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Accounting Standards, the Valuing of Intangibles and Implications for Marketing in Australia

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Accounting Standards, the Valuing of Intangibles and Implications for Marketing in Australia

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Summary

This paper returns to an issue that received prominence in the mid 1980's to early 1990's, the battle to report the value of marketing assets in corporate financial statements. The reason for this return is the impending change to Australian accounting standards that will see Australian recognition and reporting of intangible assets such as brands, trademarks and other marketing assets, curbed by the acceptance of International Accounting Standards rules of recognition and measurement. The implications for marketing as a business function seeking to account for the resources it is charged with expending are examined. Although internal reporting systems will continue to monitor and measure marketing outputs, the required specific accounting treatments will result in biases in external reporting of marketing assets and therefore marketing performance. Reporting of marketing activities to external stakeholders cannot be dismissed as inconsequential, impeding both accountability and legitimacy. Unless other external reporting methods are sought, the changes could impact on expenditures devoted to marketing activities.

Background and Purpose

Piercy (1986a) defined marketing assets as: "intangible, apparently measurable only in intermediate terms such as brand awareness or sales force productivity, normally created only through the investment of resources; largely without the scope of financial evaluation…and yet central to any concept of the distinctive competence of a business unit" (p.10). Consistent with the definition of an intangible asset, marketing assets are generated through marketing efforts directed at the marketplace that generate income (Piercy, 1986a). Others have sought to tie marketing assets to the strategic tasks of expenditures that contribute to competitive positioning and/or the strengthening of the competitive advantage of the business (Robinson, 1986, Oldroyd, 1994; Walley, et al., 1994). This can lead to potentially broader definitions. Walley, et al. (1994) consider such assets "properties which have value in the market place by virtue of their ability to influence purchase decisions" (p.967). Accordingly, they compiled a list of 53 such assets with intangible properties that could strengthen the competitive position of the firm. The diversity of items, including "assets" such as delivery on time, range offered, delivery lead times, as well as brands, points to the potential valuation dilemma.

Piercy (1986b) also addressed the need for the recognition and measurement of such assets, proposing a research agenda that included validation of measures of marketing performance and development of a marketing asset model. Although advances in internal measurement of marketing assets have occurred (Oldroyd, 1994; Blackett, 1993), the impact on external reporting of marketing assets remains a problem for marketers seeking to demonstrate the contribution of marketing to a firm’s value.

Until now, Australia has permitted a range of internally generated assets such as trademarks, brands and mastheads to be valued and included as assets in corporate balance sheets Australia has been described as “unique” because of the extent to which it has allowed such recognition of purchased and internally generated intangibles. However, Australia has deviated from historical cost measurement and its amortisation requirements for intangible assets have lacked consistency (Chalmers and Godfrey, 2003).

Continuing the process of harmonising Australian Accounting Standards with International Accounting Standards, from January 2005 both the measurement and reporting of goodwill (including the purchasing of marketing assets) and the measurement and reporting of internally generated marketing assets will alter. Focusing on internally generated intangibles, the recognition of internally generated goodwill, brands, mastheads, publishing titles, customer lists and other substantially similar items as assets will be prohibited (IAS 38, see IASB, 2003). Even some development expenditures, for example on web pages, must pass stringent recognition tests (SIC32, see IASB, 2003).

With these changes imminent, this paper examines the possible effects on marketing as a profession seeking to establish its role and value in developing the strategic competitive advantage of firms. The issue is whether the changed external reporting environment is likely to prejudice the claims of marketing activity. While there are changes in other aspects of the accounting standards that also impinge on the valuing of marketing activity, such as treatment of the purchasing of brands (goodwill), it is the measurement and reporting of intangible assets that is the focus. This change has the potential to adversely effect the external reporting of marketing’s contribution to achieving strategic objectives.

The paper addresses the importance of external reporting of marketing activity through the corporate annual report (CAR). This is followed by a discussion of the reporting effects arising from the impending changes on business generally, which then turns to focus on the marketing implications and the need for further research.

The Importance to Marketing of External Reporting

External reporting of marketing activity is required for both legitimation and accountability reasons. The two are entwined: without accountability, marketing has difficulty in claiming legitimacy. Organisational legitimation requires a congruence between the social values implied by organisational activities and the norms of acceptable behaviour in the larger social system of which organisations are a part (Dowling and Pfeffer, 1975, p.122; Parsons, 1960, ch.5). The congruence of value systems required for legitimacy can be achieved practically in two ways. The first is through action - adapting output, goals, and methods of operation to conform to prevailing notions of legitimacy. The second is through communication - the use of symbols to identify the organisation with the values believed to be legitimate (Dowling and Pfeffer, 1975, p.127). Thus, legitimacy is conferred and controlled by those outside the organization so that the CAR becomes a legitimating instrument.

Accountability is a nebulous concept but by definition it includes reporting outcomes in ways that can be verified. Interestingly, the Oxford Dictionary defines “accountability” in circular terms of responsibility and answerability or accountability, with “responsibility” being the liability to give account of, and answer for, the discharge of duties or conduct. Accountability arises out of situations involving responsibility. Responsibility engenders a need to give an account of how the responsibility has been dealt with. Responsibilities usually come with target to be achieved. The account details how the accountee has met those targets.

Others regard responsibility as engendering accountability (Uhr, 1999). According to Uhr (1999), responsibility is the gift of some authority. Responsibility refers to power to initiate courses of action whereas accountability refers to the complementary power to exercise judgement about “what constitutes an appropriate course of action”. Having “responsibility” means having an obligation to answer (French, 1979, p.170). It implies an “authority relationship” between the persons concerned. Accountability requires that the accused justifiably can be held to account or be called upon to answer (French, 1979). Justifiability is conferred by an authority relationship between the persons concerned. Marketing accountability arises in any organisation from the commitment of resources to specific marketing objectives and the consequent need to account for those resources.

The importance of reporting the value of generated marketing assets starts from the proposition that it is competitive position that usually determines business value (Simmonds, 1986). Marketing expenditures are considered critical in determining that position and therefore, are an important element in the value of the firm. This link views marketing as a strategic investment. At the same time, it creates pressures for marketing to establish its effectiveness in this role (Stone & O’Donnell, 2003).

Whether marketing achieves this is contestable. For example, Doyle (2000) observes a paradox between the apparently growing importance of marketing and a lack of influence of marketing professionals in top management. He attributes this to the failure of marketing strategy and practices to incorporate and pursue the maximisation of return on the shareholders’ investment (p.20). He argues that, although shareholder value is becoming the new maximising function, conventional accounting encourages a short term view of business that leads to an under–investment in what he terms information-based assets, including brands and customer relationships. In countries adopting International Accounting Standards, the under-reporting of marketing assets in the balance sheet, and their expensing lowering reported profits, reduces marketing’s contribution to shareholder value. This in turn may reduce the influence of marketing professionals in top management.

Ranchhod (2004) explains this importance of external reporting to marketing. He observes that marketing expenditures tend to vary with revenue, because marketing budgets are based on perceptions that marketing is an expense, and because of the difficulty of assessing marketing's impact on profitability. Consequently, "an organisation's performance measurement system strongly affects the behaviour of people both inside and outside the organisation" (p.175). Because of its use of investors' resources, marketing is accountable to those stakeholders. The corporate annual report required of listed corporations is the principal credible means of discharging accountability to such stakeholders.

An annual report is viewed as an important part of the information sources on accountability available to those seeking such information because it is the only comprehensive statement of stewardship available to publics interested in the reporting entity (Boyne and Law, 1991, p.179). The annual report is the key document in the discharge of accountability to those outside the reporting entity. Without that discharge, it follows that legitimation is more difficult to achieve.

An ongoing tension exists between accounting requirements and the reporting of marketing and other strategic activities in annual reports (Stanton and Stanton, 2002). While ostensibly a document reporting the financial and governance position of the organisation, it has been widely described by accounting researchers examining the usefulness of its content as a "marketing" document crafted to convey a particular story (for example, Lee 1994, McKinstry, 1996). Following this line of reasoning, there is scope for the reporting of marketing activities in the narrative parts of such reports. Evidence of such reporting is slight. A tension exists in the inconsistency between financial reporting of marketing activities that can be used and the story of the narrative (Stanton and Stanton, 2002).

Application of the Changes: Business Reporting Consequences

The purpose and content of corporate annual reports is, in the Australian case, largely prescribed by statutory requirements (AASB, 2004). Of specific interest, is the requirement that accounting standards will generate financial information meeting multiple goals and conditions. These include:

- allowing users to make and evaluate decisions about allocating scare resource;
- assisting directors to discharge their obligations in relation to financial reporting;
- relevance to assessing performance, financial position, financing and investment;
- providing relevance and reliability;
- facilitating comparability; and
- being readily understandable.

These guidelines should be read in conjunction with the definition of an asset as "A resource controlled by an enterprise as a result of past events, from which future economic benefits are expected to flow to the enterprise" (Deegan, 2002). Specifically, an intangible asset is defined as "An identifiable non-monetary asset without physical substance held for use in the production or supply of goods or services, for rental to others or for administrative purposes" (IAS 38, para.2 in IASB, 2003). For an asset to be included in financial statements as an asset requires establishing that there are future economic benefits that are attributable to the asset that will flow to the enterprise, and that the cost of the asset can be measured reliably (IAS 38, para.19 in IASB, 2003).

The prohibition on recognising internally generated marketing assets implies that such assets fail to meet these criteria. The primary reason for non-recognition of internally generated intangibles cited in the Australian case is the difficulty of reliably determining their "fair value" in the absence of an active market for the asset (Leo, 1999). Kohler (2003) suggests the possibility of misuse: "The International Accounting Standards Board simply does not trust directors to value brands honestly". Applying International Accounting Standards to the valuation of brands, Oldroyd (1994) illustrated the tension between accounting and marketing, particularly the dominance of the former in suppressing the reporting of brands as assets. While not espousing a conspiracy, Oldroyd asserted that "it does illustrate how accounting can misuse the power it gains from control of financial reporting, when the recognition tests which it applies are too restrictive" (p.44).

The immediate consequences of these restrictions will emerge in the stated financial positions of many publicly listed companies, as indicated in Table 1. Chalmers and Godfrey (2003) point out the adoption will alter reported performance and financial position with companies reporting intangibles likely to report significant earnings and leverage impacts.

Table 1

2002 Australian Financial Reports and carrying value of "marketing assets"

Category in the statement of financial position	Number of firms Carrying	% of sample (1300)	Mean value $'millions
Goodwill	477	37	93.3
Identifiable intangibles	555	43	143
Goodwill and/or identifiable intangibles	732	56	n.a.

Source: Chalmers and Godfrey, 2003

Implications for Marketing

The reporting of marketing outcomes to external stakeholders will be constrained by regulatory requirements that impinge on the discharge of accountability. Financially, amounts spent by the marketing department will be buried in the profit and loss account where they cannot be separated out from general expenses, and where they will impact adversely on reported profit. Companies will be affected unequally by the changes. Those with a very strong reliance on brands, for example Pacific Brands and Billabong, are likely to suffer more severely. For example, if these companies must write off internally generated intangibles as an extraordinary expense, although they may not have incurred any actual monetary loss, the book loss will adversely alter a range of financial ratios. Further consequences could flow through the reduction in net assets of the companies, particularly affecting debt ratios. While the narrative or front section of the annual report can be used to report on marketing activities and the strength of the company's brands, there remains the inability to report marketing assets in particular metrics.

Improved management accounting systems are improving the measurement of marketing assets and that this may eventually provide sufficient verification to overcome financial reporting sceptics (Oldroyd, 1994) but there is little evidence of the latter occurring. Whether it needs to occur is also disputed. One view (Kohler, 2004) is that “analysts, ratings agencies and lenders don’t take too much notice of the official balance sheet”, drawing their own conclusion on the value of assets. Similarly, Blackett (1993) argues that the “brands on the balance sheet debate” is a ‘technical exercise” that will not hinder the valuation and incorporation into the value of the firm, even if not making it to the balance sheet. Yet, as the author notes, brand valuation impinges on critical areas of strategy development, investor relations, mergers and acquisitions. If this information is reliable but not readily available, presumably it must undermine the reporting objectives and the capacity for marketing to account for and legitimate its functions.

The practice of expensing marketing expenditures can cause an inefficient resource allocation for other reasons. Rayburn (1986) suggests it can encourage marketers to consider, for example, short-term marketing programs that result in immediate sales rather than long term programs that strengthen the competitive position of the firm. Additionally, the expensing of marketing costs may encourage its use to control the level of reported income.

The imminent changes to Australian financial reporting treatment of marketing assets warrants further research. Piercy’s (1986b) marketing assets research agenda remains incomplete. The building of case evidence supporting the need for changes, empirical validation of the measurement of marketing performance and its link to asset creation, the building and consolidation of a new paradigm of marketing assets that provides the concepts and language for corporate debate, are more pertinent to Australian marketing today than they were in 1986.

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