Accounting for Marketing Activities: Implications for Marketing Research and Practice

Natalie Mizik
Gantcher Associate Professor of Business
Columbia Business School
3022 Broadway
Uris Hall, Room 513
New York, NY 10027
nm2079@columbia.edu

Doron Nissim
Ernst & Young Professor of Accounting and Finance
Columbia Business School
3022 Broadway
Uris Hall, Room 604
New York, NY 10027
dn75@columbia.edu

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Abstract

We review accounting principles related to the reporting of marketing activities and evaluate their implications for marketing research and practice. Based on our review, we argue that current accounting practices contribute significantly to the declining influence of marketing within organizations and the rise of myopic management. Financial reports misrepresent marketing contribution and impede its fair assessment. Changes to current marketing accounting practices are needed. Balance sheet recognition of all marketing-related intangibles emerged as the prevailing proposed solution. We, however, argue that balance sheet recognition of marketing intangibles will not remedy the situation. Instead, we advocate expanded mandatory disclosure of marketing-related activities and performance drivers. We advance specific propositions intended to enhance the quality of financial reporting and improve marketing management practice. We further call for specific research to help facilitate improvements in the financial reporting model as it pertains to marketing-related activities.

Keywords: Internally Developed Intangible Assets, Acquired Intangible Assets, Marketing Accounting, Marketing Practice

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1. Introduction

Several authors have recently noted the declining role and decreasing influence of marketing within organizations (e.g., O'Sullivan and Abela 2007, Nath and Mahajan 2008, Verhoef and Leeflang 2009). These studies seek to identify the causes for this trend and suggest remedies. They argue that marketers' inability to quantify and communicate their contribution to value creation is a primary cause for the declining influence of marketing. Rust et al. (2004), for example, comment that marketers have not been held accountable for showing how marketing expenditures add to shareholder value, and point to this lack of accountability as the root cause of the decline in the status of the marketing function within the firm. In response to these troubling trends, research efforts in marketing have centered on developing (i) diagnostic and predictive marketing metrics and tracking systems (i.e., dashboards) to improve internal decision-making processes and communications within the firm (Reibstein et al. 2005, Pauwels et al. 2008); and (ii) models for assessing the impact of marketing initiatives on long-term financial performance and stock market valuation (Srinivasan and Hanssens 2009).

One factor that has significantly contributed to the decline of marketing's influence, and has yet been largely ignored by the literature, is financial reporting. Under the current accounting model, financial reports fail to correctly reflect marketing contribution and thus impede the ability to assess the value and long-term impact of marketing activities. Accounting practices affect the perceptions of marketing contribution both within and outside the organization, and these perceptions in turn affect marketing budgets, resources, influence, and practice. Indeed, outside of marketing departments, marketing is often mistakenly viewed as a cost line item rather than a value-generating activity. This view is particularly manifest in the accounting for internally generated (i.e., organically developed) intangible marketing assets. Yet, the accounting treatment

of marketing activities and intangible marketing assets is not well understood by marketers, and is generally viewed as outside the scope of marketing. This unfortunate attitude and neglect have contributed to the difficulty marketers experience in assessing and communicating their contribution to financial performance and firm value.

We contend that it is imperative for marketers to recognize the importance of financial reporting as it pertains to marketing activities and the distortions introduced by the current accounting system. Such an understanding is important for both marketing researchers and marketing practitioners. Marketing researchers investigating the financial implications of marketing activities need to appreciate the data quality issues involved and their impact on appropriate measurement, modeling, and interpretation of empirical findings. Better understanding of the financial reporting model and its effects on marketing practice can help marketers better articulate the contribution of marketing activities, advocate for stable funding, and improve marketing management practice. It is important for marketers to get involved in the ongoing discussion aimed at improving financial reporting practices.

Indeed, coinciding with the growing concerns over the declining role of marketing and difficulties in evaluating the contribution of marketing to the bottom line, accounting research has documented a decline in the usefulness of financial reports (Brown et al. 1999, Core et al. 2003). This finding led to discussions and proposals aimed at improving financial reporting (e.g., Francis and Schipper 1999, Skinner 2008). Some academics and practitioners point to the balance sheet omission of internally generated intangibles such as brands, Research and Development (R&D) capital, and customer base as one reason for the growing disparity between the market and book values of equity and the low diagnostic and predictive quality of financial reports (Lev 2001). They argue that if firms were required to report all marketing-related intangibles on the balance sheet, the quality of financial information and its usefulness for firm valuation would have been

improved (e.g., “Creation, Recognition and Valuation of Intellectual Assets,” IA/Report). We disagree.

We argue that blanket recognition of marketing assets on the balance sheet is not the preferred solution. Our reasoning is based on the conceptual analysis of the policy, practices, and consequences of balance sheet recognition of *acquired* intangibles. US Generally Accepted Accounting Principles (GAAP) require balance sheet recognition of acquired intangible assets and thus provide a domain to explore the potential benefits of recognizing internally generated intangibles. Our analysis suggests that balance sheet recognition does not resolve the problems marketers face.

Instead, we advocate expanding and formalizing disclosures of marketing-related activities and performance drivers. We argue that expanded mandatory disclosure is a feasible first step toward improving financial reporting. Detailed and consistent disclosures about marketing expenditures and related revenues, and diagnostic and predictive performance drivers, can facilitate better performance evaluation, forecasting, valuation, and internal marketing processes.

The objectives of this paper are four-fold: (1) explicate the links between accounting practices, the noted decline in the influence of marketing within the firm, and the rise of myopic management with respect to marketing activities; (2) explain why balance sheet recognition of marketing assets is generally not the preferred solution for these problems; (3) advance expanded disclosures as a feasible remedy; and (4) call for a dialogue and specific research to help facilitate improvements in the financial reporting model as it pertains to marketing-related activities.

The manuscript is organized as follows. We begin with an overview of the current financial accounting system. Then, we review and evaluate GAAP for marketing activities and identify key reporting problems, both for acquired and internally-developed marketing intangibles. We discuss the two sides of the organizational conflict generated by the marketing-accounting

interface and the role the current accounting system plays in facilitating myopic behavior by management. We conclude with a call for marketers to get involved in the financial reporting debate, and delineate our propositions for improving the financial reporting system. We advocate expanded disclosure and argue that it can mitigate organizational conflict, improve the quality of information for research and evaluation, and benefit both the internal and external constituencies of the firm.

2. Overview of the Financial Reporting Model

Financial reports include three primary statements: the balance sheet, the income statement, and the cash flow statement. The balance sheet reports the resources that the entity owns or controls (assets) and the clams against those resources (liabilities and equity) as of the balance sheet date. The income statement provides accrual-based measures of performance for the period that ended on the balance sheet date. The cash flow statement provides cash flow measures of operating performance as well as information on investing and financing cash flows for the period that ended on the balance sheet date. Published financial reports also include a statement of shareholders' equity, which explains changes in shareholders' equity accounts during the period that ended on the balance sheet date. The statement of shareholders' equity is considered somewhat of secondary importance. We next elaborate on each of these statements and the relationships among them.

2.1 The Balance Sheet

The balance sheet presents the financial position of the firm, that is, the cumulative effect of all operating, investing and financing activities since the formation of the company until the balance sheet date. Indeed, the balance sheet is often referred to as the statement of financial position. The term "balance sheet" is used since this statement reflects the following equation or balance:

(1) $\text{Assets}_t = \text{Liabilities}_t + \text{Equity}_t$.

In fact, as we show below, all four statements are related to this equation.

Assets are economic resources, but not all resources are recognized on the balance sheet. To be recognized, an economic resource has to (1) represent *probable* future economic benefits which are *measurable with reasonable precision*, and (2) be owned or controlled by the entity as a result of *past transaction*. The second criterion means that the entity is entitled to receive the benefits from the asset because it has already performed (i.e., paid cash to acquire the asset or provided other goods or services) or incurred a liability.

Economic resources that do not satisfy the above criteria are not recognized on the balance sheet. In particular, economic benefits resulting from executory contracts (e.g., employment contracts, operating leases) and most internally developed intangibles (e.g., R&D benefits, brands, human capital, information technology, intellectual property) remain off balance sheet.[1] Resources resulting from executory contracts are not recognized because the firm has not performed yet, so the "past transaction" criterion is not satisfied. Investments in internally developed intangibles such as R&D expenditures are not recognized on the balance sheet because the related benefits involve high uncertainty and are not considered "probable" or "measurable." As we discuss in the next section, this omission has important implications for marketing.

A nice example of the economic significance of unrecognized marketing-related intangibles is Coca-Cola. On December 31, 2010, Coca-Cola's market value of equity was $151 billion, while the book value of equity (i.e., the amount reported on the balance sheet) was a mere $31 billion. This gap is attributed primarily to the omission of Coca-Cola's brand—its most important economic resource—from the balance sheet. This resource, which has been developed

[1] An **executory contract** is an agreement providing for payment by a payer to a payee on the performance of an act or a service rendered by the payee, such as a labor contract.

over many years of advertising and other marketing activities, is omitted from the balance sheet because advertising costs and most other expenditures to develop and maintain the brand are expensed as incurred rather than being capitalized and reported as an asset on the balance sheet.

Similarly, while liabilities are obligations of the reporting entity, not all obligations are reported on the balance sheet. To be reported as liabilities, obligations must (1) represent *probable* future sacrifice of economic benefits which can be *measured with reasonable precision* and (2) be a result of *past transaction*. The second criterion means that the other party has performed. Obligations that do not satisfy both criteria remain off balance sheet. These include obligations arising from executory contracts (e.g., purchase obligations, operating leases, employment contracts), where the other party has not performed yet, and loss contingencies (e.g., pending law suits, unsettled tax positions), where there is significant uncertainty regarding the existence and amount of related obligations. For example, in its 2010 Form 10-K, Coca-Cola reports that it has marketing obligations of $4.6 billion (e.g., contracts for future media buys), which are omitted from the balance sheet.

Equity is the residual value of the assets of an entity that remains after the liabilities are deducted. For corporate entities, owner's equity is called stockholder's equity or shareholders' equity and has the following components: contributed capital accounts (common stock, preferred stock, additional paid in capital), treasury stock, retained earnings, accumulated other comprehensive income, and noncontrolling interests.[2] Contributed capital accounts report the amount invested by shareholders. Treasury stock measures the reduction in equity due to repurchase of shares back from investors. Retained earnings represent the excess of cumulative net income over cumulative dividends since the formation of the company. That is, retained earnings

[2] Prior to 2009, noncontrolling interest was either included in liabilities or reported separately between liabilities and equity.

measure the increase in net assets (assets minus liabilities) due to earning activities since the formation of the company, minus assets that have been paid out as dividends. Accumulated other comprehensive income represents the net effect of revaluations of assets, liabilities and derivatives that did not pass through the income statement, that is, changes in net assets that were not balanced by a change in retained earnings (since the revaluations bypassed the income statement). Noncontrolling interests are equity claims of outside shareholders in the net assets of consolidated subsidiaries.[3]

The omission of some economic assets and liabilities from the balance sheet is not the only reason for the large difference between the market and book values of equity observed for most companies (e.g., the Coca-Cola example discussed above). Most recognized assets and liabilities, and consequently equity, are measured using historical (i.e., original) transaction amounts, which can deviate significantly from their current values. In many cases, historical cost accounting results in significant understatement of assets due to inflation.[4] Moreover, while assets are generally not marked up for increases in fair value, they are often marked down as accounting conservatism requires that assets should not be overstated. Thus, for example, inventory is reported at the lower of cost or market, and fixed and intangible assets are written down to fair value when impaired.

In recent years both the FASB (in the US) and the IASB (internationally) have required that some assets and liabilities be reported at fair value (i.e., the amount at which an item could be exchanged in a current transaction between willing parties). However, even if this trend toward

[3] For example, a company that owns 80% of a subsidiary reports 100% of the net assets of that subsidiary on its balance sheet but also recognizes that 20% of the net assets are owned by outsiders – the noncontrolling interests. This accounting treatment is predicated on the view that a company should report all assets that it controls, even if they are not fully owned.

[4] Examples of assets that are often significantly understated due to historical cost reporting include fixed assets, recognized intangible assets, investments in equity securities accounted for using the cost or equity methods, and inventories measured under the LIFO cost flow assumption.

fair value reporting continues, it is not likely to affect the reporting of most operating assets, particularly intangible assets.

2.2 The Income Statement

While the balance sheet reports the financial position as of a given day, the income statement reports the results of business activities—primarily operating activities—during the period that ended on that day. Specifically, the income statement lists the resources earned (revenues and gains), the related resources used up (expenses and losses), and ends with net income.

(2) $\text{Net Income}_t = \text{Revenues}_t - \text{Expenses}_t + \text{Gains}_t - \text{Losses}_t$.

Revenues and expenses relate to recurring activities, while gains and losses measure the net effect of non-recurring activities such as a gain or loss from disposal of fixed assets or investments.

The amounts reported in the income statement are based on three basic accounting principles: realization, matching, and historical cost. The *realization principle* states that revenue should be recognized and reported in the income statement when: (1) the amount and timing of net cash flows from the revenue are reasonably determinable, and (2) the earnings process with respect to the revenue is complete or virtually complete. The first criterion requires that revenue be recognized in the income statement only if cash has already been collected or the amount and timing of cash to be collected can be estimated with reasonable precision. The second criterion means that the entity has substantially accomplished what it must do to be entitled to the benefits represented by the revenue. For most transactions this criterion is satisfied at the time of delivery; by providing the merchandise or service, the firm has performed at least most of what it is supposed to do to be entitled to the revenue. Because companies deliver products or render services to customers who are expected to pay, the first criterion is usually not binding. In contrast, it is common for companies to receive advance payments from customers (so the first

criterion is satisfied) but delay the recognition of revenue until the delivery of the product or service, as required by the second criterion.

Companies incur costs in generating revenues. The *matching principle* requires that each cost be expensed in the same period in which the revenues that the cost helped generate are recognized (e.g., the cost of inventory sold is matched against the related sales revenue in the same income statement). Similar to the realization principle, the matching principle can be satisfied before, at the time of, or after the cash payment, with the expense recognized accordingly. To implement the matching principle, companies first apply the realization principle and decide which revenues to recognize. Then, they identify the costs that helped generate those revenues and expense them in the same income statement to measure net income for the period.

Applying the matching principle with respect to costs that are directly related to specific revenues—such as cost of inventory sold or sales commissions—is straightforward. However, most costs are not directly related to specific revenues but rather provide the capacity to generate revenue during the period (e.g., administrative salaries, headquarter rent, interest). Consistent with the matching principle, these costs are recognized as expense when they provide operating capacity, which is typically when they are incurred. Some costs, such as capital expenditures, jointly benefit several periods and thus require a systematic allocation to the periods that benefit (e.g., through a depreciation schedule).

While most costs are reported in the income statement based on the matching principle, two types of costs are expensed in a way that violates matching. The first type relates to costs that are expected to benefit future periods, but the amount and timing of future benefits are highly uncertain. Since the future benefits are too uncertain to be recognized as an asset on the balance sheet, these costs are expensed when incurred. Examples include R&D expenditures, advertising, start up costs, investments in human capital, and some organizational restructuring charges. The

second type of costs that are recognized in violation of matching are those that relate to past periods. For example, new information may indicate that past depreciation was insufficient and thus trigger a write down of fixed assets. Other examples include resolution of law suits and other contingent obligations, and most restructuring charges.

The realization and matching principles deal primarily with the timing of revenue and expense recognition. In contrast, the *historical cost principle* governs the measurement of most assets and liabilities; it requires that assets and liabilities be measured based on the amounts paid or received when the asset or liability was originally recognized. Because revenues are inflow of assets (cash, receivables) or settlement of liabilities (unearned / deferred revenues), and expenses are reduction in assets (inventory, fixed assets, prepaid expenses) or incurrence of liabilities (accrued expenses), the historical cost principle also affects the reported amounts of revenues, expenses and income.

2.3 The Cash Flow Statement

The cash flow statement explains how cash has been provided and used during the period that ended on the balance sheet date. The sources and uses of cash are classified into three categories: operating, investing, and financing.

The *operating section* includes all cash flows used for or provided by purchasing merchandise (raw materials in manufacturing firms), producing the products (in manufacturing firms), marketing the products, and administrating the operations. In addition, several items that relate to investing or financing activities are reported as operating. These include income taxes related to investing and financing activities (e.g., gains from disposal of fixed assets), interest income and expense, and dividends received (but not dividend paid out to the shareholders). In general, cash flows from operations include the cash counterparts of all revenues and expenses

reported in the income statement. The operating activities section of the cash flow statement is typically presented using the so-called indirect approach, which starts with net income and reconciles it to cash provided by (or used for) operating activities. The adjustments effectively "undo" the effects of the realization and matching principles. For example, depreciation—a noncash expense which is deduced from revenues in calculating income—is added back to net income, and the change in accounts receivables—credit sales which are included in revenue and income—is deducted from income.

The *investing section* of the cash flow statement reports cash flows used for acquiring or provided by selling (1) tangible long-lived assets (e.g., land, buildings, and equipment), (2) intangible assets (e.g., patents, franchises, computer software, copyrights, permits, licenses and other contractual rights), (3) existing businesses, and (4) investment assets (assets that are not used in operations such as securities issued by other firms and loans receivable). Unlike cash from operations, this section is always presented directly, that is, each type of cash inflow and outflow is reported explicitly.

The *financing section* reports cash obtained from owners (stock issuance) and lenders (bonds or notes issuance, other borrowings), cash provided to owners (cash dividends, share repurchases), and principal repaid to lenders. Similar to the investing section, this section is always presented directly, that is, each type of cash inflow and outflow is reported explicitly.

The cash flow statement is relevant for assessing liquidity, understanding changes in the financial position, and evaluating earnings quality. Cash flow information is useful for evaluating liquidity because the different sources and uses of cash vary in persistence and other liquidity-related implications. For example, a company that generates a strong cash flow from recurring operating activities is likely to have better liquidity than a company that borrows the same amount

of cash or that increases its cash position by selling a business unit or by cutting capital expenditures.

While the original motivation for requiring companies to disclose cash flow information was to inform about liquidity, the cash flow statement also facilitates a better understanding of changes in the financial position. Because assets equal liabilities plus equity, an increase in cash (an asset) must be accompanied by either a decrease in another asset or an increase in a liability or equity account. For example, “capital expenditures”—an investing cash outflow—also represents an increase in fixed assets, and “issuance of debt”—a financing cash inflow—also represents an increase in debt liabilities. Thus, by providing information about cash transactions, the cash flow statement informs not only on changes in cash but also on changes in other assets, liabilities and equity accounts. That is, the cash flow statement provides information about changes in the financial position.

Finally, analysts and other “sophisticated” users of the financial statements utilize the cash flow statement to evaluate earnings quality. As discussed above, the operating section of the cash flow statement reports the magnitude of and reasons for the difference between earnings and cash from operations. This information is useful for evaluating the sustainability of earnings because noncash earnings are generally less persistent than operating cash flows. For example, an impairment charge, which reduces net income but does not affect cash from operations, is likely to be less persistent than other earnings items.

2.4 The Statement of Shareholders’ Equity

The statement of shareholders’ equity explains changes in each of the shareholders’ equity accounts during the period that ended on the balance sheet date. Example of line items in this statement include: net income (increases retained earnings), dividends (reduce retained earnings),

issuance of new shares (increases common or preferred stock and additional paid in capital), repurchase of shares (increases treasury stock, a contra-equity account), issuance of shares from the treasury (reduces treasury stock and changes additional paid in capital), and unrealized gains and losses on available-for-sale securities (changes accumulated other comprehensive income).

2.5 Articulation of the Financial Statements

The four financial statements are not independent of each other. In fact, they are all tied together. Figure 1 depicts the articulation of (relationships among) the financial statements. As shown, the income statement articulates with the balance sheet by explaining changes in retained earnings – a shareholders' equity account, and the cash flow statement explains changes in balance sheet accounts due (primarily) to cash transactions.[5]

The primary objective of financial reporting is to provide relevant, reliable, and comparable information about the financial position and performance of an enterprise. Unfortunately, it appears that financial reports often fail to achieve this objective.[6] Accounting distortions or misrepresentations are not confined to "earnings management" or accounting fraud but are often caused by the rules and requirements of the reporting model. The articulation of the financial statements implies that any given accounting distortion affects multiple statements. For example, the immediate expensing of expenditures made to develop intangibles, instead of the more economically descriptive approach of reporting an asset (i.e., "capitalization") and subsequently amortizing, it implies the following distortions: in the balance sheet, both assets and equity are understated; in the income statement, expenses are overstated and net income is understated; in the cash flow statement, cash from operations is understated and cash from

[5] Most companies use the indirect approach for presenting cash from operations, which involves reporting all operating accruals, not just those due to cash transactions.

[6] For empirical and anecdotal evidence regarding financial reporting failures, see, for example, Melumad and Nissim (2008).

investing activities is overstated; and in the statement of shareholders' equity, net income and equity are understated. These effects, however, are reduced or reversed in subsequent years. Assets recognized under the capitalization model are amortized over time, reducing the differences in reported assets and equity compared to the immediate expensing model and reversing the difference in net income.

To demonstrate the differences between the capitalization and immediate expensing models, Figure 2 compares the effects of $100 expenditure in year 1 on reported assets, equity, and income under two alternative accounting treatments: (1) immediate expensing in year 1, and (2) capitalization and straight-line amortization over five years starting in year 2. As shown, in year 1, income is substantially lower under immediate expensing, but this difference is reversed in the subsequent five years. In contrast, assets and equity are smaller under immediate expensing in each of the first five years, but the differences gradually decline over time.

The illustration in Figure 2 serves as a warning to researchers working with accounting measures of firm profitability such as return on assets (ROA) and return on equity (ROE).[7] Consider the case of a temporary spike in advertising expenditures. Such expenditures typically increase current and future revenues and, as they are immediately expensed, reduce current income (assuming the cost is greater than same-period benefits) and increase future income (assuming the expected future benefits materialize). The immediate expensing of advertising expenditures also reduces reported assets and equity, which serve as denominators in subsequent ROA and ROE calculations. Thus, profitability measures are understated in periods of advertising spikes and overstated in subsequent periods. These distortions can lead to erroneous inferences

[7] In our simulation analyses below, we define ROA as the ratio of operating income to beginning-of-period assets and ROE as the ratio of net income to beginning-of period equity. Measuring profitability relative to the beginning-of-period investment is consistent with theory. To see why, consider a savings account that credits a 10% interest rate. An investment of $100 at the beginning of the year grows to $110 at the end of the year. The rate of return should be calculated as 10/100, not as 10/110. That noted, none of the arguments and findings in this study changes if profitability is measured using end-of-period or average values of equity or assets.

regarding the impact and value of advertising and similar activities. We elaborate on this issue in Section 3 below.

2.6 Other Financial Disclosures

The financial statements summarize information regarding many transactions and economic events. Obviously, some information is lost in the aggregation. Also, the accounting principles guiding the aggregation process may not be optimal, at least for some purposes. To mitigate these limitations, public companies are required to provide details about the amounts reported in the financial statements and the accounting principles used as well as unreported transactions and other events such as executory contracts (e.g., purchase commitments) and contingencies. This information is provided in the notes to the financial statements and in other sections of the 10-K Form (the SEC filing that contains annual financial information). Unfortunately, disclosure regarding unrecognized intangible assets and details regarding marketing expenditures are at best very limited, an issue that we return to later in the paper.

We next turn to a discussion of accounting principles as they pertain to marketing activities and assets, focusing on distortions that cause the financial statements to fail to correctly reflect the contributions of marketing activities.

3. Accounting Treatment of Marketing Activities and Assets

Current GAAP distinguish between *internally developed* and *acquired* intangibles, and require different treatments for these two categories. With few exceptions, expenditures to develop intangible assets (e.g., brand development activities, advertising, marketing-related R&D) are

expensed as incurred rather than being recognized as assets.[8] The immediate expensing of marketing costs reduces reported income, assets, and equity (see previous section). In contrast, acquired intangibles (e.g., acquired trademarks or customer lists) are recognized on the balance sheet as assets and only gradually reduce profits and equity through amortization. As discussed below, some acquired marketing-related intangibles are not subject to amortization and generally do not reduce profit or book value at all.

Academics evaluating accounting distortions related to the reporting of marketing activities have focused on the omission of internally developed intangibles from the balance sheet (e.g., Lev 2001) and called for balance sheet recognition of these resources as a remedy (Lev and Zarowin 1999, AAA Financial Accounting Standards Committee, Maines et al. 2003). That is, these researchers and commentators propose that internally developed intangibles be accounted for the same way as acquired intangibles. We argue that while this solution may alleviate some accounting distortions, it will not solve all issues and in fact will introduce new ones. This follows not only because internally generated intangibles have unique properties, but also due to distortions in accounting for acquired intangibles. We next elaborate on the two types of intangibles and their accounting treatments.

3.1 Internally Developed Marketing Intangibles

3.1.1 Treatment in the Financial Statements

Under current US GAAP, "costs of internally developing, maintaining, or restoring intangible assets (including goodwill) that are not specifically identifiable, that have indeterminate lives, or that are inherent in a continuing business and related to an entity as a whole, shall be recognized as

[8] One exception relates to direct response advertising costs; these costs can be capitalized (and subsequently amortized) if past experience indicates that the incremental future net revenues will exceed the capitalized costs and several other conditions are satisfied.

an expense when incurred."[9] Because most marketing expenditures fit the above description of internally developed intangibles, they are generally expensed as incurred and are reported in the income statement as part of "Selling, General and Administrative Expenses." This accounting treatment distorts the financial statements because marketing expenditures are often expected to generate benefits in future periods (e.g., brand building, new product development initiatives, marketing-related R&D, etc.), and as such should be reported as an asset on the balance sheet rather than as an expense in the income statement.

A similar distortion applies to the cash flow statement, which reports cash flows from operating, investing, and financing activities in respective separate sections. In particular, cash flows associated with expenses are classified as *operating*, while cash spent to acquire assets is classified as *investing*. Because marketing expenditures are expensed as incurred, marketing outlays are reported as operating cash outflows and thus reduce net operating cash flow. Many investors view operating cash flow as a measure of "cash earnings" and thus react negatively to the reduction in operating cash flow that results from expensing marketing activities. In sum, all three primary financial statements—the balance sheet, income statement, and cash flow statement—treat marketing expenditures as a cost rather than an asset acquisition.

3.1.2 Accounting Distortions: Simulation Analyses

To demonstrate the effect of the distortions that result from immediately expensing marketing investments we conduct two simulation analyses. We assume that the firm invests every year and that the investment increases at a constant growth rate each year. The investments pay off in five equal annual payments starting the year following the investment. For each investment, the undiscounted sum of cash inflows is 50% greater than the invested amount. Figure 3 plots the

[9] This is the current standard, which was originally prescribed by APB Opinion No. 17, and was restated in Statement of Financial Accounting Standard (SFAS) No. 142, *Goodwill and Other Intangible Assets.*

steady state ratio of simulated reported income under immediate expensing to reported income under capitalization and subsequent straight-line amortization over five years (consistent with the expected pattern of the benefits), as a function of the annual investment growth rate.

As shown in Figure 3, with zero growth, steady state income under the two accounting alternatives is equivalent (the ratio is equal to one). That is, the distortion associated with the immediate expensing of current period investment is exactly offset by the omission of amortization expense related to investments made in the prior five years, whose benefits are received in the current period. However, with positive investment growth, the amount expensed under the immediate expensing model is greater than the omitted amortization charge, causing an understatement of reported income. In fact, when the growth rate exceeds 15.25%, reported income under the immediate expensing model becomes negative. In contrast, with a negative growth rate, reported income under the immediate expensing model is overstated as the omitted amortization of prior year investments is greater than the expensed current year investment.

Further, under negative and moderate positive growth conditions, reported ROA and ROE are higher with immediate expensing than the corresponding ratios under capitalization and subsequent amortization. To demonstrate this phenomenon, we extend the simulation example presented in Figure 3 as follows. We assume that reported assets at the beginning of each year (the denominator in the ROA calculation) are equal to the total of the funds required to pay for the current year investment and any unamortized investments from prior years (for the immediate expensing case this latter component is equal to zero). Figure 4 plots steady state ROA calculated under the two alternative methods (immediate expensing versus capitalization and subsequent amortization) as a function of the annual investment growth rate.

ROA under immediate expensing is greater than ROA under capitalization and subsequent amortization for annual growth rates below 11%. For negative growth this is due to both

numerator and denominator effects, that is, income under immediate expensing is greater than under capitalization and amortization (see Figure 3 and related discussion) and the assets are smaller (under immediate expensing, the investment is omitted from the balance sheet). For 0% to 11% growth rates, the numerator effect reverses but the denominator effect dominates. For growth rates above 11%, the denominator remains smaller under immediate expensing, but the numerator effect becomes dominant. For growth rates above 15.25%, income and therefore ROA become negative under immediate expensing. The pattern depicted for ROA in Figure 4 also holds for ROE. In fact, because financial leverage reduces equity without changing the numerator effect, the ROE differences between the two accounting methods are greater than the corresponding ROA differences.

The simulation examples presented above are highly stylized. In reality, firms have some assets that are always capitalized (e.g., inventory, fixed assets), which attenuate the differences in profitability ratios across the two accounting methods. The directional effects, however, hold in practice (e.g., Lev, Sarath, Sougiannis 2005).

3.1.3 Implications

With no alternative source of information regarding the benefits generated (or expected to be generated) by marketing expenditures, their immediate expensing reduces the quality of financial reports and impedes modeling and analysis of marketing effectiveness. The fundamental problem the current accounting model creates for firm management boils down to the simple truism: Assets that are not properly measured cannot be properly managed. The key specific implications of immediate expensing are:

- Reported income is distorted. The direction and size of distortion depend on the stage in the firm's life cycle and marketing strategy (i.e., escalation or deceleration). For growing firms, income is understated due to the expensing of current marketing expenditures. This understatement is only partially offset by the omission of periodic amortization of

- Reported assets, and therefore equity book value (which is equal to assets minus liabilities), are understated by the value of internally generated intangible assets.[10] Unlike the effect of immediate expensing on income, which depends on the growth rate (Figure 3), immediate expensing reduces assets and equity below the capitalization / amortization levels under any growth pattern.

- Profitability metrics such as ROA and ROE are distorted in ways that are difficult to evaluate due to often-conflicting numerator and denominator effects.

- It is difficult to assess the effectiveness of the various marketing activities because there is no recognition of any resulting intangible assets. As a result, the value of internally generated marketing assets is often unrecognized and unappreciated by the internal constituency. Changes in the value of internally generated marketing intangibles are not assessed on a regular basis and as a result are not salient to management. Lack of asset recognition can lead to managerial neglect and inferior strategic decision making.

- Lack of detailed reporting of marketing activities and marketing asset recognition creates conditions allowing firm managers to manipulate reported income, assets, equity, and cash from operations by changing the magnitude or timing of marketing expenditures. For example, a myopic manager may cut value-creating marketing expenditures to temporarily inflate current reported income at the expense of future income (e.g., Chapman and Steenburgh 2011, Graham et al. 2005, Melumad and Nissim 2008, Mizik and Jacobson 2007).

3.1.4 Disclosure Notes: A Mitigating Effect?

In addition to the financial statements, financial reports include notes which provide details elaborating on some line items. For example, firms may report the marketing components of Selling, General and Administrative (SG&A) expense in the notes. Therefore, to the extent that firms provide detailed note disclosures regarding investments in internally-generated marketing intangibles, the omission of these assets from the balance sheet may not be consequential. In practice, however, note disclosures related to marketing activities are rather limited in scope, arbitrary in content, and are unstructured. For example, many firms do not even disclose the

[10] The equity distortion is partially offset by the impact on deferred taxes. To simplify the discussion, we ignore income tax effects.

advertising expenditures component of SG&A.[11] Similarly, the Management, Discussion and Analysis (MD&A) section of the annual report, which is intended to provide an overview of the firm's operations, typically contains little information regarding marketing efforts.

3.2 Acquired Marketing Intangibles

Marketing-related intangibles are often acquired in business combinations. Unlike internally developed intangibles which are expensed as incurred, GAAP requires that all acquired intangibles be recognized as assets on the balance sheet.

3.2.1 Initial Recognition

Intangible assets which are grounded in legal rights (e.g., distribution rights, licenses) or are separable from the business by sale, transfer, license, rental, or exchange are measured directly and recognized separately. These include marketing-related intangibles such as brand names, trademarks, trade names, internet domain names, noncompetition agreements, customer databases, and advertising jingles. The initial recognition of these assets requires estimation of their fair value, that is, "the amount at which the asset could be bought or sold in a current transaction between willing parties."

Acquired intangible assets which do not meet the criteria for separate reporting are referred to as "unidentifiable" and are reported as part of goodwill. Examples of unidentifiable intangibles include reputation, customer base, customer service capability, market knowledge, presence in geographic markets or locations, human capital, nonunion status or strong labor relations, ongoing training or recruiting programs, outstanding credit ratings, access to capital markets, and favorable government relations. In contrast to identified intangibles, which are measured directly, goodwill

[11] Several years ago the FASB had plans to require disclosure of information about intangible assets that are not recognized in the financial statements, including assets that are developed internally (such as brand names and customer relationships). On January 14, 2004, however, the FASB removed this project from its research agenda, presumably due to concerns regarding the reliability of such disclosures.

is calculated indirectly as the difference between the acquisition price and the value of the net identifiable assets (i.e., assets minus liabilities) acquired. Consequently, in addition to the value of unidentifiable intangibles, goodwill also reflects expected synergies from the business combination, errors in valuing acquired identifiable assets or liabilities, and any overpayment in the acquisition transaction.

3.2.2 Accounting Treatment Subsequent to the Initial Recognition

After the initial recognition on the balance sheet, the accounting for recognized intangibles is based on their estimated useful lives. Intangibles with finite useful lives, such as most franchising agreements, are amortized (i.e., reduced for the portion that has been "consumed") each period, while intangibles with indefinite useful lives, such as some brand names, are not amortized but instead are tested for impairment annually as well as when events or changes in circumstances indicate that the intangible asset might be impaired. For example, in 2008 The Molson Coors Brewing Company recognized an impairment charge of $50.6 million associated with the Molson brands intangible asset, which was recognized in the merger between Coors and Molson in 2005. The impairment was due to "unfavorable operating results and a change in management's strategic initiatives associated with these brands."

Impairment of indefinite-life intangibles is recognized when the book value exceeds the estimated fair value.[12] In contrast, intangibles are never adjusted upward for increases in value. Finite life intangibles are also subject to an impairment test, but one which is less likely to result in

[12] Although goodwill is considered to have indefinite life, it is subject to a somewhat different impairment test. For goodwill, the impairment test has two steps. First, the fair value of each reporting unit within the organization is estimated and compared to the unit's book value. If the unit's fair value is smaller than its book value, then the implied fair value of goodwill associated with that unit is calculated as the difference between the unit's fair value and the fair value of net identifiable assets. Goodwill impairment is recognized to the extent that the implied fair value of goodwill is smaller than the reported amount.

recognition of impairment losses.[13] In addition to the reporting of intangibles in the financial statements, GAAP requires annual disclosure of the carrying amount of intangible assets by major asset class, defined as "a group of intangible assets that are similar, either by their nature or by their use in the operations of an entity."

3.2.3 Implications

Although the accounting treatment of acquired intangibles appears more "correct" than that of internally developed intangibles (it recognizes intangibles on the balance sheet), it does involve similar issues: accounting distortions, difficulty in estimating marketing's contribution, managerial neglect, and myopic management. These problems arise for the following reasons:

- Companies have substantial discretion in identifying and recognizing individual intangibles, estimating their fair values, and classifying them as having either finite or indefinite life (Maines et al. 2003). Firms can use this discretion to deliberately manipulate financial reports.[14] For example, a company may classify an acquired finite life trademark as having indefinite life, thereby avoiding the periodic amortization expense and increasing reported income.

- Impairment tests are highly subjective. Companies have to determine (1) which events or circumstances should trigger impairment test; (2) the level of asset aggregation for the test (high levels reduce the likelihood and amount of impairment because profitable assets offset impaired ones); (3) the expected cash flows; (4) the timing of the cash flows; and (5) the discount rate to apply to the cash flow. Each of these decisions involves substantial discretion, which may be exploited to manipulate financial reports.

- Very few, if any, intangible assets are not subject to economic amortization. Thus, the lack of systematic amortization of goodwill and other indefinite life intangible results in poor matching of costs against revenues in the income statement. Impairment charges do not solve this problem because of their discretionary and lumpy nature.

[13] Finite-life intangibles are reviewed for impairment whenever events or changes in circumstances indicate that they might be impaired. That is, unlike indefinite-life intangibles, finite-life intangibles are not necessarily tested for impairment each year. Further, for finite-life intangibles, an impairment loss is recognized only if the *undiscounted* sum of future cash flows is smaller than the intangibles' book value. Similar to indefinite-life intangibles, finite-life intangibles are written down to their estimated fair value when deemed impaired.

[14] In general, errors in the valuation of individual intangibles are "absorbed" in goodwill. For example, an overstatement of the value of acquired brands implies an understatement of goodwill (as long as these values add up to the purchase price).

- While less subjective than impairment charges, measuring amortization expense also involves significant discretion which can be exploited to manipulate the financial statements. For example, a company may overstate the useful life of marketing-related intangibles to reduce the periodic amortization expense and increase reported income in the near future.

- Companies generally amortize finite life intangible assets using the straight line method (i.e., decreasing their value by a fixed amount each year over the useful life). In most cases, the pattern of benefits generated by intangibles is anything but flat, which results in poor matching in the income statement. This in turn increases the volatility of reported income and decreases its predictive ability.

Not only does the balance sheet recognition not eliminate the negative implications of the immediate expensing model, but the added flexibility and discretion in accounting for acquired intangibles provide new opportunities for earnings management and manipulation (Skinner 2008). That, in turn, can further obfuscate marketing benefits and make them even more difficult to assess.

4. Marketing-Accounting Interface: Implications for Marketing Research and Practice

The shortcomings of the financial reporting system have several important negative implications for marketing research and practice. First, the data distortions inhibit performance evaluation and forecasting accuracy. Second, they make marketing's contribution to firm performance difficult to assess and, as a result, promote organizational perception of marketing as a discretionary activity. Third, management practices are affected by financial reporting (Hemmer and Labro 2008) and may deviate from optimal because the regular timing of financial reporting (e.g., required quarterly earnings reports) and budgeting process do not necessarily align with the optimal timing of marketing effort and expense outlays.

Indeed, the temporal misalignment at the marketing-accounting interface creates an internal organizational conflict leading to inefficient firm management. This inefficiency stems from two sources. On one side, top management engages in myopic management with the intent to

meet short-term financial performance goals. On the other side of this conflict, marketing departments engage in gaming and mis-management of their budgets (typically through over-spending and inefficient resource allocation) with the intent to ensure that their budgets are not decreased in the following year. The structured timing of financial reporting and budgeting process drive the dynamics of the gaming practices top management and marketing departments undertake. However, with more informative reporting of marketing assets and activities, these practices may be reduced or potentially even discontinued.

4.1 Myopic Management to Meet Financial Objectives

Current marketing reporting practices create conditions that allow and, in fact, often entice managers to undertake inefficient actions to "manage" reported earnings. For example, managers may cut marketing expenditures if they expect that reported earnings would otherwise fall short of benchmarks (e.g., prior period earnings or consensus analysts' forecast). When motivated by short-term objectives rather than a deliberate strategy, budget cuts could lead to significant deterioration in performance (Cohen and Zarowin 2010, Melumad and Nissim 2008, Mizik 2010). The accounting literature refers to these types of earnings management activities as "real earnings management" (as opposed to earnings management conducted by manipulating accruals estimates). We refer to it as "myopic management."

Recent research suggests that myopic management is widespread (Graham et al. 2005, Libby and Lindsay 2007), and its prevalence has only increased following the passage of the Sarbanes-Oxley Act (Cohen et al. 2008). Libby and Lindsay (2007), for example, survey senior managers in large for-profit US firms and find a high propensity to defer necessary expenditures to meet performance targets: over 90% of the respondents acknowledge occasional or frequent occurrence of this practice. 60% of the respondents also acknowledge occasionally or frequently

"accelerating sales" near year-end. Using a large-scale survey of CFOs, Graham et al. (2005) find that the top three most preferred activities for earnings inflation involve myopic marketing strategies. When faced with a possibility of missing desired quarterly earnings targets, 80% of surveyed executives reported that they would decrease spending on advertising and R&D; 55% would delay a start of a new project; and 39% would provide incentives for customers to buy more products in the current quarter.

Myopic management related to marketing activities has been confirmed by empirical research. Studies have documented the following practices:

Cutting Marketing and R&D Investments: Firms cut R&D to reverse earnings decline or boost earnings (Bushee 1998). Because deterioration of brand equity is not immediately apparent, firms cut advertising and brand-building support to provide immediately observable improvements in financial results (Aaker 1991, Lamey et al. 2007).

Cutting Charitable Giving and Corporate Social Responsibility Programs: Firms use their charitable foundations as off-balance sheet reserves. Corporate philanthropy programs are strategically used to achieve financial reporting objectives (Petrovits 2006).

***Price Discounting*:** Firms use price discounting to temporarily boost sales and increase earnings when facing the possibility of missing performance benchmarks (Roychowdhury 2006, Chapman 2011, Chapman and Steenburgh 2011) or to deliberately "milk" a brand (Aaker 1991).

***Delaying New Projects*:** Firms engage in a ratchet game where they slow down the introduction of innovations in order to manage expectations and market reaction (Moorman and Spencer 2009).

Interestingly, while academic studies document detrimental consequences of engaging in myopia (Cohen and Zarowin 2010), managers do not recognize the negative consequences of their myopic practices. Libby and Lindsay (2007) report that most managers do not expect manipulation of real activities to meet immediate performance goals to have negative future

performance consequences. 61% of their survey respondents indicated that their organizational performance was affected "not at all or a little," 22% indicated that long-run performance was "moderately" affected, and only 17% indicated that performance was "impaired significantly" by myopic management practices. Lodish and Mela (2007) suggest that it is the managers' short tenures that likely contribute to their inability to observe and assess the long-term impact of such practices.

4.2 Gaming of Budgets by Marketing Departments

On the other side of this organizational conflict, marketing departments develop strategies and undertake actions to protect themselves and their budgets against arbitrary funding cuts. These strategies entail gaming the resource allocation and firm budgeting process with the intent to build in slack and ensure sufficient funding in the current and future periods. The gaming process involves two main stages: (1) padding or "sandbagging" (i.e., inflating beyond optimal levels) marketing budget estimates for the next fiscal period and (2) "blow-it-all" spending of current-period budget.

Empirical research into the budget gaming phenomenon has been rather limited and is mostly based on anecdotal and survey evidence. The prevailing view on budget gaming, however, contents that the practice is pervasive. The existing evidence suggests that such practices are, in fact, a behavioral norm in organizations (Libby and Lindsay 2007, Merchant 1985, Merchant and Manzoni 1989, Onsi 1973, Umpathy 1987). Some researchers have specifically studied the "dysfunctional behaviors" entailing gaming performance indicators and strategic information manipulation by marketing managers (e.g., Jaworski and Young 1992). Steele and Albright (2004, p. 81), for example, note that "It is now commonplace, in fact, for talented and charismatic managers to spin, manipulate and otherwise cajole senior management into funding their business

ideas—often in the face of numbers that would, on their own, dictate a negative decision." Prendergast (1997, p. 44) concludes that for marketing and sales managers "padding is synonymous with entertainment expenses."

4.2.1 Marketing Budget Padding

The budget numbers and funding requests submitted by marketing managers often overstate expected needs and mislead senior executives about the costs with the intent is to create budgetary slack (Onsi 1973). Of course, as some authors note, empire building and managerial belief that larger budgets command perceptions of greater organizational importance might be driving some budget padding. Prendergast (1997), however, describes a case of a corporate headquarters requesting mid-year cost savings to counter negative performance elsewhere in the corporation. Following the incident, some managers begun to routinely put in additional budget slack "to make up for the danger that the head-office might make another similar request." Onsi (1973) reports that 80% of surveyed managers admit bargaining for budgetary slack. They often do so specifically as a way to hedge against uncertainty (Dunk and Nouri 1998).

On one hand, built-in budgetary slack allows marketing managers to deal with emergencies: pursue unforeseen opportunities, more effectively adapt and respond to changing environmental conditions and competitive attacks. Merchant and Manzoni (1989), report that managers admit biasing their budget estimates to build in some slack resources to increase their operating flexibility. This operating flexibility can be beneficial because it reduces the need to react to every short-term contingency with extreme and costly actions (e.g., personnel layoffs), and allows managers to make some discretionary investments without requesting corporate approval or renegotiating the budget. On the other hand, however, budget padding by marketing managers has significant negative consequences for the firm as it diverts funding from strategic initiatives senior management would otherwise plan for in other functional or strategic areas.

4.2.2 Blow-It-All Spending of Marketing Budgets

Marketing departments typically strive to fully spend their budgets by the end of the fiscal year to avoid losing funding in the next period. Over 20% of respondents in Libby and Lindsay's (2007) survey indicated that this practice occurs "frequently" and over 65% that it occurs "occasionally."

Marketing spending can be classified into two general categories: recurring spending (e.g., relatively stable, on-going vendor and sub-contractor relationships with agencies and marketing research firms) and non-recurring expenditures (for strategic projects and initiatives, and for discretionary non-strategic spending). The non-recurring spending is easier to over-state because it is often not linked to existing contracts. The non-recurring categories typically provide the opportunity to strategically expand marketing spending to ensure the entire budgeted funding is used up before the end of the fiscal period. Once the non-strategic discretionary spending is undertaken, the inefficiencies in the current marketing processes are often "baked into" the next year's estimates ensuring continuing flow of resources.

We interviewed over 30 executives and marketing professionals regarding their budgetary practices. "Spend it all and spend it early [in the fiscal period]," was the clear on-going theme in their responses. In the process of these interviews we identified the following as the most common practices marketers engage in to ensure that their next-year budgets would not decrease: (1) engaging in inefficient promotional campaigns, (2) pre-paying vendors for services not rendered, (3) intentionally over-paying vendors, (4) undertaking expensive advertising campaigns and promotions knowing that the spending is wasteful and not justifiable based on expected returns.

These budget gaming practices on the part of marketing departments are inefficient and destroy value. They amount to a waste of company resources: the resulting resource mis-allocation is detrimental to the organizational performance and to investors. The lack of reliable metrics to track spending and evaluate effectiveness of marketing activities enables these behaviors.

5. Propositions and a Call for Marketers to Engage in the Dialogue on Improving Financial Reporting

We should not accept accounting practices that encourage and facilitate myopic management, portray marketing as a "cost," impede evaluation of marketing contribution, and lead to decreasing marketing influence. Improvements to the financial reporting model are desperately needed. Balance sheet recognition of intangibles has emerged as the dominant proposed solution (Maines et al. 2003), but we believe that in most cases it would not resolve the negative implications of the current accounting system for marketing. Our propositions for improving financial reporting practices as they relate to marketing activities differ from the proposals advanced in the literature. Rather than advocating blanket recognition of all intangibles on the balance sheet, we advocate for expanding and formalizing disclosures.

5.1 Balance Sheet Recognition is not a Feasible Solution

We believe that the balance sheet recognition of most marketing intangibles is currently not feasible and would not remedy the problems generated at the marketing-accounting interface. Our view is motivated by the following considerations.

One, the current state of knowledge regarding marketing's contribution to the bottom line is limited (Rust et al. 2004, Srinivasan and Hanssens 2009) and does not allow for measurement of probable future benefits with *sufficient precision* and *certainty*, which is a requirement for balance sheet recognition. Before balance sheet recognition can be implemented, standardized methods for reliably forecasting the contribution and dynamic impact of various marketing activities have to be established. Intangibles are unique economic resources. Many marketing intangibles are not separable from the enterprise, property rights for intangibles are often not well-defined, there are no liquid secondary markets for intangibles, and it is difficult to write contracts for intangibles

(Skinner 2008). As such, it is understandable why at the present there is no agreement on how to value them. For example, Table 1 presents the brand value estimates for the "most valuable brands" by leading brand valuation providers—Interbrand, Milward Brown, and Brand Finance—published in 2009 in the business press. As shown, little agreement exists with respect to the valuation of the brand assets and even the direction of the change in brand value from the prior year.

Two, our discussion of the accounting treatment of acquired intangible assets suggests that balance sheet recognition does not resolve the data quality, organizational conflict or myopic management issues. Given the lack of standards for valuing intangibles, and managers' discretion in accounting for acquired intangibles (including the initial recognition and subsequent amortization or impairment), the key negative implications we identify for internally generated intangible assets—accounting distortions, difficulty in estimating marketing's contribution, managerial neglect, and myopic management—are not likely to be eliminated or even reduced with balance sheet recognition.

Three, balance sheet recognition of internally generated marketing intangibles is not likely to materialize in the near future. The debate on how to value and account for intangible assets has been ongoing for over a century (Canning 1929, Dicksee and Tillyard 1906, Harris 1884, Leake 1914), without satisfactory resolution (Lev 2001). Most of the recent discussions and significant research effort had focused on intangibles generated by R&D expenditures, primarily because data on R&D spending are available (Maines et al. 2003). These studies have generated substantial evidence regarding the benefits from R&D activities, and yet several attempts at moving toward capitalization of R&D have failed. Because expenditures on other types of intangibles are not segregated, research into their value has been significantly hindered (Lev 2001). As such, efforts to institute their balance sheet recognition are even less likely to succeed.

Finally, we are concerned that the balance sheet recognition of intangible assets may potentially replace voluntary disclosures in other sections of the financial reports (disclosure notes, MD&A). This can lead to further deterioration rather than improvement of the overall information quality and further exacerbate the negative implications for marketing.

We do not rule out the capitalization and amortization treatment for all expenditures, but rather argue that this treatment should be reserved to those activities that satisfy both of the following criteria: (1) there is strong evidence regarding the magnitude, timing and certainty of the benefits that the activity is expected to generate, and (2) the expenditures related to the activity can be segregated from other outlays. Importantly, we argue that balance sheet recognition should not substitute detailed disclosures.

5.2 Expanded Disclosures are a Feasible Solution

Instead of balance sheet recognition of intangibles, we argue for improved and expanded mandatory disclosures. Consistent, observable, quantifiable, and verifiable information on marketing-related spending and performance drivers can improve performance evaluation, forecasting, internal marketing management process, and external valuation quality.

Holmstrom (1979) provides theoretical rationale for our proposal. He shows that a signal is valuable if it is contains incremental information. In a principal-agent framework, additional performance-relevant signals can improve the welfare of both the agent (i.e., firm) and the principal (i.e., external evaluator). Because many marketing assets are not reflected in contemporaneous financial reports, marketing metrics can provide incremental information and serve as useful signals about the firm's future performance. But which marketing metrics should be disclosed? As it turns out there are several "low hanging fruits."

5.2.1 Segregating Marketing Spending Categories and Revenue Sources

Providing detailed and consistent disclosures regarding the components of marketing expenditures would be a significant first step. Different elements of marketing mix spending have different dynamic impact on future financial performance. Some marketing activities generate immediate positive returns and future long-term negative profits, while others have positive long-term impact on sales and profits (Bronnenberg, Dhar, and Dube 2007; Pauwels, Hanssens, and Siddarth 2002).

Our recommendation, therefore, is that companies be required to segregate marketing spending from SGA, and also disclose the amounts spent on different activities such as advertising, customer acquisition activities (e.g., direct mail, direct sales, free samples, etc.), customer relationship management (CRM), non-cash promotions, brand-building, sponsorships, and community outreach. Additional disclosures (which may be objected to by companies but should nevertheless be considered) would be breaking down marketing outlays by geographic area, operating segment, product or line of business, brand (in multi-brand firms), or even customers (when there are major customers).

Information about components of marketing expenditures would be especially relevant if those outlays can be matched with related revenues. Thus, decomposing revenue along the same dimensions as marketing spending (e.g., geographic area, product or line of business) would lead to further improvement in monitoring, performance measurement, and valuation related to marketing activities. Additional relevant revenue source or revenue growth decompositions include: (1) new vs. existing customers; (2) new versus existing stores, ships, or other sales-generating units; (3) volume versus price; and (4) organic versus structural changes (e.g., business combinations). Many companies already disclose some of these decompositions in the notes or MD&A sections of the Form 10-K, but the disclosures are often incomplete or missing, and are generally not comparable across companies. More importantly, the corresponding marketing expenditures are rarely disclosed.

5.2.2 Reporting Non-Financial Performance Drivers

Identifying marketing-based non-financial performance drivers that should be disclosed is more difficult but potentially highly beneficial for external valuation and efficient internal management. O'Sullivan and Abela (2007), for example, report that the ability to measure marketing performance has a significant positive impact on the firm's financial performance and on marketing's stature within the firm. Ittner (2008) surveys the statistical evidence on the performance consequences of intangibles measurement and reports that most studies find positive association between intangible asset measurement and performance. However, managers are likely to object to expanding disclosures and may cite competitive concerns, the strategic nature of information, and the cost of data collection (Maines et al. 2003). While these claims deserve full consideration, the overwhelming prevalence of myopic management, which is often driven by personal benefits, suggests that these objections should not be taken at face value.

Maines et al. (2003, p. 180) acknowledge that nondisclosure creates information asymmetries, but they suggest that the fact that most firms provide little voluntary disclosures on intangibles indicates that such disclosures are not valuable for shareholders. In other words, the costs of disclosure probably exceed its benefits. There is, however, an alternative explanation for the limited disclosures observed in practice: a reduction in information asymmetry reduces managers' ability to engage in myopic management. We argue that it is important to distinguish the organizational and managerial costs of disclosure in interpreting the current low levels of voluntary disclosures. Research in economics, accounting, and marketing supports our view (e.g., Stein 1989). Aboody and Lev (2000), for example, report that managers of R&D-intensive firms (presumably firms with higher information asymmetries) are able to realize larger abnormal gains from insider trading than managers of other firms.

Surprisingly, managerial myopia and benefits of restricting disclosure are not prominent in the current discussions of accounting for intangibles. Most discussions and proposals related to intangibles have focused on benefits and implications for external audiences (e.g., Skinner 2008; see Ittner 2008 for an exception). But given the overwhelming evidence on the prevalence of myopic management and the failure of voluntary disclosure mechanisms to substantively affect the status quo, we argue that time has come to consider the regulation of and formalization of disclosures related to marketing intangibles.

5.2.3 The Role of Marketing Metrics

Marketing metrics can serve two key functions in alleviating organizational conflict and limiting myopic behavior and its consequences. First, to the extent that marketing metrics are monitored and reported, marketing assets are less likely to be dissipated through myopic management. Stein (1989) notes that managers seeking to inflate current-term earnings are most likely to sacrifice off-balance sheet assets. Efforts to track and document marketing-related performance drivers can serve to limit this type of behavior.

Second, marketing metrics can provide signals of future prospects incremental to accounting information and thus facilitate a better understanding of firm performance. For example, if a company reports enhanced accounting performance, marketing metrics can help distinguish whether that reported performance is predictive of future cash flows or instead is due to a reduction in off-balance sheet marketing assets (e.g., due to a decrease in advertising expenditures), which is likely to lead to a reduction in future cash flows.

To evaluate the current state of research on marketing-related performance metrics, we surveyed the marketing and accounting literatures. Table 2 presents our views on the current state of research on specific marketing-related drivers and summarizes our findings across two dimensions: ease and agreement on standardization of measurement, and evidence of future

performance impact. We view metrics listed in quadrant (1) as primary candidates for inclusion in financial reports. These non-financial items are generally recognized as important indicators of organizational health and future prospects. We view metrics listed in quadrants (2), (3), and (4), as potential candidates in need of significant additional research effort on measurement and/or performance impact.

5.3 The Role of Marketing Managers and Marketing Researchers

Changes to financial reporting requirements related to marketing activities will likely take a long time to materialize. Meanwhile, the decline of marketing's influence is likely to continue. Rather than waiting for regulation to change, actions can be taken within organizations and by the marketing research community to help alleviate some of the problems. Research is also needed to facilitate the required changes in financial reporting.

To improve the situation, marketing managers can: (1) enhance tracking of marketing-related performance drivers and increase their visibility and salience to the top management team; (2) institute systematic marketing performance measurement to quantify returns to marketing initiatives in financial and non-financial terms; and (3) formalize internal marketing audit to monitor spending patterns with particular attention to non-recurring items.

Marketing researchers have an important role to play. Many have emphasized the benefits and advocated for greater effort in metric development and utilization (Ambler 2003, Day and Fahey 1988, Farris et al. 2010, Gupta and Zeithaml 2006, Reibstein and Lehmann 2006, O'Sullivan and Abela 2007). Before reporting standards can be set and implemented, research is needed to identify marketing-related performance drivers and establish their dynamic impact on the top and bottom lines (Pauwels, Currim et al. 2004). Research should also demonstrate the *incremental* explanatory power of the drivers relative to accounting metrics as well as relative to

each other. Ittner and Larcker (2001), for example, highlight the tendency to examine only one of many potential non-financial value drivers at a time as a major limitation of the current research on intangibles. They report high correlations among various non-financial value drivers and argue that such studies are susceptible to omitted variable bias. Finally, research should establish reliable methodologies for measuring the metrics that would lead to comparable disclosures across companies.

In the long-term, research that identifies relevant performance drivers for disclosure purposes will lead to a better ability to estimate the magnitude, pattern and duration of the benefits that result from various marketing activities. That knowledge, in turn, could eventually facilitate balance sheet recognition of those internally developed intangibles for which the dynamic pattern and duration of future benefits can be estimated with high certainty.

6. Conclusion

Marketing activities are crucial for value creation (McAlister et al. 2007). To ensure proper support for this important organizational function, financial reports must reflect the value implications of these activities. In recent years the issue of information quality has come to the forefront of accounting research (e.g., Dechow and Schrand 2004), especially its implications for performance forecasting and valuation. This focus is consistent with the primary objective of financial reporting, as stated by the Financial Accounting Standard Board (FASB): “provide information that is useful to present and potential investors and creditors and other users in making rational investment, credit and similar decisions … in assessing the amounts, timing, and uncertainty of prospective cash receipts” (FASB, Statement of Financial Accounting Concepts No. 1, 1978).

In the marketing field, the role and implications of financial reporting practices have been largely ignored. Yet, these practices contribute significantly to the declining role of marketing within the organizations: they impede assessment of marketing's contribution and enable myopic management. Improvements to the current marketing accounting model are needed. It is imperative for marketers to understand the implications of the marketing-accounting interface for marketing research and practice and to become active participants in the ongoing discussions on how to improve financial reporting.

Recognizing that our propositions differ from the often-made call for balance sheet reporting of internally developed intangibles, we expect and welcome constructive discussions and criticisms of our position. We seek to ignite a dialogue among marketers and across the marketing and accounting disciplines with the objective of improving financial reporting and alleviating its negative implications for the marketing profession.

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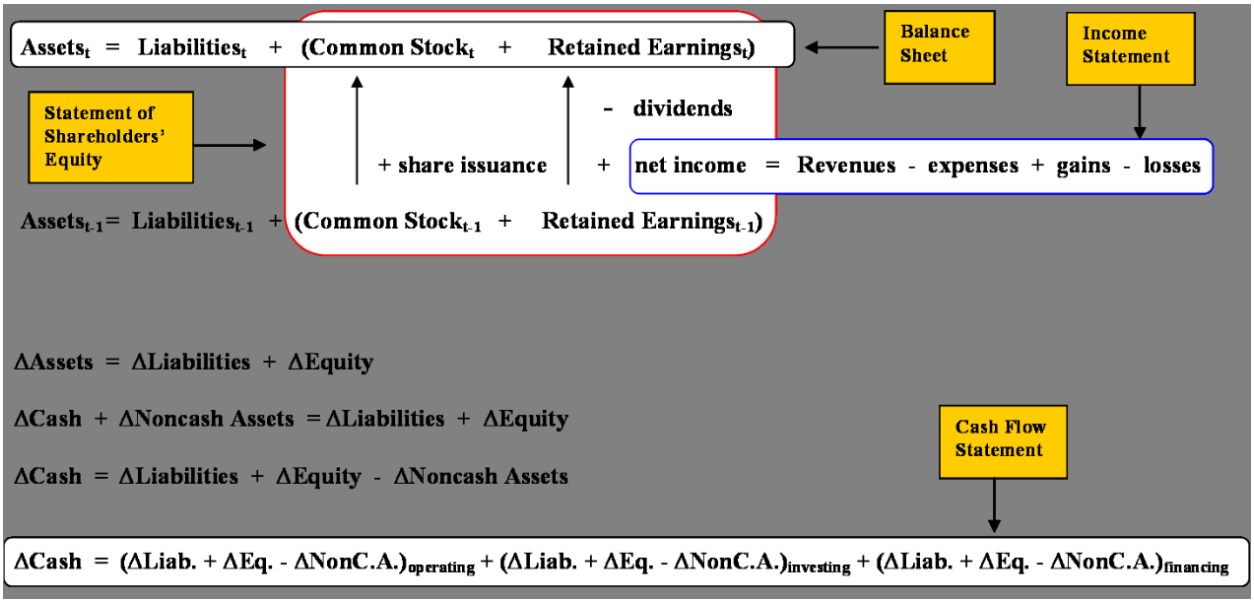
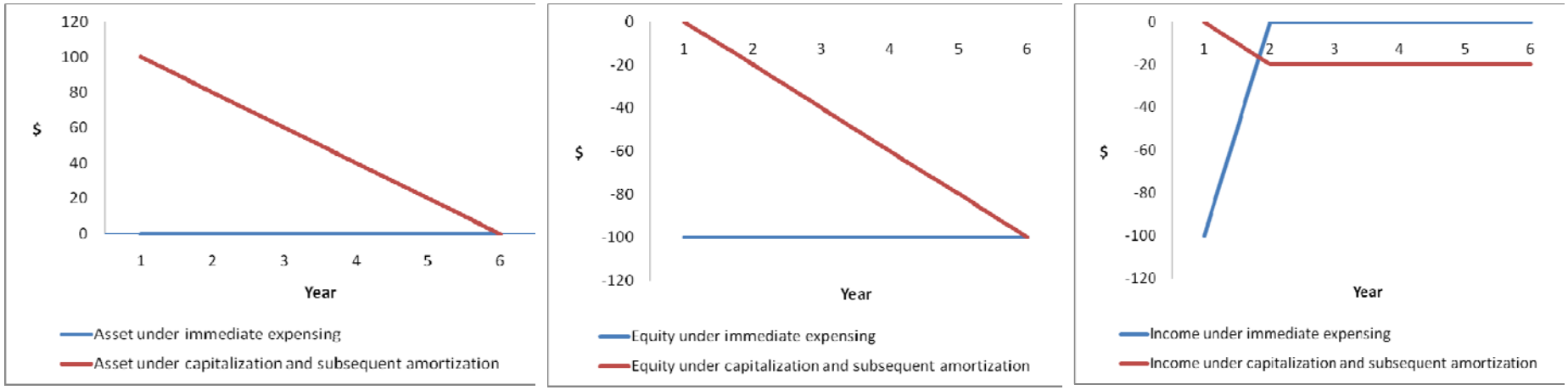
Figure 1: The Articulation of the Financial Statements



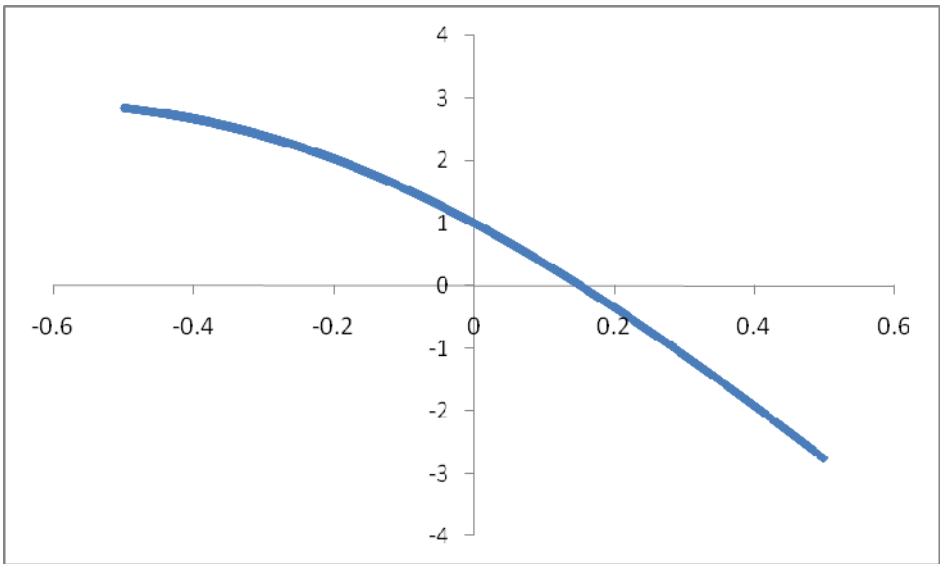
Legend:
The figure describes the articulation of (relationships among) the financial statements. The equity section focuses on the link between the income statement and balance sheet and so omits some equity accounts and transactions (e.g., additional paid in capital, treasury stock, share repurchases).

Figure 2: Implications of Expensing versus Capitalization for Reported Assets, Equity, and Income



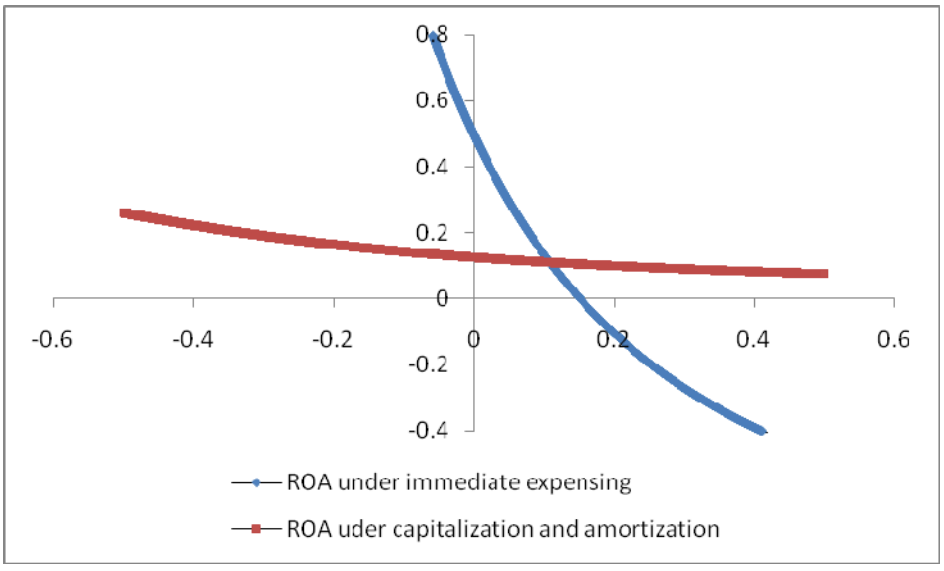
Legend: The figures depict the impact of a $100 expenditure occurring in year 1 under two alternative accounting treatments: (1) immediate expensing in year 1, and (2) capitalization and straight-line amortization over five years starting in year 2. For simplicity, we assume no income taxes and ignore the benefits that result from the expenditure (which are independent of the accounting method).

Figure 3: Steady-State Ratio of Income under Immediate Expensing to Income under Capitalization and Subsequent Amortization (Y-axis) as a Function of Growth (X-axis)



***Legend**:* This figure relates to the following illustration. The firm's investment increases at a constant growth rate each year. Each investment pays off in five equal annual payments starting the year following the investment. For each investment, the undiscounted sum of the cash flows is 50% greater than the invested amount. The figure depicts the steady state ratio of reported income under immediate expensing of investments to reported income under capitalization and subsequent straight-line amortization over five years (consistent with the expected pattern of the benefits), as a function of the annual investment growth rate.

Figure 4: Steady State ROA under Immediate Expensing and under Capitalization and Subsequent Amortization (Y-axis) as a Function of Growth (X-axis)



***Legend**:* This figure relates to the following illustration. The firm's investment increases at a constant growth rate each year. Each investment pays off in five equal annual payments starting the year following the investment. For each investment, the undiscounted sum of the cash flows is 50% greater than the invested amount. Reported assets at the beginning of each year are equal to the total of the funds required to pay for the current year investment and any unamortized investments from prior years. The figure plots steady state Return On Assets (ROA) calculated under the two alternative methods (immediate expensing versus capitalization and subsequent amortization) as a function of the annual investment growth rate.

Table 1: Brand Asset Value Estimated by Leading Brand Valuation Providers

Panel A: Highly Divergent Estimates of Brand Value across Providers (2009 estimates, $M)

Interbrand		Milward Brown		Brand Finance	
Brand Rank	**Brand Value**	**Brand Rank**	**Brand Value**	**Brand Rank**	**Brand Value**
1. Coca-Cola	68,734	1. Google	100,039	1. Wal-Mart	40,616
2. IBM	60,211	2. Microsoft	76,249	2. Coca-Cola	32,728
3. Microsoft	56,647	3. Coca-Cola	67,625	3. IBM	31,530
4. GE	47,777	4. IBM	66,622	4. Microsoft	30,882
5. Nokia	34,864	5. McDonald's	66,575	5. Google	29,261
6. McDonald's	32,275	6. Apple	63,113	6. GE	26,654
7. Google	31,980	7. China Mobile	61,283	7. HSBC	25,364
8. Toyota	31,330	8. GE	59,793	8. Vodafone	24,647
9. Intel	30,636	9. Vodafone	53,727	9. Hewlett-Packard	23,837
10. Disney	28,447	10. Marlboro	49,460	10. Toyota	21,995
11. Hewlett-Packard	24,096	11. Wal-Mart	41,803	11. Bank of America	21,017
12. Mercedes	23,867	12. ICBC	38,056	12. McDonald's	20,003
13. Gillette	22,841	13. Nokia	35,163	13. Nokia	19,889
14. Cisco Systems	22,030	14. Toyota	29,907	14. AT&T	19,850
15. BMW	21,671	15. UPS	27,842	15. Verizon Wireless	18,854
16. Louis Vuitton	21,120	16. Blackberry	27,478	16. China Mobile	17,196
17. Marlboro	19,010	17. Hewlett-Packard	26,745	17. Orange	16,799
18. Honda	17,803	18. BMW	23,948	18. Disney	16,750
19. Samsung	17,518	19. SAP	23,615	19. Budweiser	16,692
20. Apple	15,443	20. Disney	23,110	20. Tesco	16,408

Panel B: No Agreement on the Direction of Change in Brand Value from 2008 to 2009

Brand	**2009 vs. 2008 Interbrand**	**2009 vs. 2008 Milward Brown**	**2009 vs. 2008 Brand Finance**	**Is the Direction of Change Consistent?**
Coca-Cola	3%	16%	-28%	**NO**
Microsoft	-4%	8%	-31%	**NO**
Google	25%	16%	-32%	**NO**
IBM	2%	20%	-17%	**NO**
GE	-10%	-16%	-26%	yes
McDonald's	4%	34%	-8%	**NO**
Apple	13%	14%	-37%	**NO**
Nokia	-3%	-20%	-40%	yes
Toyota	-8%	-15%	-16%	yes
Hewlett-Packard	2%	-9%	-30%	**NO**
Disney	-3%	-3%	-15%	yes
Intel	-2%	4%	-45%	**NO**
BMW	-7%	-15%	-21%	yes
HSBC	-20%	3%	-28%	**NO**
Gillette	3%	6%	-75%	**NO**
UPS	-8%	18%	-20%	**NO**
Cisco Systems	3%	-25%	-40%	**NO**
Mercedes	-7%	-14%	-51%	yes
Oracle	-1%	-6%	17%	**NO**
Pepsi	3%	-3%	-38%	**NO**

***Legend**:* The data in Figure 5 were compiled by Type 2 Consulting based on data published in BusinessWeek, Financial Times, and on BrandFinance website.

Table 2: Non-Financial Marketing Metrics for Potential Inclusion in Financial Reports

		Demonstrated Future Performance Impact	
		Sufficiently	**Insufficiently, More Research is Needed**
Established Agreement on Measurement	**Established**	**Customer Base and Life-Time Value:** # customers, # new customers, customer acquisition cost, churn rate, cross-selling **Demand-Supply Conditions:** new orders, order back-log **Distribution:** # locations, # new locations, channel additions, internet traffic **Innovation:** # patents (1)	**Product Quality:** returns, refunds, buy-backs, defect rates **Innovation and New Products:** % revenue from new products **Pricing power:** % volume sold on deal **Distribution:** % ACV, order-to-delivery time, productivity per sales person **Market Share** (2)
	No, More Research is Needed	**Product Quality:** perceived quality **Branding, Customer Mind-Set:** brand perceptions, image, brand attitudes **Distribution:** Availability, channel penetration **Social Initiatives:** community involvement, environmental compliance, safety compliance (3)	**Customer Mind-Set** awareness, purchase intent, loyalty **Share of wallet** **Innovation and New Products** strength of new product pipeline **Social Networks, WOM, VOC** organic lead generation, recommendations **Customer Satisfaction** (4)

***Legend**:* We relied on the reviews of usage, perceived value, measurability and measurement quality, and value-relevance of non-financial metrics in prior studies to identify specific data items and classify them into the respective categories. These studies are: Gupta and Zeithaml (2006), Ittner and Larcker (2001), Maines et al. (2003), O'Sullivan and Abela (2007), Petersen et al. (2009), Pauwels et al. (2008), Rust et al. (2004), Srinivasan and Hanssens (2009), Srivastava and Reibstein (2005), Wiesel et al. (2008), and Winer (2000).