Varying Perspectives on Brand Equity

By Jonathan Knowles

You say *tomayto* and I say *tomahto.*

I started business life in finance (at the Bank of England in London), and in those early days I did not give brands a second thought. My life was dominated by financial facts and figures. And for the first 10 years of my career, I believed that these metrics were essentially all that were needed to manage and run a successful business.

This view survived my transition into management consulting—at least initially. But the more I worked on developing value-based business strategies for companies, the more I came to appreciate the need to expand beyond a purely financial approach. If (as management consultant Peter Drucker famously observed) the purpose of business is to create and keep a customer, then strategy necessarily involved understanding and catering to the functional and emotional needs of customers.

Chad J. Shaffer/veer

EXECUTIVE briefing Brand equity is a widely accepted concept—but its definition is frustratingly elusive. Here we'll explore the different perspectives that marketing, finance, and accounting have on the topic—and how these can be reconciled. Doing so is important because of the critical role that brand equity plays in the demonstration of marketing accountability. This article puts forward four arguments that marketers can use to show how brand equity is a critical measure for demonstrating marketing's role in adding to business value.

My desire to develop a systematic approach about how to do this led me into brand consulting and a series of roles focused on brand strategy, brand measurement, and brand valuation. The combination of my new focus on customer value and my background in shareholder value proved to be an excellent foundation for exploring when, where, and how brands can create value for business.

I mention this career path because it has given me a "both sides of the fence" perspective on business, brands, and the problems that can arise when a term—such as brand equity—is understood to mean different things by key business functions.

Historically, the coexistence of multiple definitions of brand equity was not a problem, because of the limited nature of the interaction between the marketing, finance, and accounting functions. Two developments in recent years have changed that:

1. The growing appreciation of the importance of intangible assets.
2. The demand for higher levels of marketing accountability.

Brand equity is an important component of both of these topics.

A Historical Perspective

The concept of brand equity first emerged in the marketing literature of the late 1980s. The use of a financial term for what was actually a customer-based construct was a highly effective technique for communicating the idea that brands are long-lived business assets that can have significant financial value.

The term gained widespread acceptance in the marketing community—for example, through the writings of David Aaker (*Managing Brand Equity*, Free Press, 1991) and Kevin Lane Keller (*Strategic Brand Management: Building, Measuring, and Managing Brand Equity*, Prentice Hall, 1997).

The idea of "brands as business assets" was also reinforced in the mergers and acquisitions boom of the late 1980s and early 1990s when a number of strongly branded companies were taken over. For example, Nestlé bought Rowntree for five times book value, while Philip Morris bought Kraft General Foods at a multiple of six.

These takeover multiples dramatically illustrated the relative importance of the value of brands vs. the value of factories. This led to a growing interest in brands and other forms of intangible assets from both the accountancy profession and the executive suite.

The accounting profession was primarily interested in updating the treatment of what had up until then been termed "goodwill" (defined as the difference between the purchase price of a company and the book value of its assets). As long as this difference was relatively modest, goodwill was regarded as a balancing item—rather than a topic for serious study. In an environment in which goodwill often dwarfed the value of tangible assets, it was clearly necessary to be more specific about its definition and accounting treatment. The process of reform that began in the United Kingdom with the introduction of Financial Reporting Standard 10 (1998) was extended into the United States by Financial Accounting Standard 141 (2001), and culminated in International Financial Reporting Standard 3 (2005)—which lays out the internationally agreed way of accounting for goodwill in acquisitions.

For a wider business audience, the growing appreciation of the economic significance of brands fueled and was fueled by the emergence of a number of "league tables," ranking the world's most valuable brands. Pioneered by the (now defunct) *Financial World* magazine in 1994, these revealed how brands (on average) represented close to 20% of the overall market value of their parent companies—and on occasion (e.g., with luxury goods) accounted for more than 40%. The scale of these numbers established branding as a mainstream business topic.

Meanwhile, the marketing community was evolving increasingly sophisticated ways to define and measure its version of brand equity. Their interest was not on financial value; it was on developing approaches that more accurately characterized the nature and strength of a customer's relationship with a brand. This led to research methodologies such as Research International's Equity Engine, Young & Rubicam's BrandAsset Valuator, Ipsos's Equity Builder, and Millward Brown's BrandDynamics. Each of these involves understanding the sources of brand equity (typically functional equity, emotional equity, and price) and/or measuring the strength of customer engagement with the brand.

The net result of the differing preoccupations of accounting, finance, and marketing is the parallel evolution of three concepts of brand equity.

The Marketing Concept

As a generalization, marketing (whether for products,

services, or entire companies) is the effort to create, communicate, and deliver customer value—with the goal of marketing communications being to influence the attitudes and behaviors of customers, such that the company performs better than it otherwise would in image, sales, and profit terms (short and long term).

Marketing success therefore depends on demonstrating that a preference has been created among customers for buying a certain brand of product or for doing business with a certain company.

This ability to alter the behavior that would otherwise have occurred is most concretely illustrated through blind and identified product tests. When two similar products are blind tested—with a matched sample of respondents—the preference (not surprisingly) is close to 50/50. However, if the test is run with the products identified by brand, the results can change dramatically. Depending on the brands, the stronger one may score as much as a 70/30 preference over the other.

Services and companies don't lend themselves to this type of testing, but brand influence is still clearly there. In a famous example, at the height of IBM's dominance in the 70s and 80s, there was a maxim: "Nobody ever got fired for choosing IBM."

In both of these scenarios, the brand adds a deeper dimension to the underlying product or service. This "added value" (defined in terms of customer utility) lies at the heart of the marketing concept of brand equity.

To meet the requirements of finance, brand equity has to be defined in terms of behavior that will create current and future cash flow.

The Financial Concept

With finance, the term "equity" has a specific meaning—the net of the assets and liabilities of the business. "Equity value" for a financial audience is demonstrated by the ability of an asset to earn more than its cost of capital, thus contributing the excess value of the assets of the business over its liabilities.

Brand equity is therefore understood to mean something very specific—the incremental cash flow that accrues to the company as a result of owning a brand. This is obviously a more restrictive definition than the marketing one because, as my colleagues in finance are fond of reminding me, "preference, in and of itself, doesn't put money in the bank."

To meet the requirements of finance, brand equity has to be defined in terms of behavior that will create current and future cash flow. To the extent that marketers can demonstrate that they have created "a reservoir of cash flow, earned but not yet released to the income statement" (to use the eloquent definition of brand equity put forward by Tim Ambler of the London Business School), then they will have met the mandate for marketing accountability.

The Accounting Concept

Accountants are uncomfortable with the concept of "brand" because they see the world in terms of assets. Assets can be tangible (meaning they represent physical property such as land, factories, inventory, cash) or intangible (meaning that they represent intellectual property such as contracts, patents, trademarks). The defining characteristics of assets are that they are "separable" (meaning they could be carved out of the business and sold) and that they have demonstrable value.

Accountants do not recognize any customer-based definition of brand. In fact, they do not recognize the term "brand" at all. What they do recognize is the intellectual property on which the brand is based (the trademark), because this represents a legally enforceable right to do business under a certain name. To the extent that it can be proven that the trademark could be licensed to a third party in exchange for a royalty payment, accountants will have no difficulty with the concept of brand equity (although they would use the term "trademark and associated goodwill").

In fact, "marketing-related assets" (the umbrella category for trademarks, trade dress, and other forms of brand-related intellectual property) is one of five major categories of intangible assets proposed in the recent accounting standards—which govern the treatment of goodwill arising on an acquisition.

The new standards allow brands and other forms of intellectual property to be put on the balance sheet of the acquiring company as a permanent addition to capital. The requirements for doing so are, however, onerous and include annual impairment testing. The result has been that surprisingly few companies outside the consumer goods industry have taken advantage of the opportunity to put an acquired brand onto their balance sheet. And if they did, they ascribed a highly conservative value to it (so as to ensure that the annual impairment test is a formality).

Tomaytos and Tomahtos

Based on the foregoing characterization of the mindset of the three disciplines, the ambition to establish a single, universally valid definition of brand equity appears misguided. A

much more productive ambition is to promote recognition of the validity of each of the three concepts, to define the circumstances under which each is appropriate, and to clarify the relationship between them.

The onus for this falls on marketing, because it has the broadest definition of brand equity and the one that is subjected to the greatest skepticism.

The remainder of this article focuses on four arguments that marketers should use in order to establish the validity of their concept of brand equity:

- The three definitions of brand equity lie on a single continuum that describes how marketing creates, captures, and reports value.
- Brand valuation is not the "silver bullet" of marketing accountability.
- Marketing accountability requires an explicit model for how marketing adds value to the business.
- Once the model is agreed upon, marketers should focus on customer metrics rather than financial metrics.

A single continuum. The first important point for marketers to make is that the three concepts of brand equity are not incompatible. Rather, they represent different points on a single continuum that describes how value is created, captured, and reported.

Exhibit 1 summarizes how the three concepts relate to one another, illustrating how accounting's focus is on the reporting of value, finance's focus is on capturing value, and marketing's focus is on the creation of the customer value that is the precursor to either measure of financial value.

It is therefore appropriate that the respective definitions of brand equity broaden from the trademark, to brand-induced customer behavior, to the creation of latent value in the form of brand preference.

The distinction between the finance and marketing perspective on brand equity can be illustrated by the analogy of potential and kinetic energy. A boulder, teetering at the top of a mountain, has enormous potential energy, which only explodes into kinetic energy when the boulder falls. The marketing concept of brand equity is similar to potential energy, while the finance concept is like kinetic energy. Accurate measures of marketing's contribution to the business require the assessment of realized value (seen in current customer behavior) and of latent value (where a brand preference has been created, but has not been acted upon due to lack of opportunity or other factors).

The renaissance of the Gucci brand is a great illustration of this point. In the late '90s, the brand's kinetic energy (its cash flow) was declining rapidly—because customers were deserting the brand. There was a widespread perception that the brand had lost its cachet and was being licensed for use on too many products of varying degrees of quality. In financial

Exhibit 1

Three concepts of brand equity

Marketing	Finance	Accounting	
Focus	Customer acquisition/ retention	Business performance	Financial statements
Defined in terms of	Winning heart and minds	Cash flow	Trademark
Demonstrated by	Preference	Customer behavior	License fees
Metric	Propensity to purchase	Actual purchase	Historic cost

circles, the brand was being written off.

The marketing perspective would have revealed that the potential energy of the brand (representing the brand preference developed through years of investment) remained large, and that the problem lay with the business strategy. The speed at which the Gucci business rebounded once the fundamental issues of product quality, product range, and distribution had been addressed is a testament to the validity of the marketing concept of brand equity.

Brand valuation is not the solution to marketing accountability. It's seductive to think that brand equity could be defined in a way that reconciles all of the existing concepts—and brand valuation represents the proverbial silver bullet to some. But, as political commentator H. L. Mencken famously remarked: "There is always an easy solution to every problem—neat, plausible, and wrong." Let me explain why this remark is very appropriate to this context.

Brand valuation is a highly specialized area. It involves two main methods for estimating the value of brands:

- Determine the perpetuity value of the licensing revenue that could be generated through licensing the trademark.
- Determine the net present value of the future stream of incremental cash flow that accrues to a company as a result of their brand(s).

The first approach (known as the "relief from royalty" method) produces a figure that is acceptable to accounting, because it represents the cash flow attributable to the legal asset (the trademark) on which the brand is based. The second produces a figure acceptable to finance in that it is based on the incremental cash flow that derives from the company's ownership of a brand.

This is what makes brand valuation, on the surface, attractive as a working tool for assessing the success of marketing activity.

However, the valuations are sensitive to certain assumptions (most notably the role of the brand in the purchase decision) and, depending on who is doing the evaluation, this can result in significant differences in the estimates of brand value.

Exhibit 2 shows examples of this variation, as observed in the 2007 data from the consultancies that produce annual league tables. The estimates of brand value vary widely between the three agencies (by anywhere from 50% to a multiple of more than three). No wonder Aaker has warned us to keep brand valuations in perspective. He acknowledges that they "can show that brand assets have been created," but also warns that "because of the wide margin of error, such estimates cannot be used to evaluate marketing programs."

This means that marketers should approach brand valuation with great care. Embracing it without realizing its limitations will hurt their credibility with finance. My experience is that marketers hoping to garner accolades from their finance colleagues are usually disappointed, as they find themselves embroiled in lengthy and unproductive debates about the assumptions in the valuation model.

However, there is one very productive use to which this data can be put—namely the framing of the business case for marketing investment. Imagine a conversation that begins in the following terms:

"Based on the latest *Business Week/Financial Times* data, brand value represents an average of 9% of market value in our industry, with the strongest brands accounting for up to 13% of the value of their parent company. Our brand is probably a little weaker than the average, so our guesstimate is that its value represents around 8% of our market value of $5 billion, or $400 million. We believe that the new marketing strategy has the potential to increase the strength of the brand significantly, to well above the industry average. The upside of investing in the strategy is perhaps 3% of our market value, or $150 million."

Now that sounds like a conversation worth having!

An explicit hypothesis about how marketing adds value. The conversation outlined here is a strong start but it is only one element of the business case for marketing investment. Marketers often make the mistake of assuming that the mechanisms by which marketing adds value to the business are self-evident.

The reason why the business case for marketing is far from self-evident is that the (unspoken) assumption of most finance people is that customer decision making is dominated by purely rational criteria. Given this, it is far from obvious what the role of marketing is—beyond that of demand stimulation in the short term.

A very effective way to bring this difference of opinion to the surface is for marketing to develop a causal model for how investment in marketing adds value to the business. The specifics of each causal model will vary by industry and company, but the underlying structure is similar. The causal model illustrates how the company's cash is converted into three different "currencies," before it reemerges as the cash generated as a result of customer behavior:

From cash into image equity. The marketing investment results in a stronger image profile for the brand among target customers.

From image equity into preference. The improved image translates into higher preference.

From preference into behavior. The higher levels of preference translate into greater purchase frequency or size of transaction.

Creation of a causal model (however simple) provides the basis for a frank exchange of views about the direction and magnitude of the effects. Although they are frequently heated, these conversations typically produce a consensus that two types of measures are valuable: (1) measures that express the types of customer behavior that drive the profitability of the business and (2) attitudinal measures that predict which kinds of customers are predisposed to demonstrate the desired behaviors. Examples of each kind of measure include:

Behavior-based measures of brand equity

- Purchase frequency
- Price premium
- Re-order rate
- Share of wallet
- Cross-sell ratio

Preference-based measures of brand equity

- Relevant differentiation
- Willingness to recommend
- Worth paying a premium for
- Affinity

Exhibit 2

Divergent estimates of brand value

2007 Brand Value	Interbrand	Millward Brown	Brand Finance
Coca-Cola	$65bn	$44bn	$43bn
GE	$52bn	$62bn	$32bn
Intel	$31bn	$19bn	$25bn
Marlboro	$21bn	$39bn	$27bn
Google	$17bn	$66bn	$24bn
L'Oreal	$7bn	$12bn	$25bn
BP	$4bn	$6bn	$12bn
Starbucks	$3bn	$6bn	$9bn

As a practical application of this, I worked at one point in the brand unit of Stern Stewart, the value-based management consultancy. We wanted to understand if any of the preference metrics could be correlated to higher-than-expected market valuations.

Our analysis was based on a robust source of data on brand health, namely Young & Rubicam's BrandAsset Valuator database. We also had Stern Stewart's EVA database on corporate performance and valuation.

Through complex econometric modeling we learned, not surprisingly, that profitability was the major determinant in the valuation of companies. What was surprising was that profitability alone only explained 55% of the observed differences in valuations. Something other than current profitability was exerting a significant influence on the valuation of companies. We found that adding brand health as an additional factor meant that the model was able to explain close to 80% of the difference in valuations.

The particular metric of brand health that we found to be meaningful in the context of our valuation model was relevant differentiation. The result held true for the eight industries we studied.

It is, however, improbable that a single customer-based measure for brand equity exists (despite the claims that are made for the Net Promoter Score). The diversity of industry and customer dynamics means that certain metrics will be better suited to certain situations than others.

An important point for marketers to recognize is that, in most industries, it will be possible to find a stable relationship between some measure of preference and the financial performance of the company. The goal for marketers is to discover what that metric is for their industry.

Customer metrics, not financial metrics. This leads to my final point. Marketers are quick to assume that marketing accountability is all about return on investment. My experience is quite the opposite. I am constantly surprised by the number of clients that insist—at the outset of the assignment—that one of the key deliverables is a valuation model. Yet once the brand strategy work is complete and has been defined entirely in reference to the business strategy, their need for a valuation model has disappeared. What I take from this is that most clients are primarily interested in discipline and transparency in the process; the role of the valuation model is to achieve this.

In fact, I have found that, once this need to see how marketing is aligned with the business strategy, finance becomes one of the most vocal proponents of protecting marketing from having to adopt too narrow a definition of brand equity.

The most productive collaboration occurs when there is explicit recognition of the insight that both the marketing and finance perspectives bring to the table. Marketing brings insight on customer value: the ratio of perceived benefits to price. Finance brings insight on cost structure: the costs incurred in delivering a given level of customer benefit. The secret to sustainable business success lies in finding ways that brand equity can be built at attractive costs to the company.

Reconciling Definitions

The current multiplicity of definitions of brand equity is certainly a challenge, as it creates a perception that marketing, finance, and accounting occupy distinct universes that exist in isolation from one another.

The goal here has been to show that the differing definitions of brand equity can be reconciled, once you clarify the perspective that each represents. This process of clarification offers marketers an important opportunity to demonstrate the business case for marketing, and the importance of including a customer-centric definition of brand equity.

By avoiding the trap of assuming that a single definition of brand equity is the objective, marketing can demonstrate why the preference-based approach is valid while conceding that it will tend to overestimate ultimate cash flow—because preference does not always result in purchase. Meanwhile, finance can be confident of the focus on cash flow, while acknowledging that it may be too narrow. That's because it fails to account for circumstances where a brand preference exists, but some circumstance prevents it being acted on (such as lack of product availability or price).

A healthy debate about the relationship between brand preference and actual purchase behavior is exactly what should occur. It is both inevitable and desirable that these different perspectives give rise to differing schools of thought about brand equity. And why not? Let's not forget that both tomaytos and tomahtos make excellent Spaghetti Bolognese. ■

About the Author

Jonathan Knowles is the CEO of Type 2 Consulting. His background includes more than 10 years in finance and management consulting (Bank of England, Marakon Associates) and 10 years in brand consulting (Wolff Olins, BrandEconomics, Brand Finance). He may be reached at j.knowles@type2consulting.com.

Custom Reprints

Custom article reprints offer information at a glance at trade shows, conferences, and seminars. They can also be a great way to share with your colleagues some of the cutting-edge research, opinions, and insights featured in Marketing Management.

•

To order reprints of any article in *Marketing Management*, contact Sheridan Reprints at 800-352-2210. For subscription information or to order single copies, call 800-262-1150.