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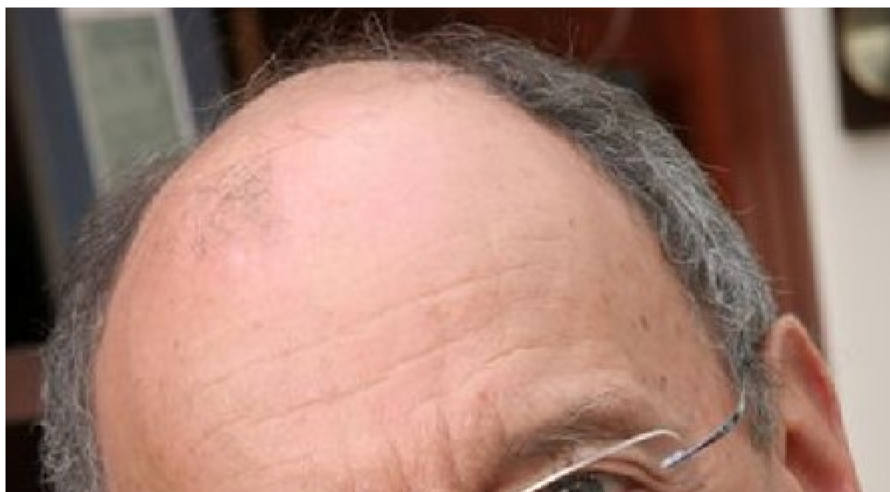
March 29, 2016

Proposed Mega-Deal Underscores Flawed Accounting Rule

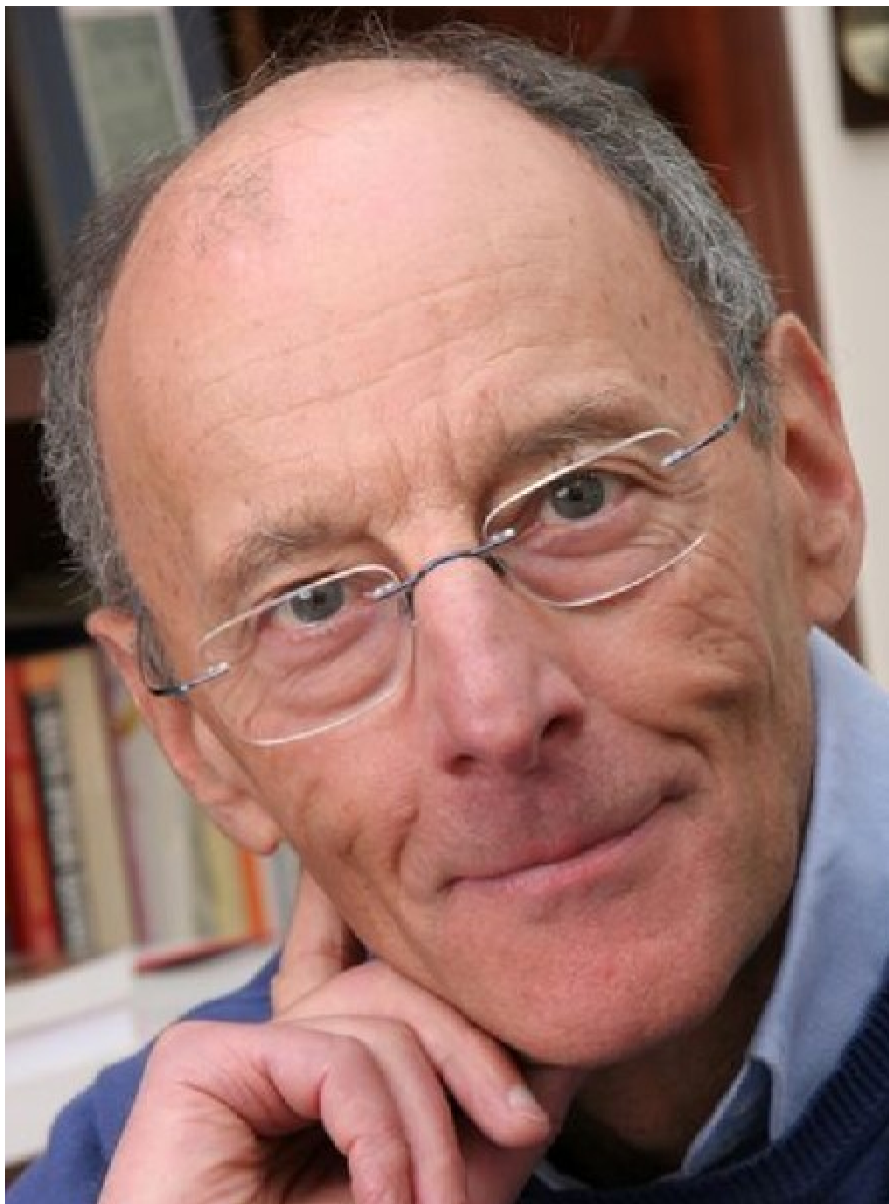
If AB Inbev does acquire SABMiller, the company's accounting won't be able to show any future gains in the value of the target's brands.

Roger Sinclair



AB InBev's offer to purchase competitor SABMiller for $106 billion casts a spotlight on a flawed accounting rule that may confuse investors about the post-deal worth of companies that make acquisitions.

If the AB InBev-SABMiller deal is approved by regulators and concluded, AB InBev will be obliged by accounting standards for business combinations to provide a breakdown of the intangibles that comprise the whopping $86.2 billion premium being offered.



Roger Sinclair, 1938 – 2016

Both companies have leading brands in their portfolios, and brands account for much of SABMiller's appeal to AB InBev. Another notable intangible that will figure in is the relationships that SABMiller has built up with trade customers that ensure the brands have optimal exposure at the point of sale.

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Modern organizations recognize that a strong CFO-CIO partnership is key to the future. According to The Hackett Group's 2019 Key Issues Study, a significant majority of finance executives firmly believe that digital transformation will have an outsized impact on the future of the finance function in the next two to three years, with 86% anticipating a boost in financial performance.

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But it's the accounting for brands that is our concern in this article.

Roger Sinclair, inaugural research fellow of the Marketing Accountability Standards Board, and Kevin Lane Keller, renowned author and brand academic, coined the term "The Moribund Effect" to describe a strange anomaly that arises from M&A accounting. That is, once the deal is done, the value of SABMiller's brand intangibles at the date of transaction will be measured and added to the balance sheet of AB InBev.

This value, carried in the company's financial statements, will be tested annually for impairment. But even if AB InBev achieves great success with its new brands, any increase in their value will not be shown in the accounts. It will appear as though the acquired brands have been shelved, become inactive, or even become obsolescent. Investors might gain the impression that AB InBev has ignored these brands, even left them to die. Over time, they may appear increasingly moribund.

We propose that finance partner with marketing to put this situation right. Companies must ensure that any gains in value are measured and communicated both internally and externally, because any gain in value will almost certainly add to shareholder wealth.

A Closer Look

“The Moribund Effect” highlights an aspect of financial reporting that is broken and should be fixed. The term refers to what happens when a company is acquired and the brands it owns are identified and measured as part of the premium paid to buy the business.

The acquired brands are valued at the time of the transaction and the value at that date is carried on the balance sheet until a reason emerges to remove it. That might not happen for a decade or more. Or ever. That’s what the relevant accounting rules say.

To all intents and purposes, readers of the annual accounts will assume that no value has been added to these brands. If value were added, it theoretically would be reflected in the stock price. But that cannot happen, because the relevant accounting standards do not permit a gain in value to be shown in the accounts. The brands therefore appear to be “moribund,” which, in its primary sense, means “close to death.”

This is an opportunity for marketing to step up and partner with finance to fix the issue. By conducting an annual update of the brand value and writing a comment on strategic actions taken, they could report together, in the Management Discussion and Analysis (MD&A) section of the annual report, information that accounting ignores: that the brands acquired at the time of the deal have gained value (or have not). The former information, provided to investors and lenders, would have an effect on the share price and help them understand marketing’s role in creating shareholder value.

The MASB

The Marketing Accountability Standards Board was formed in 2007 with the following mission: “Establish marketing measurement and accountability standards across industry and domain for continuous improvement in financial performance and for the guidance and education of business decision-makers and users of performance and financial information.”

And with this modus operandi: “Setting the measurement and accountability standards that visionary leaders in Finance and Marketing rely on to guide investment decisions for enterprise value.”

MASB has a number of projects designed to improve the manner in which finance and marketing cooperate. Leading these are:

Brand Investment and Valuation Project (BIV): Over a four-year period, multi-disciplinary teams from across a spectrum of companies and organizations collaborated to devise an empirically based brand investment and valuation model to assist companies in their investment decisions.

The model integrates a consumer behavioral measure of brand strength that predicts market share, sales volume, and future cash flows. A time-value-of-money, present-value calculation measures the brand value. This number will vary as marketing impacts consumers and their preferences.

Companies suffering from the Moribund Effect can employ the model to track the true performance of acquired brands. The model is currently being tested internally at Miller-Coors to help determine where to invest (across the brand portfolio as well as other investment opportunities).

Marketing and Finance Pairs: Each year the MASB hosts two summits, in February and August. The participants represent a range of industries and disciplines. The MASB's charter members include PepsiCo, Kimberley Clark, General Motors, Miller Coors, ESPN, Nielsen, and Millward Brown, among others. Academic members hail from such business schools as Wharton (University of Pennsylvania), Darden (University of Virginia), UCLA, Columbia, Stern (New York University), and Loyola Marymount.

A major section of the program is devoted to presentations by finance and marketing pairs that report on how the two functions are collaborating within their companies. A feature of these talks is the honesty with which the partners tell of both success and failure. Here are three summary statements from the many marketing/finance pairs who have spoken at MASB summits:

"The relationships between marketing and finance that seem to work the best are the ones where both parties recognize they need each other to achieve their desired outcomes." — *Travis Colvin, head of marketing supply chain, Kimberly-Clark*

"We're now starting to work with our marketing teams — the budget owners — to evaluate their annual plans and assess what they're doing with those dollars and what return we expect to get." — *David Barclay, director of brand finance, Quaker Foods (a PepsiCo subsidiary)*

“A couple years ago our Decision Analytics team said we can’t continue to look at brand health as our [key performance indicator] — we need a team that can monetize that return. Finance is now looking at every dollar against a certain threshold of return.” — *Kerry Welsh, director of global marketing analytics, Citicorp*

The sense that delegates to the MASB summits take away is that there is a very definite move to bring finance and marketing closer together, both internally and across firms, with measurement standards that tie marketing activities to financial performance.

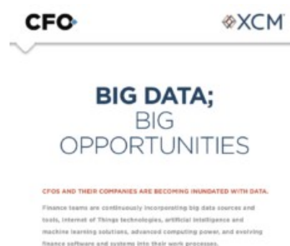
Summary

The Moribund Effect will not go away soon. But it presents a golden opportunity for the finance function to partner with the marketing function to fix a problem with financial reporting that, until now, has been largely ignored.

Roger Sinclair, PhD., who was appointed in May 2015 to the post of Inaugural Research Fellow of the Marketing Accountability Standards Board, passed away on Jan. 21.

Meg Henderson Blair, president and CEO of the Marketing Accountability Foundation, contributed to this article.

Ab Inbev, Kevin Lane Keller, Marketing Accountability Standards Board, MASB, Meg Henderson Blair, Moribund Effect, Roger Sinclair, SAB Miller



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13 responses to “Proposed Mega-Deal Underscores Flawed Accounting Rule”

Jean Charles Belliol says:

March 30, 2016 at 5:34 am

Interesting article but I don’t agree with the author. Annual evaluation of the brands will create unbalance when analyzing a balance sheet. Indeed, what about existing brands of the company? Presently, the brands is not evaluate in the balance sheet if the company has created it. On the contrary, all marketing expenses are recorded as a cost in P&L. Acquired brands have been paid, either in cash or in share so it is normal to evaluate them.
I don’t think to always evaluate all assets and liabilities of a company at market price is good. For example, the more a company has financial problems, the more it benefits now as its corporate bonds value decreases so it has to register a (non-cash) profit even though the actual debt has not reduced! Similarly, when the situation improves, it will have a loss as the value of the bonds recovers!
Accounting now is becoming a casino where there are less and less correlation between what a company has paid and what the value is recorded in the balance sheet due to annual assessment based on “market” price, sometime for assets with no market price. Better to have the market value indicated in notes and not in the balance sheet itself.
I am a banker and the cautious approach to financial statements is better!

Reply

DR M H Blair says:

April 1, 2016 at 4:34 pm

Since Brands are among the most valuable assets owned by any company, both those acquired and those developed internally should be accounted for in financial reporting (and adjusted up or down at least annually), whether it be on the balance sheet or in the MD&A notes.
Further, The Marketing Accountability Standards Board has recently developed an empirically based methodology for valuing brands that can facilitate this process for

improving financial reporting. The methodology is simple, transparent, practical and consistent over time, starting with a behavioral measure of consumer brand strength and ending with projections of future cash flows.

Reply

James Gregory says:

April 2, 2016 at 2:15 pm

I agree that internally grown brands must be included on the financials in some form. If not on the balance sheet then certainly included in the notes. It is just too important to continue to ignore this significant asset.

Reply

Erich Decker-Hoppen says:

April 4, 2016 at 1:16 pm

For more from Dr. Sinclair, check out "Accountable Marketing: Linking Marketing Actions to Financial Performance" and Roger's chapter "Reporting on Brands." Available through themasb.org.

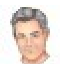
Reply

Edgar Baum says:

April 4, 2016 at 2:24 pm

Intangible Assets represent more than 80% of the S&P500 (Ocean Tomo) yet the financial reporting requirements were established decades ago when more than 80% of assets were tangible. Today's investors are looking to understand what are the assets that are driving the cash flow that is being generated. 40 years it was easy to lump labor, machinery, and plant costs into discernible buckets accounted for by cost/managerial accounting methods. Today, at the minimum, guidance should be given to internal employees that need to make investment decisions (hence the need for MASB's validated brand investment valuation model or something similar for non-consumer brands) as well as for investors that want to understand comparative businesses in a less opaque manner.

Reply



Jonathan Knowles says:

April 5, 2016 at 8:28 pm

A couple of observations:
Any changes to the accounting rules around brands is doomed to failure unless the proposals extend to other forms of intellectual property. I wish that MASB would take on the broader mandate of accounting for intangible assets more broadly, rather than just brands.
The "moribund" argument applies to all balance sheet assets, tangible and intangible – even land remain on the balance sheet at the lower of cost or net realizable value
Based on 2015 data for the largest 14,000 publicly traded companies in the world, the proportion of enterprise value represented by intangible assets is actually 59% (not 80% as estimated by Ocean Tomo)

Reply

Allan Kuse says:

April 6, 2016 at 2:54 pm

In 2011, the value of the GE brand accounted for as much as 25% of its market cap (depending on the valuator), which is nearly half the 59% enterprise value of intangible assets reported by Knowles in 2015 data. What other intangible asset is quite as sizable and ubiquitous as brand(s)?
Since we have to start somewhere in accounting for the intangibles, it makes sense to start with brands (arguably the largest intangible across companies), which would also give credibility for the tremendous amount spent on marketing each year to maintain and grow them.

Reply

Jonathan Knowles says:

April 27, 2016 at 11:57 pm

The international accounting standards allow for the recognition of five major forms of intangible asset – knowledge assets (e.g patents); contracts (e.g drilling rights); artistic assets (e.g. copyrights); customer assets (order backlogs, amortizable relationships); and marketing assets (e.g trademarks, brand names).
My analysis of 150 recent merger transactions showed that contract, customer and marketing assets were roughly equal in terms of the amount of goodwill allocated against them. Which only serves to underscore my earlier point that MASB's credibility would be enhanced if it chose to address the issue of accounting for intangibles in general, not just brand

Reply

Edgar Baum says:

May 12, 2016 at 11:00 am

Hello Jonathan – for clarification, Ocean Tomo captured data for the S&P 500 not the global 14,000, which, correctly, does have a lower share of intangibles. The matter at hand is critical or the US where the % of intangibles for the economy as a whole is estimated to be around 70% as per Brand Finance's GIFT study. Either way, we don't have any guidelines on how organizations report on these intangibles. With respect to tangibles on the balance sheet having a higher value, there is a 'market' to understand the value of those physical goods and that can be carved out of the market value of these companies.

Reply

Christof Binder says:

April 7, 2016 at 2:50 am

I very much agree with Jonathan K. Accounting is a "system" following overall ideas and concepts. Changing this for brands only will be both impracticable and inacceptable.
Most marketers and MASB err in believing that brands are the largest or most important intangible asset. Brands can be important, but often their importance is minor in relation to other assets. Evidence from numerous PPA studies (purchase price allocations) with tens of thousands of acquired businesses analyzed suggests that brand is far smaller than both technology/IPR&D and customer/contract related assets (i.e. Houlihan Lokey, PwC, KPMG, EY, and other). And above all is the value of "goodwill" which captures – among other – the future of a business going concern beyond the foreseeable period. Goodwill includes the ability of an organisation to improve and innovate its offerings, and to improve its organisation, processes and inputs, in short to stay competitive in the long-run. Most of this is human capital, or the knowhow and abilities embedded in the workforce.
It is undisputed that the brand asset plays an important role for consumer goods businesses. To start with, why not implement the proposed accounting for brands on a voluntary basis in the MD&A notes of such companies?

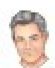
Reply

David Stewart PhD says:

April 8, 2016 at 11:13 am

The MD&A notes is a logical place to start reporting and discussing the value of brands, after a standard model is applied internally to inform investment decisions.
According to feedback from a MASB Panel of representatives from FASB, CFAI, and BlackRock: Most important is to align Finance & Marketing sides of the house (make sure those who have to do the work understand what is coming and why); Use the standard BIV model for internal management decisions (how to manage/invest in the brand/asset for future growth and cash flows).
There are MASB best-in-class member companies, among others, who are ahead of the pack in terms of applying this model for internal purposes to provide context and drive decision-making for activities such as portfolio strategy and resource allocation.

Reply



Jonathan Knowles says:

April 28, 2016 at 12:08 am

By the way, GE is a bad example to choose as regards calculating the proportion of intangible value represented by brand because, until GE Capital was sold late last year, GE had a balance sheet that looked like a bank. Intangible value is generally defined as the difference between total enterprise value (market cap plus total debt minus cash & short-term instruments) and net tangible assets (net working capital plus PPE). This calculation is meaningless for banks because the concept of "net working capital" is not useful for businesses that funds long term loans using short term borrowing (as all banks and finance companies do).

But on average for all non-financial companies, my analysis suggests that, of the 59% of enterprise value not represented by tangible assets, brands account for 10 to 15%

Reply

Edgar Baum says:

May 12, 2016 at 11:02 am

Jonathan, I would be curious to know what the impairment of the goodwill would be if the companies sold their brand and started with a new one. Consider that the 'brand' is not an isolated asset but one that has its own inherent value and a value that it confers (or detracts) from other assets within the company – especially goodwill.

Reply

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