irreconcilable provided correct internal controllable short-term performance measures are used which fit into the total long-term strategy for the brand.

For the purposes of measuring managerial performance the impact of managerial decisions on brands should be evaluated or else very bad decisions can follow. For example using ROI (based

on tangible assets) as the prime performance measure can lead to distributor brands being produced to fill 'spare' capacity in the short-term and enhance short-term ROI, but to the detriment of the value of the manufacturer's brand and hence it would threaten the long-term competitive position of the organisation.

Competitive analysis

The key to brand values is external relative performance over the long-term. This requires measurement and incorporation into brand and marketing strategies. This is an iterative process as competitors' moves may require changes in our strategies to maintain or build brand values. Therefore accounting systems should be competitor focussed: there should be less emphasis on measuring internal efficiency and more on competitive effectiveness. This does not involve simply monitoring expenditure levels but also requires relative comparison of brand value drivers. Organisations need to know their brand attributes and those of their competitors' brands to differentiate from the competition.

Conclusions

The aim of the strategic brand accounting workshop was to draw on the combined academic and empirical resources of MARC and the practical experience of the delegates present at the workshop, to reflect on the events that had occurred in the field of brand accounting and to contemplate what might happen in the future.

MARC believes that the real value in brand accounting will not be achieved so much by resolving the current controversy over brands in the published accounts, but from the enhanced understanding of the brand cash flows and the competitive advantage to be gained by organisations through effective brand management.

Management accounting within the business therefore has to be developed to account for the life-cycles of brands, brand cash flows and performance evaluated against standards based on these criteria.

In considering the accounting information requirements for managers responsible for brand investment, it was recognised that cash flows were of far greater importance than published financial information for use in marketing decision-making to measure brand performance, motivate managers and undertake competitive analyses.

While it was desirable to be seen to be performing well in the short-term, competitive advantage should be sought by following the lead of the Japanese and now also the Americans and looking at the long-term value of market share. In today's competitive global environment enhancing cash flows from brand investment was therefore the main criteria for achieving success.

One of the delegates at the MARC workshop, Peter Cartmell of Cadbury Schweppes, is leading the ASC working party which is looking at the area of accounting for intangibles.

MARC continues to monitor developments and explore and develop new techniques in the area of strategic brand accounting. MARC has also contributed through the penmanship of its chairman, Keith Ward, to a book on the subject. It is entitled "Brand Valuation: establishing a true and fair view" edited by John Murphy of Interbrand and it also includes contributions from Martin Moorhouse of RHM. The book is published by Hutchinson.

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