

**SWP 45/89 THE STRATEGIC USE OF BRAND  
VALUATIONS: THE REAL ISSUE  
OF BRAND ACCOUNTING**

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**The strategic use of brand valuations: the real issue of brand accounting**

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"Brand valuation ... is a unique management tool ... [aiding] brand planning and the determination of advertising and marketing strategies."

This statement from Ranks Hovis McDougall's 'defence document' on brand valuation (issued January 16, 1989) is of far greater significance than any other utterance or action concerned with the large but fundamentally misguided debate around brand accounting over the past 12 months. Many financial commentators and the accounting profession may still not be satisfied with RHM's method for valuing its brands, but in recognising that brand valuation has other applications apart from the capitalisation of intangible assets to improve the structure of the balance sheet, RHM's statement should make the financial community realise that how the financial statements look at the end of each year is not the be all and end all of running a business.

There have been strong suggestions by David Tweedie and Jeannot Blanchet (*Accountancy* January 1989, pp20-22), amongst others, that the accountancy profession must urgently consider the objectives of the balance sheet and re-examine the rules for accounting for goodwill. Such calls have been prompted by companies trying to limit the damage done to their balance sheets by high premium takeovers.

The balance sheet should be seen as an historical cost statement which allows inter-company comparability of financial information, and it should reconcile the profit and loss account to the cash flow statement. Agreement on the role of the balance sheet would focus the attention of companies on maximising shareholder wealth by other means than by creative accounting; for example, by following an effective marketing strategy, which is surely the key to competitive advantage in the long-term. For marketing managers to make effective decisions they require accounting information relevant to their needs: because brands are so important to a business,

systems that account for brands are therefore a necessary aid to strategic marketing decision-making.

Thus one of the main requirements for improving the competitiveness of UK companies is for accountants to focus less on the preparation and presentation of accounts for shareholders and more on the accounting information requested by managers within the organisation. This is not to suggest that accountants and auditors should fail to fulfil statutory obligations. They still need to prepare annual accounts to comply with the Companies Act. What it means is that accounting standards should be developed to recognise the long-term nature of many business decisions especially in marketing activities where management cannot expect a return from marketing investment in brands and customers in a short period. Reed International, the forward thinking publishing organisation, is presently giving thought to this. "Companies must ask themselves whether accounting principles should still dictate the running of the business," says Mr Reg Plumb, Reed's Chief Accountant. Indeed one of the underlying accounting principles, namely the going concern concept, acknowledges this essential long-term strategic need.

Many accountants still remain sceptical about marketing expenditure being treated as a long-term investment. To them Grand Metropolitan and RHM's belief that positive cash flows will be generated by their valued brands indefinitely and that the normal level of annual marketing expenditures represents the cost of maintaining the brand in this position must seem over-zealous as they think back on the fate of Double Diamond, Woodbine and Park Drive. But in today's business environment organisations should not be straitjacketed in their approach to the treatment of marketing expenditure which may lead them towards making a gain in the short-term at the expense of long-term growth through brand development. Companies should be marketing orientated and their management accounting systems market-facing and product, brand and customer focused. In dynamic, but mature markets where a sustainable technological edge is a rarity and there are relatively few cost or product advantages to be gained, most products appear fairly homogeneous. Therefore to create a competitive advantage firms invest more in the 'product surround' or the intangible benefits of the package - brand image, customer service. That is why

accounting systems that help companies make such investment decisions and then monitor the actual results are so important.

Also, consumers have become more sophisticated and demanding of manufacturers and retailers. They too realise the similarities in product design and capability, and so tend to base their purchasing decisions either purely on price, thus relegating the product to a commodity, or by relying more on the intangible factors. Companies that are marketing orientated have increasingly realised this and in an attempt to prevent their products from becoming commodities they spend more on their brands, both in developing and maintaining the awareness of the brand and its attributes by the consumer.

Organisations with marketing orientated accounting information systems have also increasingly noticed the importance of differentiating marketing development expenditure, which is incurred to develop a brand and to gain market share, from maintenance expenditure which is incurred to maintain market share and brand image at a desired level (see Figure 1). GrandMet has recognised this distinction by acknowledging that brand maintenance expenditure, which can be included in advertising and promotional activities, is akin to the cost of using an asset; i.e. depreciation. The fact that GrandMet has not recognised development expenditure of created brands reflects an overriding concern with the published balance sheet and a consequent desire to protect its stated reserves after an acquisition involving a large element of goodwill which was immediately written off to reserves. The greater usefulness of measuring and differentiating between all marketing expenditure, including that spent internally, has thus apparently been ignored.

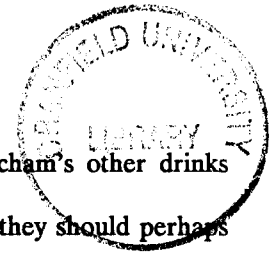
The damage to the business that a short-sighted approach to marketing investment might cause can be illustrated by the matrix in Figure 2, which compares the rate of marketing investment in a brand with its market share over the product's life. A company launches a new brand, the strength of which is low at this early stage of its development, but the potential for market growth is high. The company spends a lot on investing in the new brand to try to increase brand awareness and so build market share. Cash flows at this stage are negative (the brand is in quadrant A). As brand

spend continues so the brand's market share increases, generating revenue to pay for the initial investment in the brand. The company has now reached a crucial stage (quadrant B). The brand is just starting to make positive cash flows, but market share growth is decelerating, and for market share to be maintained or increased, further brand investment is needed. The marketing managers may be confident at this stage that an increase in brand spend over the next 12 months will reap handsome benefits in 2-3 years time. Their desire is to move the brand over this period into quadrant C, where high market share is achieved for a low investment, relative to the volume of sales generated.

On the other hand, there are the company's finance managers who realise that if the expenditure on the brand is reduced, the awareness already created will be sufficient to maintain the current level of sales in the very short-term (say the next financial year), and because the company would then be spending very little on supporting the brand, high positive cash flows and accounting profits would be generated in this period. Hanson, for example, is stated as making big short-term profits by slashing advertising budgets on acquired brands (source: *Economist*, December 24, 1988, p103). However, without an increased level of brand investment after this short period of harvesting the source may well dry up with future potential revenues unrealised and market share declining irretrievably.

Logically therefore, companies that wish to continue to compete effectively in the long-term should treat the brand as part of the inherent worth of the business and invest in the brand to ensure this life-line is not severed, but not expect a high return initially from any new investment. Unfortunately, accountants, in trying to provide the City with the short-term strategic performance indicators it requires, dictate that the latter path is followed.

The investment in the brand needs to continue indefinitely, or else the marketing managers' adage, "products have life cycles, not brands" will not hold. Beecham's *Lucozade* and *Ribena* are two examples of famous brands that were neglected, whose market share had fallen because of little brand investment. They have now been revitalised by new investment in the brand and by



substantial product development. (They were also not sold along with Beecham's other drinks businesses.) So when accountants quote *Double Diamond, Woodbine et alia*, they should perhaps ask themselves whether they were as much responsible as the marketing or production managers of the companies concerned for the destiny of these brands.

Devising an accounting system that can account for the assets created by marketing expenditure requires the integration and coordination of accountants and marketing managers who, traditionally, have been reluctant bed-fellows. There is then the need for a change of attitude on both sides, and the accountants, because of their influential position on this issue should lead the way.

The formulation of a brand accounting system will provide accounting information relevant to the needs of marketing managers. A valuation of brands which is incorporated in this system would enable the managers to decide the level of brand investment required to hold or gain market share, or to increase revenue; in other words, to achieve the organisation's objective.

How does a company approach the problem of valuing its brands for these purposes? At the heart of the argument on brand accounting and valuation is the problem of defining what a brand actually is. If the brand is merely seen as a natural extension of the production process, namely the 'label' attached to the product, then the value of the brand element is represented by the excess value created by the additional costs of the brand's packaging and marketing over that spent on unbranded products. This added value is normally reflected in the premium price charged to the customer. From the accounting perspective, the costs of the packaging and marketing are seen as a necessary part of the production and distribution process, and so are expensed in the current accounting period. The perceived level of investment in the brand is normally low, in that direct marketing support levels are often minimal. The managers hope that the brand will differentiate the product enough to achieve high market share.

On this basis it should be relatively easy to measure the performance of the brand in terms of the profit from the 'added value' element, and to control the brand expenditure by looking at the effects on profits and yields; in other words to measure the *efficiency* of the brand achieved by minimising the costs of the added value and by maximising the profit. The brand is in effect a fairly tangible factor.

To regard a brand in this light may all be very well if the product is new. But the objective of the business should be to develop the brand so that it is capable of being completely divorced from the product: a 'brand image' is created, and the consumer becomes more aware of the brand name than the product, for example *Hoover*, where the product category is synonymous with one brand. Such a successfully created and effectively managed brand image becomes an integral and valuable part of the business, and it can be transferred to new products or line extensions. Its performance can be measured in terms of the *effectiveness* of the image on the consumer over a long period. The problem is identifying the elements of investment specific to one individual brand. One objective of the company should be to achieve high market share for a relatively low investment (quadrant C in Figure 2).

Efficiency is measured by relating the input resources consumed (in this case the incremental costs of packaging and advertising) to the outputs achieved (additional sales and profit). Effectiveness measures how much these outputs contribute to the corporate objective (increased market share). So to achieve the desired goals with minimum input resources management should be monitoring levels of both efficiency and effectiveness. Unfortunately the traditional short-term requirements of reporting systems has meant that there has been undue emphasis on controlling efficiency.

A common measure of managerial and divisional efficiency is return on investment (ROI). However, the inconsistencies and manipulations that can arise in defining 'return' (the adjustments that are made for depreciation, inflation, interest payments) and the fact that investments are measured over the short-term, when a better judgement of investment in terms of managerial performance would be obtained by taking a longer-term outlook, makes ROI an unreliable guide to

the performance of the organisation's managers. Often factors are included in the measurement over which the manager concerned has no control; for example, short and long-term debt may be negotiated at corporate level and then allocated to each division or cost centre.

By concentrating on efficiency, management is paying little attention to whether it is on the road to achieving its desired goals in the long-term. What is needed is a measurement that monitors both efficiency and effectiveness. Net present value (NPV) is one such measure, where investment is evaluated over a long period (say 10 years) in terms of the cash flows it generates over that period, discounted back into current values and subtracted from the amount of the investment. Unfortunately information on cash flows and the discount rate (incorporating a 'risk' factor) to be employed cannot be obtained using the same accounting information collected for use in the published financial statements. Therefore the organisation requires internal accounting systems that can measure investment in marketing including brands, as well as in other functions.

While RHM can be praised for recognising not only expenditure associated with both acquired and created brands, as represented in its balance sheet, but more importantly the role brands can play in internal management and control, its chosen method of valuation is not without criticism. The use of historical earnings in the calculation would seem to suggest that the company is still influenced by short-term accounting principles. In trying to satisfy the accountancy profession and the City on one hand, and the needs of its own managers on the other, RHM has fallen between two stools and in the end satisfied neither party. By deciding that accounting information for internal management is of greater importance than that required for external purposes, RHM would be able to adopt a more realistic approach, such as applying a multiple to average sustainable cash flows for the next 10 years. Prudence, as required for published financial statements, in this context is irrelevant. If the cash flows are over-estimated and the brand is therefore overvalued, management can subsequently revise their estimations and reappraise the investment.



RHM have also assumed that each of their brands can be isolated and valued separately. But how have they apportioned the investment in management expertise, in research and development, in the distribution networks and in the other support systems that have been provided for *all* of its brands? Individual brands cannot be treated independently from this corporate infrastructure. As Robert Heller writes (*Management Today*, January 1989, p29), "brands aren't just brands, they are businesses involving people, technology, production facilities, distribution, and much else in addition to the customer franchise nurtured down the years."

Without an analysis of this infrastructure it becomes impossible for companies to make comparisons with competing brands. But management can still look at the structure of its brand portfolio to determine its most valuable brands, something which many companies without brand accounting systems fail to do, to their disadvantage. Because of the amount of management resources needed by each brand, there is, says Heller, a limit to the number of branded businesses that can be effectively run by central management. Heller believes that financial manoeuvres involving intangible assets and reserves are attempts at covering up undermanaged subsidiaries. Playing with balance sheets is irrelevant to the real task of management, which is to extract value from brands and other assets to ensure long-term growth and returns.

Unfortunately management efforts to run the business on a long-term basis will continue to be compromised by the mistaken belief that the City is only interested in short-term performance. It is time that managers realised that the City does in fact accept that effective long-term strategic planning is crucial to the success of the organisation. There is evidence in the US (see *Fortune International*, November 21, 1988, pp30-35) to suggest that a longer-term perspective, more in line with the Japanese approach, is now favoured and that institutional investors place considerable value on future profits. Coca-Cola was described by an admiring consultant as being "as good as any company at understanding the long-term value of market share and incorporating that into decision-making". It has made a series of major investments in recent years, that will take years to pay off, to protect market share in the US and to expand and restructure its overseas operations. Coca-Cola's shareholders, along with others in the US, have faith in this long-term approach to the

running of the business: a comparative analysis of share prices with the present value of the next five years' dividends has revealed in many cases large differences which reflect the long-term payout that investors anticipate (source: Alcar Group 1988).

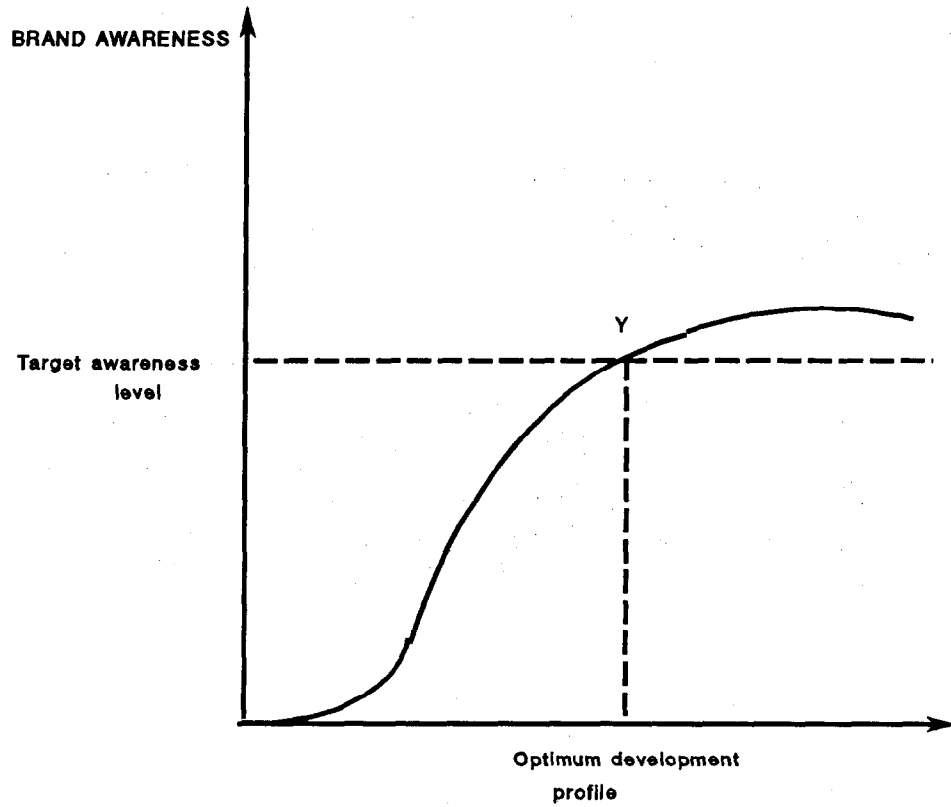
In this country, in complete contrast, financial institutions now seem to make investment decisions more on the basis of whether cash flow can cover the immediate interest and dividend payments, rather than on the long-term prospects of the investment being repaid.

The argument over brand accounting has made manifest the inappropriateness of accounting philosophy towards the management of the organisation in today's business environment. This is in part due to financial managers' misunderstanding of the objectives of the City, which does in fact recognise the long-term. The value it attaches to companies (the share price) reflects the present value of future cash flows generated by all the assets of the business regardless of whether or not these are shown on the balance sheet. Hence the role of the balance sheet is not to show the current value of the company. Many organisations feel that they are under pressure from the City to perform well in the short-term because they fail to communicate their strategic aspirations. The misunderstanding has arisen because the City does look for short-term results, but only as a means of discovering what the potential strategic performance of the business is likely to be. So if a company is investing heavily in brand development but it fails to inform the City that this will be expensed in the current year, the resultant downturn in the company's short-term profitability will be interpreted by the City as an indication that the business is faltering and that its future is not looking good. The company's share price will thus be marked down.

This confusion is a major problem that the ASC's waiting game will not solve. The message that must be put across is that putting brand values on the balance sheet is not the fundamental issue in brand accounting; their use in strategic decision-making and managerial control is.

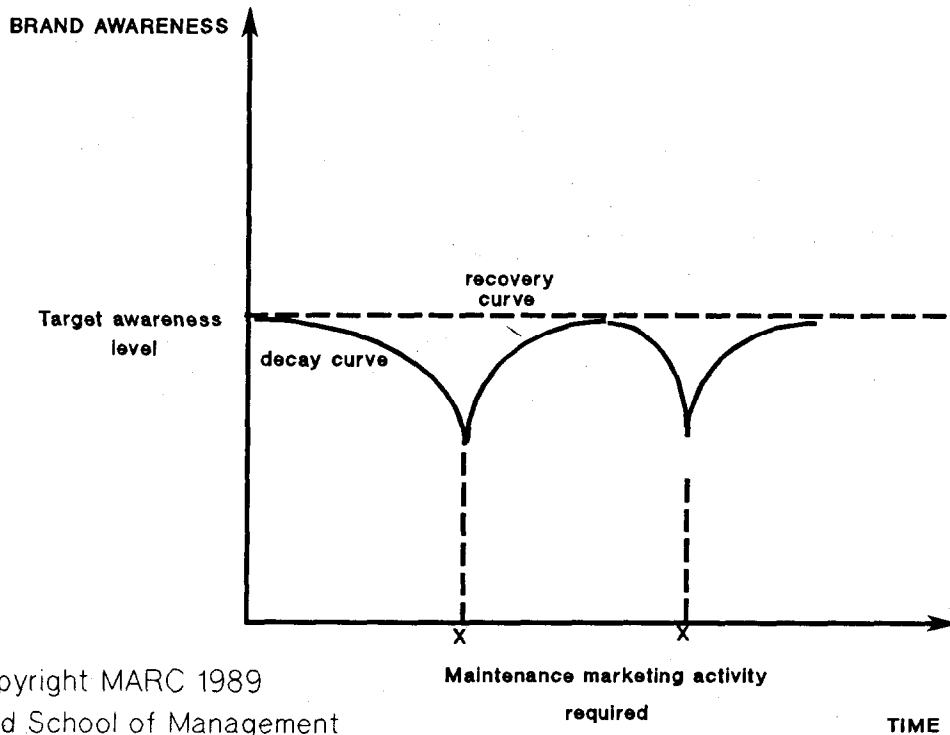
FIGURE 1: Brand Development and Maintenance Expenditure Profiles

(a) Development expenditure profile



DEVELOPMENT EXPENDITURE  
Explanatory note: beyond point Y, the cost of raising awareness to a new, higher level increases disproportionately.

(b) Maintenance expenditure profile



**FIGURE 2: Market Share/Brand Investment Matrix**

