



1402782448

SWP 46/89 MARKETING ASSET ACCOUNTING

**SRI SRIKANTHAN & RICHARD NEAL
Marketing Accounting Research Centre
Cranfield School of Management
Cranfield Institute of Technology
Cranfield, Bedford MK43 OAL
UK**

(TEL: 0234 - 751122)

Copyright: Srikanthan & Neal, MARC, 1989

MARKETING ASSET ACCOUNTING

Introduction

With competition growing ever more intense, organisations have in recent years begun to realise the importance of the marketing function in defining profitable products and markets. There is also a growing awareness of the assets of marketing - customer lists, publishing rights, trademarks, brand names - that these assets should be recognised as such and that the costs attached should be reflected in their value and not simply accounted for in the year's profit and loss account.

The fact that marketing asset accounting is such a new field is in the main due to the misunderstanding and mutual mistrust that has existed between accountants and marketeers within the organisational structure. The managerial, professional, bureaucratic 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 that end: costs must be identified and regulated at every level.

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

In today's business environment, an integrated marketing accounting approach is essential for a company's survival. To shift the bureaucratic paradigm requires give on both sides; this has been slow to happen. While many organisations are now more externally geared towards satisfying the consumer, there has been little change within the corporate body: costing systems are still unsuitable for a market-orientated organisation. The accountants are reluctant to accept the existence of marketing assets; and the marketeers rely on initiative rather than financial guidance to construct the firm's marketing strategy.

The major obstacle to overcome is the attitude of the accountancy bodies, who refuse to accept that there is no longer a place for a rigidly bureaucratic, prudent structure in business: even the bastions of the traditional business values, the banks, now realise this fact.

Intangible marketing assets are so valuable to a company because they are more directly related to the customer than tangible assets. There is no point in having the most advanced item of machinery to produce your products if the consumer will not purchase them. It is the role of the marketing personnel to ascertain whether the products will be accepted by the consumer or to persuade him that he should accept them. 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. If for example a company with the same net book value for its assets as Rowntree produces a chocolate coated wafer snackbar which rivals 'KitKat', Nestle would not have paid nearly as much to purchase this hypothetical company as it did for Rowntree. This is because it has placed a value on 'KitKat' and Rowntree's other brands which is not recognised on the company's balance sheet.

Several organisations are advocating, indeed some have already acted, to capitalise their brands and other intangible marketing assets. The Accounting Standards Committee (ASC) is the hurdle to climb before this practice becomes widespread.

Some explanation for the ASC's refusal to accept that marketing assets have a place on the company balance sheet can be found in the accounting treatment of another intangible, research and development (R&D).

The need for an accounting standard to cover the treatment of R&D expenditure became fully apparent when Rolls-Royce was liquidated in 1971. The problems for Rolls-Royce began back in 1961, 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 R&D costs. So the directors decided 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."

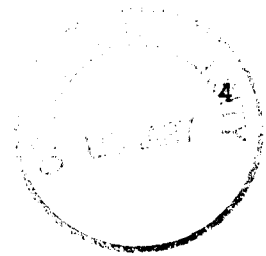
While the directors may have been adopting the 'matching' (or 'accruals') concept, there can be no doubt that their actions were not prudent, particularly when the RB.211 programme was in full swing in the late 1960s and it became clear that the costs of R&D and the matching revenues could not be estimated with any degree of accuracy or certainty. This was mainly because no prior research into the RB.211 had been carried out.

The financial implications of this accounting policy are clearly highlighted by the Rolls-Royce accounts for 1967 (1), which showed a trading profit after interest of £17.5m; the company spent £9.6m on R&D, but 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. As more and more funds were poured into the RB.211 programme, the liquidity position worsened culminating in the arrival of the receivers in 1971.

Against this background, the ASC started work on producing a standard on this topic. SSAP 13 was published in 1977, and was legally affirmed by the Companies Act 1981. Companies are not allowed to treat the costs of research as an asset in the balance sheet, and only in special circumstances can development costs be capitalised if the matching revenue can be anticipated with reasonable certainty. In the ASC's opinion, the future potential benefits of development expenditure can only be evaluated if there is a clearly defined project and the related expenditure is separately identifiable.

The uncertainty attached to matching R&D costs and revenues can in a sense 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 difficulties 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.

However, surely companies like GrandMet are not attempting to put a value to something so intangible that these benefits will not arise. It is perhaps less reputable companies that the ASC is targeting, who find themselves in financial difficulty like Rolls-Royce was, and who, to increase their asset value, capitalise a brand. This is all very well if that brand will continue to reap benefits indefinitely; but if that brand turns out to have little or no worth and the company has used the extra asset value as security against which to borrow, then it will be struggling to repay its debt.



1. SSAP 22 and the legal considerations

Recommendations for accounting for marketing assets can be found in SSAP 22 'Accounting for goodwill' (issued in 1984). The standard requires that purchased goodwill should normally be eliminated from accounts by immediate write-off against reserves, so as to be consistent with the treatment of non-purchased goodwill. Under no circumstances does the standard allow non-purchased goodwill to be carried forward on the balance sheet. This, say the ASC, would be anticipating gains yet to be realised.

However the standard does recognise that there is an alternative way of looking at goodwill: although goodwill is intangible, it does exist, and when a business is purchased the price paid includes an amount attributable to the purchase of that company's 'goodwill' or other intangible assets, such as brand names. Thus capital has been used to buy an asset, and this asset should be recognised and treated in the same way as any other asset: it should be capitalised and then amortised over its economic life. The ASC advises in the notes to SSAP 22 that in determining the useful economic life of purchased goodwill, the effects of subsequent expenditure or other circumstances affecting the company after the date of acquisition, should *not* be taken into account, since this would have the effect of creating non-purchased goodwill.

Unfortunately this recognition by the ASC merely serves to highlight a double standard: a company, such as Rowntree, that develops its own brands is not permitted by SSAP 22 to show their value in the accounts, but a predator (Nestle) can come along, offer way over the paper value for Rowntree's assets (in recognition of the value of the company's brands), and then be entitled to include its recently acquired brands as an asset on its balance sheet.

This situation not only fails to show the true value of a company with developed brands and so make it vulnerable to take-over, but it actually encourages companies to purchase rather than develop their own brands; and it is a situation that can only worsen unless the standard is changed: the costs of setting up a brand from scratch will rise and the chances of failure will increase, and so the value of successful brands must go on increasing.

If a company can identify the intangible assets of another business at the time that it acquires that business, then these assets can be classed as net separable assets and valued as such on the acquirer's balance sheet, and can be revalued to their current cost in subsequent years. If the acquired intangibles cannot be separately identified as, say, research and market development, customer loyalty and brands, they must remain bundled together as goodwill, which may not be revalued.

Of course SSAP 22, in common with other standards, is not gospel, unless affirmed by law. The UK law in this case takes a different line from that laid down in SSAP 22, which was changed in 1981 to accommodate European policy. Schedule 4, Companies Act 1985 allows intangible assets, if they are identifiable as concessions, patents, licences, trademarks or other similar rights or assets (in other words not goodwill as a collective asset), to be shown as assets on the balance sheet, whether purchased or not.

Why is it then that decisions like News International's to put values to its newspaper titles in the accounts (1983), or more recently, Grand Metropolitan's proposals to capitalise its acquired brands, while being quite legal, do not receive the blessing of the accountancy profession?

The attitude of accountants, that all types of marketing expenditure be written off as incurred, is one of the factors that has led to the creation of the 'communication gap' which exists between the marketing and finance functions. Despite the realisation that in today's increasingly competitive environment the

maintenance and development by marketing of products, distribution channels and customers are vital for the continued success of the company, the attitude towards the accounting treatment of expenditure on developmental marketing activity has not changed. It is not surprising that marketing managers become so frustrated when tangible items such as plant and machinery can be classified as assets on the balance sheet even if they are "of no real value" because, say, they do not produce goods which customers are willing to buy at prices which show a satisfactory return on the company's investment; and yet marketing assets of undisputed value, such as Rowntree's 'KitKat' brand name, are excluded because they are intangible.

Accountants' attempts to act prudently by refusing to capitalise marketing expenditure and put values on intangible assets, has led to the ill-conceived marketing strategies described earlier. In the not too distant past, when competition was not as great as it is today, companies could get away with high costs and unprofitable products and markets; but now it is simply not prudent policy for the marketing and accounting functions to be divorced.

There are circumstances though, as has been seen, where intangible values are recognised by accountants, and that is in the case of brands or other intangible assets purchased in a take-over situation. Since a value is attached to the brands as a result of a definitive market transaction, this is considered to be a satisfactory measurement, because, say the accountants, it is capable of objective and consistent appraisal, unlike brands which a company has developed itself.

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 cannot always be taken seriously, and that no-one has yet developed a sophisticated technique for valuing brands, purchased or otherwise.

A valuation of brands does not directly affect the market capitalisation of a company. Yet the market capitalisation reflects the value of shares attributed by shareholders. Their judgement depends on their perception of a company's worth.

So are the ASC right in advising companies to write off and ignore the worth of their brands? Or are companies such as GrandMet right in wanting to show its true value on the balance sheet? Or how about the argument that a balance sheet is not for showing value, but for recording the effect of transactions; and so the undervaluation of Rowntree occurred because the earnings stream which the brands could produce was underestimated?

2. Industrial Practice

The issue of marketing asset accounting was brought to a head recently by Grand Metropolitan's recent move to value for the first time some brand names in the accounts for the year to the end of September 1988. The directors and auditors of GrandMet have agreed to credit those brands acquired since the beginning of 1985 "to ensure a better understanding of the nature of the business."

GrandMet's move is in response to what chairman Allen Sheppard describes as the "absurd situation" whereby accounting practices mean that brands are valued at nil, although foreign take-over bids for brand-rich British companies (Rowntree, Ranks Hovis McDougall) show how much value should be attached to established brands.

GrandMet should benefit from the recovery of value of Smirnoff which the company acquired as part of a £760m acquisition of the US drinks conglomerate Heublein and Almaden (2). The tangible assets GrandMet also acquired were worth just £200m, which required a write-off of £560m goodwill against reserves. Companies like GrandMet which undertake large acquisitions suffer a diminution of net worth as their reserves are eaten away. This will diminish return on equity even though the company's assets are boosted.

The company is not proposing to amortise its brand valuations on a regular basis "since their values should be preserved by the extensive brand support provided."

GrandMet is not however an innovative leader on this front. Reckitt and Colman has fixed a value to acquired trademarks since 1985. There is no annual provision for depreciation of these assets as their useful economic lives are considered not to be limited. Their carrying value is reviewed annually to see whether there should be a reduction to reflect a permanent diminution in value.

To enable expansion into TV and satellite which required heavy borrowing, News International put its newspaper titles on the balance sheet in 1983. When revalued in 1984, they added £88.5m to the balance sheet which provided security against which to borrow (3). 1984 borrowings increased from £44m to £169m. A second revaluation in 1987 realised a further £294m. That year borrowings soared from £974m to £1.8bn.

Without revaluation, News International's gearing (Debt/Equity) would have risen alarmingly from 3.57:1 to 4.4:1; instead it actually eased to 2.47:1 in 1987. The change in accounting policy also improved the company's profit position: instead of writing off intangible assets over 20 years, as had been the case, which resulted in a charge against profits of £500,000 in 1983, the publishing rights subsequently were not depreciated as they were said to have an infinite life.

Rupert Murdoch's moves pose a number of questions. Why did the banks and other lenders accept his valuation's for the intangible assets on which their decision to lend was based? Why did his actions not stir up a hornet's nest among the accountancy profession or in the City, as is now occurring with GrandMet? Are not the economic lives of 'KitKat' or 'Hovis' just as infinite as those of 'The Times' or the 'Sun'?

Another publisher, Reed International, has also capitalised the publishing rights of its leading magazine titles since 1984. These rights were valued at £620m by the end of March 1988, with total shareholders' funds £990m.

Beecham has recently stated that the "brand names of Beecham's quality products are a major

asset...Management concentrated in 1987/88 on furthering market development of these established brands." 'Goodwill' is carried on books and amortised over 40 years, but intangible marketing assets are not separately identified and valued, probably because SSAP 22 'forbids' the capitalisation of developed brands.

Cadbury-Schweppes favours a new accounting policy which will allow the part-capitalisation of its most valuable assets, its brands and its employees. It spent £227m on consumer advertising and marketing in 1987. Such a policy would prevent the understatement of assets per share, and the overstatement of gearing. The company does not account for marketing assets at present because:

- 1) normal UK practice is to write off such expenditure;
- 2) this method is the one preferred in SSAP 22;
- 3) it avoids affecting future profits by making a subjective decision as to the amortisation period;
- 4) it avoids the illogicality of capitalising purchased marketing assets, but not developed.

Cadbury-Schweppes is watching with interest the moves of GrandMet and others.

Conclusions

So where do we go from here? It is as long ago as 1966 that Joel Dean wrote that "advertising belongs in the capital budget..." (5). There clearly is an hiatus between what is in practice required from marketing asset accounting to help value businesses and measure the performance of brands and markets, and what is provided as accounting information for these decisions by accountants.

Should the accounting profession insist on continuing with the existing system on the basis that we must be prudent and consistent? Or should the view be taken that it is the function of accountants to provide information on the 'actual' financial status of the reporting entity to all those who have a reasonable right to such information?

October 1988

REFERENCES

- 1 Ashton, R.K., UK Financial Accounting Standards, Woodhead-Faulkner, 1983, p130.
- 2 Parker-Jarvis, Geo., 'Brands called to account', Observer, September 11,1988, p57.
- 3 Mitchell, A., 'No accounting for brands', Marketing, July 7,1988, p25.
- 4 Mitchell, A., (ibid.), p24.
- 5 Dean, J., 'Does advertising belong in the capital budget?', Journal of Marketing, October 1966, Vol 30 No 4.