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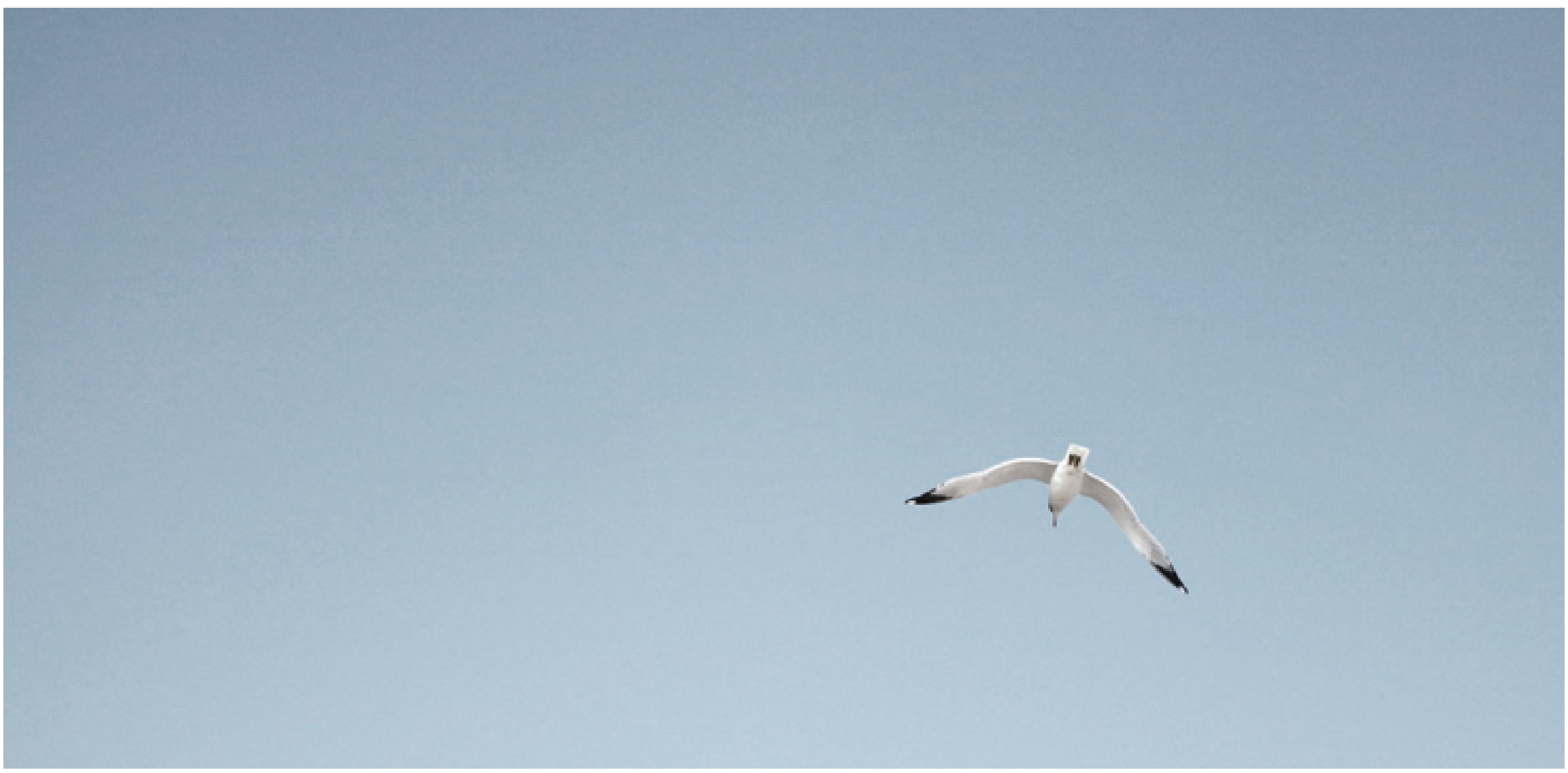

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Aligning Marketing and Finance with Accepted Standards for Valuing Brands

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Abstract

With this paper we hope to create awareness and support among the financial community for the need to have consistent brand measurement and metrics that tie investments in corporate and product brands to financial value. There are many obstacles to overcome before the financial community accepts such brand value measurements. Our initial proposal suggests that brand value created (or lost) by the investment in brands be reported in the Management Discussion and Analysis section of the financial reports. This will promote a consistent methodology for valuing brands for internal management purposes and will provide to all external parties full disclosure about the benefits and value created (or lost) by investment in brands.

Introduction

There has been considerable effort by the Marketing Accountability Standards Board (MASB) to raise awareness regarding financial reporting of marketing intangibles. In many cases, these intangibles have grown to be of significant value, but receive little attention in internal financial and managerial accounting records, nor are they reported to external users of financial statements. Yet, boards of directors and management are allocating resources for marketing activities of the firm with little guidance as to the values created by these expenditures.

Investors and analysts attempt to value and compare firms and try to predict how assets owned by the firms will produce future income with little knowledge of the value of marketing intangibles. MASB was created by the Marketing Accountability Foundation as an independent private sector, self-governing body where marketing and finance align on measurement for reporting, forecasting, and improving financial returns from buyers in markets. MASB's mission is to establish marketing measurement and accountability standards across industry and domain for continuous improvement in financial performance and the guidance and education of business decision makers and users of performance and financial information.

MASB has several projects underway designed to raise awareness of the benefits and obstacles of formalizing the recognition of the brand as a major marketing intangible.

The Brand Investment/Valuation Model (BIV) Project has the objective of providing the critical "missing link" between marketing and financial communities by developing consistent, credible, and actionable brand valuations through the establishment of "generally accepted brand investment and valuation standards," using metrics that are simple, transparent, relevant, and calibrated across categories and conditions and that reliably tie marketing actions to customer impact, to market outcomes, and to financial returns both short term and over time.

The Brand Investment/Valuation Marketing Communication Project has a goal of effectively clarifying and communicating the operational importance of the BIV Project to all constituencies.

The Improving Financial Reporting (IFR) Project has as its goal to facilitate partnering with the financial reporting and investment communities for improving the accounting and/or reporting rules related to marketing such that financial returns from corporations will be driven and measured by buyer behavior in markets over time and to ensure that marketing is at the table when reporting of brand value is required for internally developed brands.

The current landscape

The implementation of a goal of reporting brand values is not without hurdles since a significant change in accounting practice and reporting will be necessary. Both the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) have been very reluctant to depart from the current practice of deducting most advertising and marketing expenses as ordinary operating expenses.

For accounting (and tax) it is assumed that advertising costs incurred in anticipation of future probable economic benefits are usually expensed currently because the benefit period is presumed to be short or the periods in which economic benefits might be received or the amount of economic benefit cannot be determined easily and objectively. As such, internally developed (self-created) assets are not recognized as assets in the accounting records. Intangible assets acquired in a business combination are measured and reported in the financial records under both FASB and IASB standards.

Marketing assets

With respect to branding and other marketing intangibles there are noticeable inconsistencies between the treatment of purchased intangibles and internally developed intangibles. Additional characteristics should also be noted. Internally developed intangibles are always carried on the books at adjusted historical cost and are not written up to market. Likewise, purchased intangibles are recorded at cost and are adjusted down by amortization or impairment and never written up to market.

The current debate about whether or not intangible assets such as the brand can be recorded on the balance sheet in situations where economic value was created as a result of prior expenditures shows a large gap between those who espouse such treatment and the policy makers at FASB and IASB. Recording assets at fair value using Generally Accepted Accounting Principles (GAAP) or International Accounting Standards (IAS) is generally limited to marketable securities and write-downs for asset impairments.

It is felt by many marketing professionals that the balance sheet does not adequately reflect the fair value of marketing assets or in most cases does not even reflect the existence of an asset. Most feel that such a treatment falls short of information necessary for evaluation of areas such as marketing effectiveness, investment and portfolio optimization, asset management, and benchmarking.

Recording marketing assets on the balance sheet under mark-to-market accounting may not occur for several years. Development of a model for recording internally developed marketing assets that measures fair value is critical to its acceptance by FASB and IAS. The fair value concept focuses on the price that would be received upon the sale of an asset or paid to transfer a liability. It is an exit price rather than a price that would be paid to acquire the asset or received to assume the liability, called an entry price. In other words, fair value is a market-based measurement, not an entity-specific measurement. A fair value measurement should be determined based on assumptions that market participants would use in pricing an asset or liability.

Valuation issues

For both FASB and IAS, valuation techniques that are consistent with the market approach, income approach, and/or cost approach are used to measure fair value. A market approach uses prices and other relevant information generated by market transactions involving identical or comparable assets or liabilities. A valuation technique consistent with the market approach might be one that uses market multiples derived from a set of comparables. The income approach uses valuation techniques to convert future amounts to a discounted present value amount. The techniques include present value models, option-pricing models, lattice models, and the multi-period excess earnings method. The cost approach is based on the amount that currently would be required to replace the service capacity of an asset (current replacement cost).

There are many inputs (assumptions) that market participants use in pricing an asset or liability. These include assumptions about risks inherent in a valuation technique and/or the risks inherent in the inputs to the valuation technique. These inputs are classified as observable and unobservable. Observable inputs are inputs that reflect market participant assumptions based on market data obtained from sources independent of the reporting entity. Unobservable inputs are inputs that reflect the reporting entity's own assumptions about market participant assumptions that would be used based on the best information available in the circumstances. There is a hierarchy that prioritizes the inputs to valuation techniques used to measure fair value. These are prioritized into three broad levels.

- Level 1 inputs are quoted prices in active markets for identical assets or liabilities that the reporting entity has the ability to access at the measurement date.
- Level 2 inputs are inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly. Level 2 inputs include the following:
  - Quoted prices for similar assets or liabilities in active markets.
  - Quoted prices for identical or similar assets or liabilities in markets that are not active.
  - Inputs other than quoted prices that are observable for the asset or liability (for example, interest rates and yield curves observable at commonly quoted intervals, volatilities, prepayment spreads, loss severities, credit risks, and default rates.
  - Inputs that are derived principally from or corroborated by observable market data by correlation or other means.
- Level 3 inputs are unobservable inputs for an asset or liability. Unobservable inputs are used to measure fair value to the extent observable inputs are not available. This allows for situations where there is little or no market activity for the asset or liability at the measurement date. Unobservable inputs are developed based on the best information available in the circumstances. This might include the reporting entity's own data. Unobservable inputs are intended to allow for situations in which there is little, if any, market activity for the asset or liability at the measurement date [FASB (2006), IFRS (2011)].

In addition to the general fair value models from FASB and IAS and specific branding commercial valuation models such as Brand Finance, CoreBrand, Interbrand, and Millward Brown, other models have been proposed, notably International Organization for Standardization (ISO), Monetary Brand Valuation (ISO 10668), and International Valuation Standards which issued International Valuation Standards (IVS) -2011. This study sets standards for the valuation of a wide range of assets, including intangibles.

In order to persuade the FASB and the IAS that marketing assets should be reported at fair value in the financial statements, a valuation model must be developed that has the characteristics consistent with fair value inputs prescribed by FASB and IAS. MASB is currently working on validating such a fair value model. This project involves creation of general principles and standards/methodologies for investing in and valuing brands. It will involve empirical trials among three to five brands to serve as examples of applying the standards/methodology. The BIV methodology is based on an income approach or cash flow approach that uses valuation techniques to convert future amounts to a discounted present value amount. This model will have several levels of impact metrics: customer level, market level, operating financial level, and non-operating financial level.

Fair value and financial statement

There are three approaches to the treatment of fair value write ups and write downs on the financial statements. Using investments in debt and equity securities as an example, debt securities that a firm has the intent and ability to hold to maturity are classified as "held-to-maturity" and reported at amortized cost less impairment on the balance sheet (historical cost approach). Debt and equity securities that are purchased principally to sell in the near term are classified as "trading" securities and reported at fair value on the balance sheet (mark-to-market approach). Unrealized gains and losses are included in earnings. Debt and equity securities not classified as above are classified as "available for sale" securities and reported at fair value (mark-to-market approach) on the balance sheet. Unrealized gains and losses are reported as other comprehensive income, which is reported in a separate component of shareholders' equity.

Problems abound even with fair value balance sheet measurements that are currently acceptable methods of accounting. In a recent Wall Street

Journal article it was reported that the Public Companies Accounting Oversight Board (PCAOB) found 123 audit deficiencies of 250 audits in 2010 among clients of the big four accounting firms that were related to fair-value estimates and asset impairments in 2010 [Chasan (2012)]. PCAOB questioned the assumptions and methodologies that went into some of the asset pricing models.

Marketing assets do not fit well in this current framework of fair value measurement for inclusion of such assets on the balance sheet and many issues still need to be resolved by MASB and accounting policy makers. MASB realizes that acceptance of fair value reporting of marketing assets on the balance sheet may take a number of years.

A need for better reporting

In the meantime the need exists for a consistent dashboard measure for management and investors who need to know if a firm is creating value through investments in advertising and other marketing activities. For reasons stated above, rather than entering the fair value of marketing assets on the balance sheet, MASB is proposing that disclosure be made in the Management's Discussion and Analysis of Financial Condition and Results of Operations (MD&A) section of the firm's annual report. The MD&A seems to be a solid first step in encouraging development of disclosure of marketing expenditures and results as seen through the eyes of management.

Examples:

The following note is an example of a suggested MD&A disclosure for product brand values:

> "As of June 30, 2012, the senior management of Gadget Corporation values the Widget Brand at U.S$2.9B, up 7% from year ago, and 20% over the past three years. We estimate this value using the methodology provided by ValuePack LLC, a MASB qualified Brand Valuator."

The following note is an example of a proposed MD&A disclosure for corporate brand values:

> "We, the senior management of Alpha Corporation, believe the value of our corporate brand, as of December 31, 2011, is $26.4 billion, up 2.7% from a year ago, and down 3.8% over the past three years. We estimate this brand value using the methodology provided by BrandTop, LLC, a MASB qualified Brand Valuator."

Both examples utilize continuous quantitative research study models based on how investments in the product or corporate brand impact future cash flows.

The simple inclusion of these notes, either separately or together, in the MD&A section of the annual report will have a profound impact on the practice of marketing and not cause any disruption to current accounting practice for external users. This single change will make marketing more accountable and unite finance and marketing toward creating a common goal – increasing enterprise value.

Additional benefits include the consistent diagnostic evaluation of the long-term financial health of the company. It will provide a dashboard measure by which the company management, investors, and employees alike would be able to determine if the investments being made in marketing were wise and provided the company with an effective return.

Marketing activities can be highly efficient for value creation, but not when accounting standards obstruct reasonable requests. Valuation standards for intangible assets such as brands need to be recognized to finally get marketing and finance on the same page.

What is in it for the CFO?

It depends on whether individual CFOs define their role by providing accounting reports, or by providing financial leadership. Though intangible assets have grown in value there is less understanding than ever of what drives that value. There is no doubt that accounting standards for intangible assets will eventually be changing worldwide. CFOs who see their role from the accounting perspective will wait until IASB standards for valuing intangibles are updated and distributed sometime in the distant future. But from the financial leadership perspective, CFOs will embrace and encourage forward thinking ideas about what drives the value of intangible assets. Those CFOs who lead the charge will be providing better acceptance of company value and future value estimates by investors, analysts, employees, and management. CFOs will be at the forefront of helping marketing and finance to work together toward common goals with clear ROI measures in place.

Conclusion

We believe the establishment of brand valuation standards will help companies make better investment decisions, meet organic growth targets more often, improve performance as measured by customer, market and financial outcomes, build strong brands more profitably and consistently, and will serve as the primary forward looking marketing KPI in Corporate Scorecards and in MD&A discussions.

We seek to have CFOs, CPAs, and the world of finance join MASB to achieve consistent, comparable, credible and actionable brand valuations for both externally and internally developed corporate and product brands. MASB is establishing "generally accepted brand investment and valuation standards" using metrics that are simple, transparent, relevant, and calibrated across categories, cultures, and conditions. The ultimate goal is to tie reliably marketing actions to customer impact, market outcomes, and financial returns both short term and over time.

For further information please visit: http://www.themasb.org

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