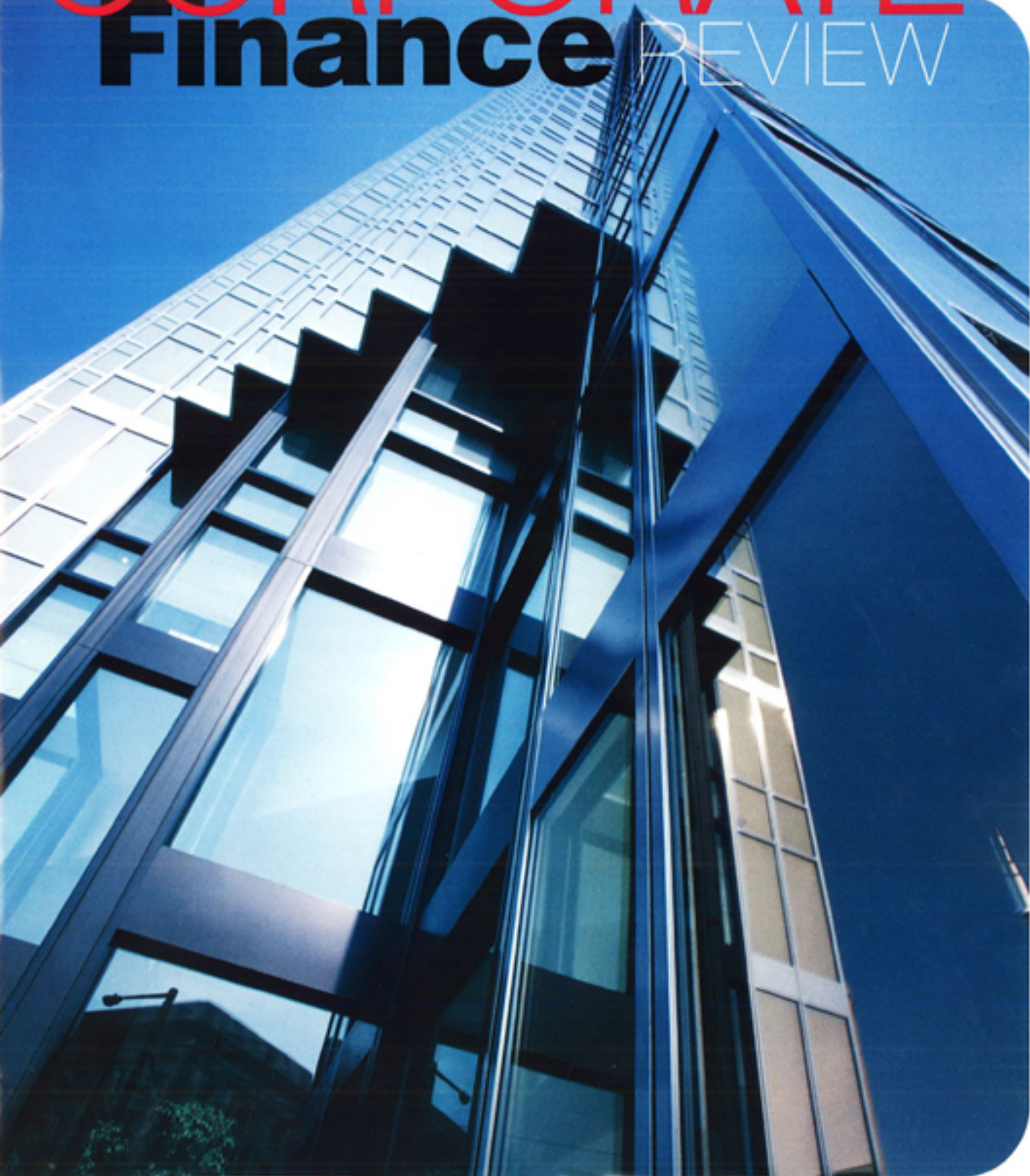


November
December
2012

CORPORATE Finance REVIEW



ALIGNING MARKETING AND FINANCE WITH GENERALLY ACCEPTED STANDARDS FOR

In this article the authors argue that there is a need to create awareness and support among the financial community for consistent brand measurement and metrics that tie investments in corporate and product brands to financial value.

VALUING BRANDS: OPPORTUNITIES AND OBSTACLES

JAMES GREGORY AND MICHAEL MOORE

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 yet receive little attention in internal finan-

cial and managerial accounting records, nor are they reported to external users of financial statements. However, 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 attempting to

JAMES GREGORY is founder and CEO of CoreBrand. He is one of the U.S. communications industry's recognized experts and leading advocates of corporate branding. Jim oversees all key strategic issues relating to the corporate brand. Over the years, he has developed a unique blend of creative and analytical expertise. Jim speaks widely on the subject of corporate branding to both business and academic audiences. He has also authored four books: Marketing Corporate Image: The Company as Your Number One Product, Leveraging the Corporate Brand, The Best of Branding, and Branding Across Borders. Jim is a founding member of the MASB Advisory Council.

MICHAEL MOORE is a professor of accounting at the University of California Riverside. Professor Moore is co-author of US Tax Aspects of Doing Business Abroad, now in its sixth edition. His published work has appeared in the Journal of Accountancy, the Journal of the American Taxation Association, The Accounting Review, the Journal of Accounting Research, and the International Tax Journal, among others. He has twice been the recipient of the American Taxation Association's Award for Best Tax Manuscript. He is past president of the American Taxation Association. Michael earned his Ph.D. and M.S. from Pennsylvania State University and a BA from the University of Washington. He is a certified public accountant. Michael is a member of the MASB Advisory Council.

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 an 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 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 revolving around 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 policymakers at FASB and IASB. Recording assets at fair value using Generally Accepted Accounting Principles (GAAP) or International Financial Reporting Standards (IFRS) is generally limited to

THERE ARE NOTICEABLE INCONSISTENCIES BETWEEN THE TREATMENT OF PURCHASED INTANGIBLES AND INTERNALLY DEVELOPED INTANGIBLES.

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 seems years in the future.

Development of a model for recording internally developed marketing assets that measures fair value is critical to its acceptance by FASB and IASB. 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 IASB, 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. 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. 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 (e.g., interest rates and yield curves observable at commonly quoted intervals, volatilities, prepayment spreads, loss severities, credit risks, and default rates); and
- inputs that are derived principally from or corroborated by observable market data by correlation or other means.

Level 3. 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.¹

In addition to the general fair value models from FASB and IASB and specific branding commercial valuation models such as Brand Finance, Core-Brand, 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 *Inter-*

national 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 IASB 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 IASB. 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 2010.² 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 policymakers. MASB realizes that acceptance of fair value reporting of marketing assets on the balance sheet is likely years in the future.

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 market-

RECORDING
MARKETING ASSETS
ON THE BALANCE
SHEET UNDER
MARK-TO-MARKET
ACCOUNTING SEEMS
YEARS IN
THE FUTURE.

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.

ing 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 \$2.9B, up 7 percent from a year ago and 20 percent 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 percent from a year ago and down 3.8 percent 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 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's in it for the CFO?

It depends on whether individual CFOs approach their role as providing accounting reports or approach it as providing financial leadership. Although 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 reliably tie marketing

actions to customer impact, to market outcomes, and to financial returns both short term and over time. ■

NOTES

¹FASB ASC 157, *Fair Value Measurements* (2006) and IFRS 13, *Fair Value Measurement* (2011).

²Chasan, E., Asset valuations trip up audits, *Wall Street Journal*, May 22, 2012.

VALUATION STANDARDS FOR INTANGIBLE ASSETS SUCH AS BRANDS NEED TO BE RECOGNIZED TO FINALLY GET MARKETING AND FINANCE ON THE SAME PAGE.