THE MARKETING IMPLICATIONS OF FINANCIAL ACCOUNTING

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ABSTRACT

Marketers frequently lament the lack of representation of marketing in the boardroom and the short tenure of CMOs. The most common explanations offered are that marketing is not perceived as a strategic discipline and that marketers do not demonstrate a strong enough understanding of how the business makes money.

Financial accounting is how "score is kept" in terms of business performance. It is, therefore, in the self-interest of marketers to become familiar with financial reporting. Doing so will allow them to understand how marketing activities are recorded. In addition, academic researchers need to understand the meaning of the financial measures that they often use as the metrics of success when researching marketing strategy questions.

This is especially important since financial reporting generally does not recognize assets created by marketing investments. In order to substantiate a claim that "brands are assets", marketers must be able to explain how the financial accounting rules misrepresent economic reality and why managers might use a different set of principles for management reporting.

We argue that the misrepresentation of market-based assets has two forms of negative impact for marketers: external and internal. The external problems are that financial statements are not especially informative about the value of marketing for the providers of capital and do not provide a true portrait of the economic resource base of the company. The internal problems are that marketers cannot point to valuable assets that they are creating, nor can they be effectively held accountable for the way that these assets are managed given that the assets are not recorded.

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We do not expect immediate radical changes in financial reporting because financial accounting rules are designed with the specific interests of the suppliers of capital (debt and equity) in mind. To influence financial accounting developments, such as encouraging greater disclosure of marketing activity in the notes to the published accounts, marketers must be able to communicate in language understood by accountants and the current users of financial accounts. To aid this we provide guidance for marketers on the purpose and practices of accounting. We also discuss how academic marketing researchers might wish to adjust financial accounting data to capitalize a proportion of marketing expenses for companies where marketing is a primary driver of business performance.

Keywords: Accounting for marketing; financial accounting; managerial accounting; asset recognition; balance sheet; market-based assets

KEY INSIGHTS

- A distinction must be made between financial accounting (how companies report their results externally) and managerial accounting (how companies report for internal management purposes).
- Financial accounting primarily serves the needs of the providers of capital and aims to ensure consistency in the recording of transactions, rather than to represent economic reality.
- Financial accountants are aware of intangible assets - but disallow most because they do not meet the requirements of being identifiable/separable, material, be controlled, and have relatively certain future benefit.
- This non-recognition problem applies not only to marketing investments, but also those by HR and R&D.
- Rather than aim to change financial accounting rules, we recommend that marketers focus on how to adjust managerial accounting so that internal decision making can be based on reports that include the economic assets of the business, not simply those assets that qualify for recognition in the external financial accounts.

INTRODUCTION: FINANCIAL ACCOUNTING CONVENTIONS AND INTANGIBLE VALUE

Accounting is the way that companies "keep score." *Managerial accounting* deals with *internal* reporting – the provision of information to managers to allow them to make effective decisions. *Financial accounting* deals with *external* reporting – the provision of information to suppliers of capital, e.g., shareholders and creditors.

As "scorekeepers," accountants play a key role in business because they characterize what success looks like. If marketers want more influence over businesses (Webster, Malter, & Ganesan, 2003), we need to understand how performance is reported and so understand how accounting works. Knowledge of accounting will be useful to marketers in just preserving their jobs which are never that secure (Whitler & Morgan, 2017).

The first point to note is that how accountants act is largely determined by the fact that their primary "customers" for external reporting are the suppliers of capital (debt and equity). For this reason, accountants will not always act how marketers would like. Greater knowledge of the ideas underpinning accounting might allow marketers to exert more influence over accounting practices. There is significant potential for changing *managerial* accounting (Bendle & Wang, 2017) because such accounting exists to generate the information useful for those running the business. Changes to managerial accounting policies do not require regulatory approval and can be implemented to reflect the needs of marketers and/or other internal constituencies.

A challenge is that "accounting" is generally conflated with *financial* accounting by both marketing academics and practitioners. Our paper therefore focuses on how marketers can understand *financial* accounting given the importance of external reporting rules and the fact these govern how the providers of capital assess business performance and management action.

At the heart of financial accounting is the concept of double-entry book-keeping (first codified in fifteenth century Venice – see Sangster & Scataglini-belghitar, 2010), which uses transactions with third parties as the fundamental unit of account. There are three main forms of financial account (see below) that together provide the "score" as measured by the cumulative impact of the transactions that an entity (e.g., publicly listed firm) has undertaken with third parties. The objective of the financial accountant is largely to provide objective, transaction-based data to assist suppliers of capital in their assessment of the creditworthiness of a business.

The three major financial statements are as follows:

(1) The Income Statement: This shows the profitability of a firm over a period, defined as the sum of the revenue-generating transactions net of the costs incurred by the firm in generating these revenues;
(2) The Balance Sheet: This shows the position of a firm at the end of a period, based on its assets, liabilities, and equity;
(3) The Cash Flow Statement: This shows how the firm's cash position changed over a period. (Although the least frequently referenced statement, cash movements are important because they are harder to manipulate than profits; in addition, cash flow matters, as profitable firms can run out of cash and go out of business.)

To support the generation of these reports, financial accounting has evolved a set of conventions that specify how transactions are recorded. The standards set by FASB (the US Financial Accounting Standards Board) and IASB (International Accounting Standards Board) define the rules for external reporting. Generally accepted accounting principles (GAAP) is the term typically used to refer to the ideas underpinning external reporting in the United States. Although GAAP is not a single set of rules, they tend to be broadly consistent across jurisdictions. Indeed, accountants are actively working internationally to converge international and US accounting. Suffice it to say that, when following GAAP, a financial accountant is following the standards set by the appropriate standards board for the specific context.

As we will discuss below, these financial accounting conventions are not well-suited to a world in which intangible assets – defined as assets without physical form (such as intellectual property, human capital, trademarks, business contracts, and customer/stakeholder relationships) – represent some of the key economic resources of a business. As a result, in industries in which intangible assets are important determinants of financial performance, the portrait of the company that is presented by its financial reports is incomplete and potentially misleading.

In this chapter we identify the key distortions caused by applying current financial accounting conventions to investments in marketing, human resources, and R&D due to their treatment as period expenses. In addition, we discuss the problems of accounting for intangible assets generally (noting that these assets may take many different forms).

WHAT PROBLEMS WAS ACCOUNTING CREATED TO SOLVE?

At the outset, it is important to emphasize that accounting rules do not exclude/underreport intangible assets because accountants, and the financial community more generally, are unaware of the existence and importance of these types of assets. Creators and users of financial statements *are* aware of the importance of intangible assets (Guilding & Pike, 1990; Lev & Zarowin, 1999; Ross, 1983) but consider their measurement to be problematic. It will not be enough for marketers to "educate" accountants about the existence/importance of intangible assets in order for the rules to be changed. For example, 74% of a (convenience) sample of accountants in the United Kingdom agreed that brands are assets even if the current accounting rules prevented them from being formally recognized as such (Tollington, 2002).

The challenge financial accountants face is that different stakeholders require different information. GAAP rules have evolved as a compromise between the needs of different stakeholders – with primacy being given to the needs of suppliers of capital. The financial accounting profession, collectively, has agreed that *underreporting* of intangibles is an acceptable price to pay to avoid the risk of *overstating* intangibles and thereby making firms look more creditworthy than they actually are to suppliers of capital.

In our experience, it comes as a surprise to nonfinancial business people that the numbers given in the financial accounts, known as book value (which we explain in more detail below), do not represent the economic worth of a firm. Many assume that the purpose of financial accounting is to give investors a view of the amount that it should cost to purchase a firm. Even some involved in business make inaccurate statements about book value along these lines. For example, "[i]n theory, book value is the value that should be received if a company is sold" (Gerstein, 2019). "Book value matters because it's what the company is worth" (Farrington, 2019). "Book value is the theoretical value of what a company's net assets are worth" (Rotblut, 2010). None of these statements are true but, as these quotes illustrate, this confusion about the meaning of book value is widespread.

The idea that book value represents what a firm is worth – its economic value – reveals a fundamental misunderstanding of what the financial accounting rules are trying to do. The rules are an attempt to *standardize reporting*, not to represent economic reality. The rules are designed to eliminate discretion about how transactions are recorded by accountants and validated by the auditors who oversee their reporting. A foundational belief of external reporting is that it is better to report a number that is clear and relatively judgment-free than it is to have a number that is closer to economic reality but which requires more judgment and is harder to justify objectively. Accounting is a language (Avery, 1953) and, as such, exists to promote common understanding between the users of that language. For this to happen, the language must be, insofar as this is possible, unambiguous.

This desire to eliminate ambiguity leads to the requirement that any asset recorded in the financial accounts be clearly identifiable from other assets. "Identifiable" means that the asset is based on legal rights and can be separated and sold independently from the other assets that the company owns. An asset whose value is dependent on other assets, and is therefore impractical to separate from the firm, will not have a recorded value, even if all observers agree that the asset has considerable value.

The balance sheet therefore does not represent a comprehensive inventory of a company's assets. It generally only reports those assets that are clearly identifiable and separable from all the other assets and that have been acquired through a transaction with a third party – in other words, only those assets that can be recognized under the conventions of GAAP.

The incomplete nature of the balance sheet is one basis for the argument that the current accounting rules can result in poor decisions by investors and lenders. For example, a firm with significant unreported market-based assets might be sold for less than its economic worth if book value is taken as a proxy for economic value. Over the years, those unhappy with the financial accounting rules have tried to make changes to capture the value of underreported assets (Murphy, 1989). Indeed, the failure of financial reports to reflect economic value leads to periodic soul searching in accountancy about what they are doing (Elliott, 1991; Lev & Gu, 2016). Despite this, GAAP has proved relatively resistant to change defending the way it approaches external reporting as the best for its primary constituency – the providers of capital.

Even if the challenge of the separability of the assets created by marketing, human resources, and R&D activities were to be resolved, there would remain a second major hurdle regarding the measurement of these assets. What is the proportion of marketing, HR, or R&D spending in any given year that aims to generate sales in the current year versus the proportion focused on generating sales in future years (Dean, 1966)? When judging whether to capitalize spending on "brand building" or other marketing investment activities, the argument is often not about whether the spending was effective at generating an asset but rather about whether the spending conforms to the established rules. A value everyone agrees exists, if it does not confirm to the rules, will not be recorded. There are benefits to such an approach – relatively consistently applied rules allow informed readers to understand how the accounts were put together. The cost is that financial reports may misrepresent the economic value of a firm.

Given GAAP drives external reporting, let us review some of the criteria used by (a financial accountant applying) GAAP when deciding whether to create an asset, e.g., capitalize some of the spending on the basis that it represents an investment that will generate a benefit in future time periods.

Firstly, the asset should be *material*. This concept means that reasonable people would think that omitting the asset would made a difference to how suppliers of capital viewed the firm. Many firms have unrecorded intangible assets, most obviously internally generated brands and intellectual property, that are material. Using materiality as the sole criterion, these assets would be recorded.

Materiality, however, is not the only criterion. As noted above, the asset being created should be *identifiable*, arising from contractual or other legal rights, and separable from other assets. Furthermore, it is not enough for an asset to be material and separable for it to appear on the balance sheet – the firm must also have *control* over the asset. Control can be challenging for many intangible assets given that they, unlike tangible assets, lack the sort of substance that allows for identification of who exactly possesses the asset. (For example, knowledge can be simultaneously owned by multiple parties.) Concerns about control are often used as reasons for not recording the value of many intangible assets in the financial accounts.

The final significant criterion that is used to assess the reportability of an asset is the level of *certainty* around the future benefits that will accrue to the firm from ownership of the asset. It must have predictable future economic value to the firm.

Lastly, it is important to understand that accounting is a human activity, and, as such, a degree of politics is involved in the choices made by those setting the rules. Compromises have to be made when legitimate aims are at odds with each other, as materiality and control often are. This is evident when one looks at the circumstances in which estimated numbers are permitted. Generally speaking, financial accountants prefer to avoid estimated numbers due to concerns about using incorrect estimates in their reports – but this is not a blanket policy. For example, financial accountants regularly use estimates when deciding upon the value to add for a bad debt provision (the amount of debt owed the firm that it anticipates not being able to collect). The benefit gained (avoiding overstating the value of debtors given some debts may never be paid) is thought to be sufficiently large to justify the use of an estimate. A more conservative approach might be to exclude the value of *all* debts to the firm on the basis that there is no absolute certainty of repayment. Yet, excluding all debts from the financial accounts is thought to be overly conservative given that the majority of debts will indeed be paid.

Similarly, inventory numbers are also estimates. These may be based upon sampling or other techniques that give an approximate number. The inventory number is not established by an arms-length transaction that financial accounting rules typically require before an asset can be recognized on the balance sheet. Compromises between the need for estimates to give a meaningful view of the firm and the desire to avoid estimates underpin GAAP. The simple truth is that marketers have not yet proved a powerful enough lobby to persuade the financial accounting bodies to accept more estimates in judging the value of marketing-based assets. In part, this reflects the fact that the significance of the assets generated by marketing activities varies greatly by industry sector. Brand value may be highly important in consumer industries, but it is relatively unimportant in primary industries, such as mining and forestry, and in certain business models (e.g., brand is less important in cost-based rather than differentiation-based models).

A further complication is that the balance sheet states a firm's assets and liabilities at a specific point in time, yet the assets reported are required to have forward looking value. These aims can conflict; imagine an asset which has value at period end but had unexpectedly become obsolete before the accounts were signed off. Reconciling the need for financial statements to represent a snapshot at a specific date with the need for future looking, i.e., useful, statements is challenging and requires intelligent compromise.

Valuation problems abound in financial accounting. An elegant solution is to base your accounting system around values verified by a market transaction (as double-entry bookkeeping does). If something is bought for a specific amount by an arms-length third party, then GAAP uses that value as a starting point for its book value. If there was no clear market transaction, as is often the case for internally developed intangibles, then there is no externally verified value on which to rely. When there is no market transaction to reference, GAAP often avoids assigning value and so reports the value of the internally generated asset as zero.

It is worth repeating that financial accounting regulations are about establishing a reliable and transparent reporting system; representing economic reality is, at best, a secondary objective. This is a problem for marketing, HR, and R&D alike because a significant portion of the spend in any given year in each of these disciplines is not expected to pay off until future time periods. Without the ability to record the asset created by this spend, each of the three disciplines is vulnerable to having its budget cut. This is especially true for marketing since, unlike the other two disciplines who are seen to enhance the internal capabilities of the business (technology development and the upskilling of employees), marketing is focused on the creation of market-based assets (brand equity and customer equity). The lack of visibility of these types of asset to senior managers in their everyday interactions at work means that the business case for investing in market-based assets may be harder to make.

HOW DO ACCOUNTING CONVENTIONS FAIL TO REPRESENT ECONOMIC REALITY?

Concerns about Accounting Rules

Accounting rules require that assets be shown at the lower of their acquisition cost or their net realizable value (if there is evidence that the current market value is lower than the acquisition cost). Any asset that has appreciated in value since the time of its acquisition will therefore be undervalued in the financial accounts. Even a business without any intangible assets is therefore likely to have an enterprise value that exceeds its book value. Periodically, there are attempts to argue for "mark-to-market" accounting to be permitted so that assets can be revalued and the current value of the asset base of a business be shown in the financial accounts. However, the experience of the Global Financial Crisis in 2008 (in part caused by financial institutions abusing the "mark-to-market" rules to inflate the value of securities for which there was no clear reference price) has convinced accountants that underrecording value is a lesser evil than risking using inflated values.

If there are concerns about how to value financial and tangible assets (whose value can generally be verified by looking at market comparables such as similar buildings or types of financial instrument), these are doubly felt for intangible assets for which there are very few comparables. Accounting rules allow for the recognition of specific forms of intangible assets following a merger. Companies can use Purchase Price Allocation (PPA) to identify the proportion of the purchase price that can be attributed to the nontangible assets of the acquired business. In the United States, companies typically make allocations to four broad types of intangible assets – developed technology; in-process R&D; trademarks and trade names; and customer-related intangible assets. The remaining difference between the purchase price and the assets specifically identified (tangible and intangible) is allocated to goodwill.

However, the intangibles acquired through business mergers are less than one-third of total intangibles. Internally generated intangible assets – i.e., built within the company rather than purchased – represent more than two-thirds of intangible assets (Brand Finance, 2019). These cannot be recognized on the grounds that financial accounting rules have problems assessing their value in the absence of clear comparables. This matters to business and the economy more generally (Haskel & Westlake, 2017). Many have argued that the value of intangibles has risen in the modern economy (Sidhu & Roberts, 2008) and that intangibles are not treated in a fashion that is informative for the readers of various financial statements (Lev, 2001; Lev & Gu, 2016).

While economy-wide problems exist, it is often easier to consider specific complaints. Up to now we have not discussed what is arguably the most relevant accounting concept to marketers' complaints, namely the concept of *matching*. This is the principle that the costs and revenue relating to the same activity should be reported in the same period. For example, the costs of a sale should feature in the same period as the income generated by that sale. Matching is a central concept in financial accounting as it allows for net income to be accurately shown for a specified period. Otherwise the net income in any period will be incorrect as it will contain costs or revenue unmatched for the period. The problem with treating marketing investments as expenses is that the marketing investments, assuming they were successful, generate something of economic value going forward. The revenue related to that investment will be recorded in the future, but the costs are expensed now. The financial accounts therefore give an inaccurate view of what happened during both the period where the costs are recorded (by excluding the revenue to which they eventually give rise) and the period where the revenue is recorded (but without the associated costs).

Matching costs and revenues is a major principle of financial accounting. It is the essential feature of accrual accounting, the modern form of accounting which has largely supplanted cash accounting. Under the latter, the timing of when cash changes hands dictated what was shown in the accounts, which was not necessarily when the substance of the transaction happened. Accrual accounting removes any lag between the transaction and the corresponding cash settlement to provide more of a "real-time" representation of the business. Despite the obvious value of accrual accounting, the idea of matching is largely abandoned by GAAP when deciding whether to capitalize certain elements of spending (relating not just to marketing but also to employee training and investments in R&D). This decision to ignore matching is based on a legitimate concern that matching might lead to overstated financial statements. The implication of this is that any investments in intangible assets (such as brands, internal capabilities, and other types of intellectual property that are hard to measure and are not clearly separable) *do not* represent assets from a financial accounting perspective (and therefore cannot be recorded on the balance sheet), even though most business managers would agree that they *do* represent assets in an economic sense.

Financial accountants accept this because, as we have noted, the balance sheet is not intended to represent the comprehensive inventory of a company's assets. The idea that the financial statements omit or underreport assets is accepted by the financial accountants producing the reports and the auditors that sign off on them. That does not mean that such an approach is problem free. Marketers, in particular, are worried that this leads to a lack of appreciation for the value of marketing.

Marketing drives the Coke brand, yet the investments in brand (specifically, advertising) that fuel this company are not the same as sales-focused expenses designed to drive short-term revenues. This is why Coca-Cola reports its advertising expense separately from the promotions expense. Coca-Cola advertising is mostly about the long-term perceptions of the product; its branding activities aim to have an enduring impact. This is shown by the fact that many consumers still have an emotional reaction to classic Coke commercials: "Mean Joe Green," Santa, the Polar Bears. Effective brand marketing pays back over many years, but all the costs are immediately expensed. There is no ability to capitalize spending on the activities which build up the long-term value of the company – e.g., developing a customer base, creating a strong brand – and therefore should qualify among the assets in the financial reports.

Marketers have put on record their disagreement with the way intangibles are recorded (Sinclair & Keller, 2014). As noted above, this concern is shared by other business disciplines that are in a similar situation of not being able to capitalize investments in the future financial performance of the business, such as those made by HR and R&D. For example, training employees results in long-term benefits, but such spending is expensed.

Example: In the year to December 31, 2017, Coke (The Coca-Cola Company 2018, p. 77, Note 1, Advertising Costs) spent over $4 billion on advertising. Another $4.3 billion was spent (page 6, Item 1, Promotions and Marketing Programs) on promotional and marketing programs. This is clearly important to their business, i.e., material, and is noted in the annual report. The financial reports show that Coca-Cola is a heavily marketing focused company. As the report says, "Our competitive strengths include leading brands with high levels of consumer acceptance; a worldwide network of bottlers and distributors of Company products; sophisticated marketing capabilities; and a talented group of dedicated associates" (p. 7, Item 1: Competition).

The financial reports capture important details of the marketing activities even if these appear in the notes, rather than being highlighted on the key statements. Unfortunately, the conceptualization of the role of marketing taken in the production of these accounts is not one most marketers would recognize. Marketing, though important, is presented as an expense just like the cost of sweeteners in the company's beverages. "Our Company expenses production costs of print, radio, television and other advertisements as of the first date the advertisements take place. All other marketing expenditures are expensed in the annual period in which the expenditure is incurred" (p. 77, Note 1, Advertising Costs). To translate, all the marketing is treated as an in-period cost – i.e., charged to one period and not treated as an investment – the only concern from an accounting perspective is which specific period bears the cost.

This makes HR professionals a key group of potential allies in discussing the limitations of financial statements. HR's work often develops assets in the broader economic sense of an asset as something valuable (such as a well-trained workforce) but not in the financial accounting sense of an asset. This poses challenges for accountants (Brummet, Flamholtz, & Pyle, 1968). Assets generated by investments in people are hard to value but that does not mean that they do not exist or bring value to the firm. Culture is often claimed to be a key distinguishing factor for many firms. Indeed, "our people are our most valuable asset" has reached the status of cliché, but such ideas are not reflected in the financial statements. As noted above, control is a major problem for classifying investments in HR as creating assets. Employees can leave the firm before the firm's investment in them pays off (Rouen, 2019). On average, offering training may pay off, but it is hard to even verify this hypothesis given the limited nature of the financial records that are kept. Training, thus, looks like an employment expense, not an investment in people. Like marketers, HR professionals worry that this view means that vital activities that boost long-term performance may be cut given they appear as a drag on short-term corporate profits.

It is easy to see the parallels between HR and marketing spending. Like employees, customers are not controlled by the firm; classifying the customer relationship (rather than the customer) as the asset helps somewhat but it is still hard to argue that the company controls the relationship (recall that control is a requirement for recognition of an asset). Yet creating customers certainly is a sign of future value for the company, with Peter Drucker describing it as the key role of a business (Drucker, 2001), even when customers are not tied to the firm by any enforceable legal contract.

If the financial statements only represented the assets at a specific date in time, i.e., ignoring future value, then some of these problems with control (e.g., in respect of customers and employees) would not matter too much as the issue would simply be whether the customers and employees were "managed" by the firm at the date of the accounts. The challenge is that financial accounts are also supposed to be useful for decisions about the future. There is no guarantee that the employees supplying the know-how are still with the firm by the time the accounts are published or that their services will continue to be available to the firm in the future. This is the problem that accounting standards refer when they talk of the problem of control. If the firm has insufficient long-term control over the asset, then it will not be recorded in any external financial report. An accounting asset is required to meet the two criteria of being controlled by the company and for there to be near certainty about the future financial benefit that the asset will provide to the company.

Consider also the problem of research and development. Accounting rules (specifically here those of the IASB – but FASB rules have the same issue) put considerable restrictions on the types of R&D spending that can be capitalized – i.e., recognized as creating an asset. For example, IASB 38 says for development spending to be capitalized the firm must be able to demonstrate "the technical feasibility of completing the intangible asset so that it will be available for use or sale" (IASB 38, item 57, bullet point a). This is extremely restrictive and ensures that basic research, although it clearly creates value in aggregate and over time, has no chance of meeting this test, never mind any other test required to permit capitalization of these expenses. R&D professionals therefore have similar complaints to marketers and HR professionals.

What Do International Accounting Standards Say?

IASB provides examples of intangible assets in International Accounting Standard (IAS) 38. Though not as clearly organized as one might hope, the Standard lists

- brand names;
- mastheads and publishing titles;
- computer software;
- licenses and franchises;
- copyrights, patents and other industrial property rights, and service and operating rights;
- recipes, formulas, models, designs, and prototypes; and
- intangible assets under development (Item 119).

IASB also gives more examples in the same standard: computer software, patents, copyrights, motion picture films, customer lists, mortgage servicing rights, fishing licenses, import quotas, franchises, customer or supplier relationships, customer loyalty, market share, and marketing rights (Item 9). Note that these intangible assets can be added to the balance sheet if *acquired* as part of a transaction, but internally developed brands and other types of intellectual property cannot be classified as a recordable intangible.

We can compare these lists to what marketers might think of when they consider intangible assets. When marketers talk about brands, they typically mean a much larger concept than "brand names" alone. The market-based assets view, which we will discuss more later, includes many more items. For example, customer franchise research has been progressing rapidly (Bonacchi, Kolev, & Lev, 2015; McCarthy, Fader, & Hardie, 2017). Clearly some customer-related items have potential to be recognized as intangible assets by IASB, e.g., customer lists, yet, effective customer franchise management creates much more than just a list of names. Economic value arising from the customers, beyond what could be gained from selling the list of names, can become much harder to identify precisely. Much of the value of customer relationships fit into intangibles unrecorded using IASB rules. Such omissions from recording help explain why the financial accounting treatment of intangibles is regarded as unduly restrictive by many observers – especially those in industries where intellectual property, human capital, and customer relationships are among the key drivers of value.

Does Marketing Have a Material Complaint?

Let us use The Coca-Cola Company as a case example to investigate marketers' assertions about how financial reporting misrepresents economic reality. At the time of writing (September 2020), The Coca-Cola Company is valued at around $252 billion. This figure comprises $210 billion of equity value (based on a share price of $50.00) and $42 billion of net debt. If you wanted to acquire The Coca-Cola Company and all its assets, $252 billion is the total amount that you would need to pay (assuming that the shareholders would sell to you at the current share price, and the lenders would allow their loans to be repaid without penalty).

If we look at the latest balance sheet (June 2020), we see that this $252 billion company reports only $95 billion in accounting assets. $40 billion of this is tangible assets ($29 billion of current assets plus $11 billion of property, plant, and equipment) and $27 billion is other long-term assets (mostly investments and tax assets). The remaining $28 billion comprises intangible assets – $11 billion of trademarks acquired through acquisitions and $17 billion of goodwill (the premium paid during those acquisitions). So intangible assets represent about 30% of total reported assets. Have marketers got a genuine complaint if this level of intangible assets is already being recorded on the balance sheet? The answer is yes because, although the reported figure is material, it does not capture how important intangible assets are to this company.

How can we know that the reported asset figure is not a good estimate of the market value of the firm's assets? We know at end June 2020, the shareholder's equity of The Coca-Cola Company reported on the balance sheet was $17 billion. But, as noted above, the market value of that equity was $210 billion[1], an order of magnitude difference. What are the hidden assets responsible for the shares in the company to be worth more than 12 times their book value? This difference must be the result of some combination of the undervaluation of the $95 billion of reported assets and the failure to include internally generated intangibles. Specifically, much of this discrepancy is likely accounted for by the value of the Coca-Cola brand itself – being generated internally, no brand value can be reported. Yet the Coke brand is estimated by Forbes at $64 billion (Forbes, 2020), by BrandZ at $80 billion (WPP & Kantar, 2019), and by Interbrand at $63 billion (Interbrand, 2019). In Coca-Cola's case, the omission from the balance sheet of any value for the Coca-Cola brand is one of the primary reasons why the market is saying that the company's shares are worth $210 billion but the book value of these shares is only $17 billion.

Let us dig a little deeper into why the balance sheet may not represent a complete portrait of the true resource base of a company. Here we can leverage the "accounting equation," which is the basis for the double-entry bookkeeping underpinning the balance sheet. This equation is Assets – Liabilities = Equity. We will break this out, writing it as Tangible Assets + Intangible Assets – Liabilities = Equity. Let us consider how completely each of these four components is captured in the reported balance sheet, starting with liabilities. Financial accounting's emphasis on conservatism means that the financial reports seek to capture essentially all the liabilities of the firm. (GAAP aims not to understate liabilities to avoid presenting an overly positive view of the firm to suppliers of capital). Financial accounting is an imperfect activity, but given the effort put into identifying and quantifying liabilities when preparing and, critically, auditing the financial reports, we can be confident that the published figure for Coke's liabilities as at end June 2020, $76 billion, is a reasonable estimate.

Tangible assets, given they have physical substance, are also relatively easy to identify and value. This means that although GAAP requires accountants to use historical cost (net of depreciation if appropriate) rather than market value to report these assets, the financial accounts include a reasonable approximation of the value of tangible assets. (A notable exception to this is property that tends to appreciate over time but is still recorded at the lower of historical cost or net realizable value.) If the tangible assets figure were too high, the auditors would insist upon a reduction. As noted above, this means that tangible assets are likely to be only somewhat undervalued. Following this logic, both the liabilities and tangible assets reported in the financial accounts are imperfect but ballpark representations of the market value of those items.

Intangible assets are where the complications lie. Reviewing this section of the financial statements of a typical business will reveal that the balance sheet records intangibles that have been specifically identified as part of a PPA exercise plus goodwill (any premium paid as part of a merger). Internally generated brands and know-how do not appear on the balance sheet.

It might be helpful to clarify some terms here. Enterprise value is what you care about if you are considering buying a company. It represents what you need to pay to the existing shareholders and creditors in order for you to take full ownership of the assets of the business. There are two ways of looking at this value – either as the market value of all the firm's assets less its cash or as the value of the capital invested in the firm by the shareholders and those providing debt financing.

The book value of *assets* is the total value of the assets as reported on the balance sheet. This is the asset base used when calculating ROA (return on assets).

The value of these assets minus what is owed to creditors – the liabilities as reported on the balance sheet – is the book value of *equity*. This is what is used to calculate ROE (return on equity).

The book value of equity represents what belongs to the owners of the shares, while the book value of assets is what belongs to all those who have a claim to the firm (shareholders, lenders, and other creditors).

It is important to distinguish between the book value of equity versus the book value of assets. Critically, book value of assets will typically be a much larger number because the book value of assets represents the gross assets reported by the business, while the book value of equity can be thought of as net assets (reported assets less reported liabilities). The providers of financial information (such as Standard & Poors and Bloomberg) typically focus on the book value of equity, comparing it to the market value of equity as a measure of how expensive a share is (they refer to this as the Price to Tangible Book Value ratio). This metric is also reported for the market as a whole – the S&P 500 index currently has a Price to Tangible Book ratio of 10, meaning that the market value of the equity of these 500 companies is 10 times the reported book value of their equity.

Commentators often mistakenly assume that this ratio refers to the tangible book value of *assets* (not equity), leading them to assert that only 10% of the value of the S&P 500 is represented by tangible assets and that therefore intangible assets account for 90% of value. The correct way to calculate intangible value is to sum the value of all of the reported tangible assets of the companies in the S&P 500 and deduct this from the sum of their enterprise value. This produces a figure of closer to 80% for the proportion of enterprise value represented by intangibles.

Looking at the accounting equation we can see that equity, what the owners possess, is a balancing figure. It is not independently verified but arises mathematically after calculating the assets and liabilities. Here is where we can use theory to check our values against the financial markets, if we are willing to assume that financial markets are relatively efficient (that is, they give a relatively accurate view of the market value of equity). As noted above, tangible assets and liabilities are assumed to be reasonably well recorded, and if the market value of equity is reasonably accurate, we can conclude the omissions are largely in respect of the underreporting of intangible assets and other items.

$$\text{Financial Statements}: \text{Tangible Assets} + \text{Intangible Assets} - \text{Liabilities} = \text{Equity}$$

$$\text{Market Value}: \text{Tangible Assets} + \text{Intangible Assets} - \text{Liabilities} + \text{Other} = \text{Equity}$$

Subtracting tangible assets and liabilities (assumed to be roughly similar) gives

$$\text{Market Value Intangible Assets} - \text{Financial Statement Intangible Assets} + \text{Other} = \text{Market Value of Equity} - \text{Financial Statement Equity}$$

That many assets omitted from the financial reports leads to the two broad categories of negative impact for marketers: external and internal. The external problem is that financial statements are not especially useful at assessing the value of marketing for the providers of capital and do not provide a true portrait of the company's economic resource base. The internal problem is that marketers cannot point to many assets they create, nor can they be effectively held accountable for the management of these assets given the assets are not recorded.

Actions to Measure and Report Intangible Value

There is no problem-free alternative that solves the issues arising from not reflecting the value marketing creates in the financial accounts. Suggested changes to the way marketing is accounted for have been aired (El-Tawy & Tollington, 2008). Greater recording of intangible assets on the balance sheet would have obvious benefits in creating statements that more closely reflect economic reality. The obstacle is establishing a commonly agreed reliable valuations. Some progress has been made with the creation of ISO standards for monetary brand valuation (ISO 10668:2010) and for brand evaluation (ISO 20671:2019). Together, these put forward a common conceptual approach for the activities involved in the creation of brands and for the measures used to evaluate the strength and performance of brands (the focus of ISO 20671), thereby providing key inputs for the brand's subsequent monetary valuation (the focus of ISO 10668). While directionally very helpful, the need for the ISO standards to be relevant globally means that they are insufficiently prescriptive for the purposes of financial reporting.

Accountants' reluctance to include assets whose valuation involves a degree of subjectivity is reinforced by the inconsistency between the brand value rankings published by Interbrand, BrandZ, and Brand Finance – each of which claims that their approach is compliant with ISO 10668. This inconsistency reflects the fact that valuation providers have different conceptions of brand and use proprietary valuation methods. Using numbers arising from proprietary methods which cannot be independently verified goes against the idea of transparency which is required for auditors to sign off the financial accounts.

Perhaps the most compelling argument suggesting that marketers, however much they wish it, will not get balance sheet recognition for all marketing-related intangible assets in the foreseeable future is that there is limited evidence of demand from investors that brands be recorded on the balance sheet. Instead, investors have expressed considerable appetite for greater detail to be provided about the scale and nature of marketing activities so that they can use this information in their own financial models. Financial accounting standards already grant discretion over what appears in the notes to the accounts and the management commentary than what is allowed to appear on the balance sheet itself. The Marketing Accountability Standards Board (MASB) is advocating for more disclosure. This would allow readers to gain a better idea of economic value without having to amend the balance sheet in a way that proves challenging or controversial. Given this, there is little incentive for accountants to expose themselves to the lawsuits that might occur from including brands on the balance sheet.

One area where considerable progress could be made is in reporting on the customer base of the firm. Many firms can produce customer numbers relatively easily and there seems little reason why more information cannot be given on, for example, customer bases, attrition and acquisition, profitability by customer segment, etc. Indeed, customer valuation is already a promising area linking marketing and financial value, especially in the context of subscription-based businesses. This largely works by assessing the value of customers and aggregating this up to a firm value (Berger et al., 2006; Gupta & Lehmann, 2006; Kumar & Shah, 2009; McCarthy et al., 2017).

Even so reconciling customer valuation and brand valuation can be challenging. Brand value arises (in large part) from the positive views held by customers. Therefore, brand equity and customer equity can be seen as two sides of the same coin. Valuing both the brand and the customer franchise creates the potential for double counting. To reduce this concern, companies with a regular contractual or quasi-contractual customer base might report on customers whereas companies whose relationship to customers is via intermediaries (for example, a CPG company selling via grocery stores or bricks and mortar retailers) might consider that a brand valuation was both simpler and more meaningful.

The initial step we recommend is that companies conduct internal valuations of key forms of intangible assets. As we have noted above, managerial accounting allows companies to adopt the practices most useful to the management of their business. The value of any asset can be recorded internally (Bendle & Wang, 2017) and better internal measurement would be a useful goal in itself, as it could assist managerial decision-making. Improved internal reporting could also help provide templates for later changes to external reporting if suitably robust systems could be developed and proven internally as companies experiment with improved levels of managerial reporting.

WHAT WOULD AN ECONOMIC BALANCE SHEET OF A BUSINESS LOOK LIKE?

Market-based Assets: Types and Importance

If the goal is to provide an accurate portrait of the economic resources that underpin a company's ability to compete in the marketplace – that is, its economic balance sheet – what types of "assets" might we include that do not meet the financial accounting definition of an asset?

A firm's competitive advantage is based on having resources, things unique to the business, that allow it to create something of value more efficiently than other organizations. To understand any firm, we can look at the resources that make it unique. Historically, these resources typically took the form of tangible assets, for instance, fertile agricultural land, property in a particularly desirable location, or a special form of machinery. The improvements in distribution, communications, and computing over the past 40 years mean that these resources have increasingly taken the form of patents, specialized know-how, or a unique brand.

The seminal thinking about the nature of a firm's market-based assets (Srivastava, Shervani, & Fahey, 1998) can be thought of as an extension by marketers of the resource-based view of the firm (Barney, 1991; Wernerfelt, 1984). While the earlier researchers had focused on internal resources and capabilities, the insight of the market-based asset approach was that the resources driving market performance could be *external* to the firm – specifically in the form of customer and partner relationships. Market-based assets were assessed to be relational (embedded in customer and partner relationships) or intellectual (Srivastava et al., 1998).

While much has been written about market-based assets (Srivastava and his colleagues' 1998 article had 3,070 citations on Google Scholar at the time of writing, September 2020), there is still much to do to fully incorporate this perspective into marketing strategy thinking. Marketers have focused on brands and customer relationships, but other intangibles also impact the firm's "license to operate" – such as corporate reputation with regulators, government, and community stakeholders rather than consumers. These "assets" have real financial consequences – they can accelerate and enhance cash flows as well as reduce the volatility and vulnerability of cash flows and enhance the residual value of the cash flows.

The Challenge of Value Arising That Is Not Clearly Tied to an Asset

The preceding discussion works on a simplifying idea, namely that the value of a firm is the sum of the value of its economic assets. The reader does not have to be wed to an orthodox definition of asset from financial accounting (that is, an asset is what GAAP allows to be recorded as an asset) to be concerned that the term asset cannot be extended to encompass the entirety of the value that a firm creates. It would be impossible for any definition of asset to include all economic value the firm creates without extending the term asset beyond what is meaningful.

To understand this point, let us imagine how accounting principles might look in a world where marketers dictated GAAP to accountants. Some assets are more valuable in combination, e.g., a brand plus the know-how to use it fully plus the distributor relationships is worth more than the sum of the individual values. Accounting for such synergies is a real challenge, as the value lies in the combination more than in the individual assets. A similar consideration arises in respect of the financial benefit that arises from any of the corporate management activities of the firm (capital allocation; risk management; talent development) – should these be considered as an asset? For now, we will merely note that even recording all value-producing assets will not perfectly capture firm value.

HOW CAN THE FINANCIAL STATEMENTS BE ADAPTED TO PRESENT A MORE ACCURATE ECONOMIC PICTURE?

If the wholesale reform of financial accounting standards is not a realistic goal, where should marketers focus their efforts in terms of changes to the existing rules? Given that the financial statements are the accepted way for companies to keep "score," what adjustments should marketers be seeking make in order for their role in enhancing business performance to be more evident? The good news is that the current biases in financial reports are relatively well understood and, with certain assumptions, can be somewhat adjusted for. Advocating for adjustments that would allow for the capitalization of certain forms of marketing investments is more likely to result in progress than an agenda to amend the definition of accounting assets to allow for the reporting of internally generated intangible assets.

Information Needed to Adjust the Financial Statements

In addition to the usual financial reporting data, several pieces of information will be needed to perform the relatively simple adjustment on the financial statements that we outline.

- An estimate of total marketing spending
- An estimate of the percentage of annual marketing spending that is an investment (i.e., that portion of the spending that is expected to pay off in future time periods)
- An amortization policy. The simplest approach is just to write off investments at a fixed percentage of the initial value per period. For example, the approach we use in the example is 20% is charged (amortized) each period for 5 years

Combining these estimates and policy with the accounting data from the balance sheet and income statement allows a restatement of the accounts to create a new set of accounts that contains an approximation of the value of market-based assets and better matching of costs and revenues. This restatement can then be used in academic analysis. To be clear, this method is designed to suggest a way forward. It is deliberately high level and leaves room for scholars to tailor it to specific circumstances. (We most emphatically do not give a prescription such as "60% of marketing spend should be treated as an investment.") As such this work is broadly applicable to a range of situations but not ready to apply "out of the box" by anyone.

We suggest the adjustment procedure in three steps:

(1) Creating baseline market-based assets,
(2) Estimating marketing investments and marketing expenses, and
(3) Adjusting the level of market-based assets.

The Adjustment for Market-based Assets Approach

Creating Baseline Market-based Assets

It is important to start the accounts with an appropriate level of market-based assets. There are two ways we would suggest doing this. First, if you can find valuations that you have confidence in for the initial period, then use these. This might involve, for a firm reliant on a brand, adding the value of the brand at the starting date of your analysis. This may be simple if valuations already exist or can be easily interpolated from public data. However, this may not be the case for many market-based assets given the general lack of reliable and comprehensive reporting on these. (For example, the published brand valuation league tables only feature the largest global brands, and these are concentrated in a minority of industries – so the league tables provide limited guidance on brand value in other sectors, many multi-brand firms, or for brands that are not as strong as those featuring in the league tables.)

The second method (the one that we adopt in this example) is to start your adjustment of the financial accounts several periods before the first data you will use to ensure that a full cycle of amortization has occurred during the run-in data. In our example, we start the adjustment five years before the data that we want to use. This allows time for assets created before the start of the run in to have been fully amortized. Similarly, if you amortize marketing spending over 10 periods, then starting 10 periods prior to the date that your investigation starts might be an appropriate assumption. To be clear, choice of amortization policy needs to be justified for each specific scenario – we give no general advice, 5 or 10 years should not be assumed to be "correct" in every situation. You then apply the steps below to get a figure for market-based assets as at the starting period. An example below shows these methods being used.

Estimating Marketing Investments and Marketing Expenses

One needs an estimate of marketing spend. Ideally, the accounts will show an amount for marketing spending in the notes. Unfortunately, this is often not the case. Where no estimate is given, one can apply an adjustment to any available data to give an estimate of marketing spending. For example, below total marketing spend is assumed to be 75% of SG&A. One could equally well adjust up the advertising spending figure, assuming this is available, to account for non-advertising marketing. For example, marketing spend could be estimated to be 200% of advertising spend. Clearly, these assumptions should be justified, consistent with the industry in question and a firm's business model and tested for their impact on the results.

Once a total marketing spending number is obtained, then a percentage of this spend should be adjudged to be an investment. This should be driven by the business model but could be as simple as a fixed percentage is adjudged to be an investment, while the remaining spend is focused purely on generating sales in the current time period. In the example below, we assume 50% of spending is an investment. To be clear, this is just for this illustration. Research specific to a given company/industry will be needed to establish any baseline for any given academic research. Any amount not capitalized (treated as an investment) is treated as an expense, which is consistent with current accounting practice. Again, such assumptions can, and should, be tested for robustness and for the incremental explanatory power that they provide.

Adjusting the Level of Assets Related to Marketing

Next the marketer adjusts the level of assets related to marketing brought into the period by adding the value of any investment in the period. The total value is then reduced by any amortization of marketing investments from prior periods. This final figure gives the value of the market-based assets.

Example of Adjusting the Financial Statements

To make more concrete the idea of adjustments, consider this hypothetical example company (Table 1).

We must make some adjustments to these published accounts to reflect the investments in marketing. The procedure we use is to create a value based on SG&A for investments in marketing. To do this, we reverse out the amount of marketing spending which we assume as a fixed percentage of SG&A. We then assume that a fixed percentage of marketing spend is an investment with the rest returned to the income statement as an expense. Marketing is assumed to be amortized as a straight-line percentage of the investment, and amortization is assumed to be over 5 years, meaning 20% is charged each year. We create a schedule of these amortization charges and enter these into the income statement, reducing profit by the appropriate amortization charge each period. We then create a schedule of the unrecorded assets that are added to the balance sheet from the amount at the period beginning plus investments less amortization (Table 2).

This allows us to create a restated set of accounts including unrecorded assets (Table 3).

One of the benefits of the approach is that we can easily adjust the assumptions. For example, consider if we decide this industry is much less marketing heavy than we previously thought. We change our assumption to being that only 25% of SG&A is assumed to be related to marketing. We only need to change a couple of cells and get an entirely new table of results. We can then compare the impact on widely used metrics; here ROA, see Table 4.

Table 1. Simplified Financial Accounts.

			Year										
Description	Ref.	*Note*	−5	−4	−3	−2	−1	0	1	2	3	4	5
Accounts of SEC: Simplified Example Company Balance Sheet At period End ($millions)													
Current Assets – Total	BS1	*1*	$500	$500	$500	$500	$500	$500	$500	$500	$500	$500	$500
Plant, Property, and Equipment (Net)	BS2	*1*	$1,000	$1,000	$1,000	$1,000	$1,000	$1,000	$1,000	$1,000	$1,000	$1,000	$1,000
Recorded indefinite life Intangibles	BS3	*1*	$20	$20	$20	$20	$20	$20	$20	$20	$20	$20	$20
Total Assets	**BS5**	*Sum(BS1:B3)*	**$1,520**	**$1,520**	**$1,520**	**$1,520**	**$1,520**	**$1,520**	**$1,520**	**$1,520**	**$1,520**	**$1,520**	**$1,520**
Total Current Liabilities	BS6	*1*	6	8	7	8	8	7	8	7	7	7	7
Long-Term Debt	BS7	*1*	10	11	12	13	12	14	14	13	14	13	13
Total Liabilities	**BS8**	*BS6+BS7*	**$16**	**$19**	**$19**	**$21**	**$20**	**$21**	**$22**	**$20**	**$21**	**$20**	**$20**
Total shareholder Equity	**BS9**	*BS5-BS8*	**$1,504**	**$1,501**	**$1,501**	**$1,499**	**$1,500**	**$1,499**	**$1,498**	**$1,500**	**$1,499**	**$1,500**	**$1,500**
Total Liabilities + Shareholders' Equity	**BS10**	*2*	**$1,520**	**$1,520**	**$1,520**	**$1,520**	**$1,520**	**$1,520**	**$1,520**	**$1,520**	**$1,520**	**$1,520**	**$1,520**
Income Statement Year to Period End ($millions)													
Sales	IS1	*1*	2000	1990	2010	2020	2200	2100	2110	2200	2220	2300	2250
Cost of Goods Sold	IS2	*1*	1,200	1,194	1,206	1,212	1,320	1,260	1,266	1,320	1,332	1,380	1,350
Gross Profit	**IS3**	*IS1-IS2*	**$800**	**$796**	**$804**	**$808**	**$880**	**$840**	**$844**	**$880**	**$888**	**$920**	**$900**
Selling, General, & Administrative Expenses (SG&A)	IS4	*1*	480	480	520	520	520	560	560	560	520	520	520
Operating Income before Depreciation	**IS7**	*IS3-IS4-IS5-IS6*	**$320**	**$316**	**$284**	**$288**	**$360**	**$280**	**$284**	**$320**	**$368**	**$400**	**$380**
Depreciation, depletion, and Amortization	IS8	*1*	100	100	100	100	100	100	100	100	100	100	100
Operating Income After Depreciation	**IS10**	*IS7-IS8*	**$220**	**$216**	**$184**	**$188**	**$260**	**$180**	**$184**	**$220**	**$268**	**$300**	**$280**
Non-operating income/expense	IS11	*1*	5	5	5	5	5	5	5	5	5	5	5
Pre-Tax Income	**IS12**	*IS10-IS11*	**$215**	**$211**	**$179**	**$183**	**$255**	**$175**	**$179**	**$215**	**$263**	**$295**	**$275**
Income taxes – Total	IS13	*1*	100	100	100	100	100	100	100	100	100	100	100
Net Income (loss)	**IS14**	*IS12-IS13*	**$115**	**$111**	**$79**	**$83**	**$155**	**$75**	**$79**	**$115**	**$163**	**$195**	**$175**

Notes: (1) Data taken directly from financial reports. (2) Total liabilities (BS8) + shareholders' equity (BS9) should equal total assets (BS5).

Table 2. Amortization Schedule and Schedule of Unrecorded Assets.

Amortization Schedule ($ Millions)

Period Investment Made in	−5	−4	−3	−2	−1	0	1	2	3	4	5	
Period Amortization Charge Made	180	180	195	195	195	210	210	210	195	195	195	**Charge in Period**
−4		36										**36**
−3		36	36									**72**
−2		36	36	39								**111**
−1		36	36	39	39							**150**
0		36	36	39	39	39						**189**
1			36	39	39	39	42					**195**
2				39	39	39	42	42				**201**
3					39	39	42	42	42			**204**
4						39	42	42	42	39		**204**
5							42	42	42	39	39	**204**

Schedule of Unrecorded Intangibles ($millions)

	−5	−4	−3	−2	−1	0	1	2	3	4	5
At Period Beginning	0	180	324	447	531	576	597	612	621	612	603
Investment in period	180	180	195	195	195	210	210	210	195	195	195
Amortization Charge in Period	0	36	72	111	150	189	195	201	204	204	204
Reported in Adjusted Statements	**180**	**324**	**447**	**531**	**576**	**597**	**612**	**621**	**612**	**603**	**594**

Note: Amortization is a charge of 20% of investment in each of the five years after the initial investment.

These assumptions can have a profound effect on how we judge performance. Fig. 1 shows how assets, net income, and ROI change over time with different assumptions.

There are two somewhat contradictory lessons from this work.

(1) That assumptions make a difference, so marketers are right to be concerned about the way score is being kept by financial accounting as this makes a significant difference to the way marketing performance is judged.
(2) That assumptions make a difference, so those who worry about leaving too much leeway to those doing the presentation – including financial accountants and those reading academic marketers research papers – have a point that allowing too much discretion is a cause for concern.

To our mind what is needed is greater understanding from users of the information about the process employed by financial accountants. There is a need for greater clarity about the decisions and assumptions being made. While we encourage financial accounting to evolve, our immediate goal is to encourage clarity by marketing academics in presenting their view of marketing

Table 3. Restated Accounts Capturing Some Previously Unrecorded Assets.

			Year										
Description	Ref.	*Note*	−5	−4	−3	−2	−1	0	1	2	3	4	5
Accounts of SEC: Simplified Example Company Balance Sheet At Period End ($millions)													
Current Assets – Total	BS1	*1*	$500	$500	$500	$500	$500	$500	$500	$500	$500	$500	$500
Plant, Property, and Equipment (Net)	BS2	*1*	$1,000	$1,000	$1,000	$1,000	$1,000	$1,000	$1,000	$1,000	$1,000	$1,000	$1,000
Recorded indefinite life Intangibles	BS3	*1*	$20	$20	$20	$20	$20	$20	$20	$20	$20	$20	$20
Unrecorded Intangibles	*BS4*	*3*	*$180*	*$324*	*$447*	*$531*	*$576*	*$597*	*$612*	*$621*	*$612*	*$603*	*$594*
Total Assets	**BS5**	*BS1:BS4*	**$1,700**	**$1,844**	**$1,967**	**$2,051**	**$2,096**	**$2,117**	**$2,132**	**$2,141**	**$2,132**	**$2,123**	**$2,114**
Total Current Liabilities	BS6	*1*	6	8	7	8	8	7	8	7	7	7	7
Long-Term Debt	BS7	*1*	10	11	12	13	12	14	14	13	14	13	13
Total Liabilities	**BS8**	*BS6+BS7*	**$16**	**$19**	**$19**	**$21**	**$20**	**$21**	**$22**	**$20**	**$21**	**$20**	**$20**
Total shareholder Equity	**BS9**	*BS5-BS8*	**$1,684**	**$1,825**	**$1,948**	**$2,030**	**$2,076**	**$2,096**	**$2,110**	**$2,121**	**$2,111**	**$2,103**	**$2,094**
Total Liabilities + Shareholders' Equity	**BS10**	*3*	**S1,700**	**$1,844**	**$1,967**	**$2,051**	**$2,096**	**$2,117**	**$2,132**	**$2,141**	**$2,132**	**$2,123**	**$2,114**
Income Statement Year to Period End ($millions)													
Sales	IS1	*1*	2000	1990	2010	2020	2200	2100	2110	2200	2220	2300	2250
Cost of Goods Sold	IS2	*1*	1,200	1,194	1,206	1,212	1,320	1,260	1,266	1,320	1,332	1,380	1,350
Gross Profit	**IS3**	*IS1-IS2*	**$800**	**$796**	**$804**	**$808**	**$880**	**$840**	**$844**	**$880**	**$888**	**$920**	**$900**
Selling, General, & Administrative Expenses (SG&A)	IS4	*1*	480	480	520	520	520	560	560	560	520	520	520
Marketing Spend from SG&A	*IS5*	*4*	*-360*	*-360*	*-390*	*-390*	*-390*	*-420*	*-420*	*-420*	*-390*	*-390*	*-390*
In-period market expenses	*IS6*	*5*	*180*	*180*	*195*	*195*	*195*	*210*	*210*	*210*	*195*	*195*	*195*
Operating Income before Depreciation	**IS7**	*IS3-IS4-IS5-IS6*	**$500**	**$496**	**$479**	**$483**	**$555**	**$490**	**$494**	**$530**	**$563**	**$595**	**$575**
Depreciation, depletion, and Amortization	IS8	*1*	100	100	100	100	100	100	100	100	100	100	100
Marketing amortization	*IS9*	*6*		*36*	*72*	*111*	*150*	*189*	*195*	*201*	*204*	*204*	*204*
Operating Income After Depreciation	**IS10**	*IS7-IS8-IS9*	**$400**	**$360**	**$307**	**$272**	**$305**	**$201**	**$199**	**$229**	**$259**	**$291**	**$271**
Non-operating income/expense	IS11	*1*	5	5	5	5	5	5	5	5	5	5	5
Pre-Tax Income	**IS12**	*IS10-IS11*	**$395**	**$355**	**$302**	**$267**	**$300**	**$196**	**$194**	**$224**	**$254**	**$286**	**$266**
Income taxes Total	IS13	*1*	100	100	100	100	100	100	100	100	100	100	100
Net Income (loss)	**IS14**	*IS12-IS13*	**$295**	**$255**	**$202**	**$167**	**$200**	**$96**	**$94**	**$124**	**$154**	**$186**	**$166**

Notes: (1) Data taken directly from financial reports (2) Total liabilities (BS8) + shareholders' equity (BS9) should equal total assets (BS5) (3) See Schedule of Unrecorded Intangibles (4) Marketing assumed percentage of SG&A: 75% (5) Assumed to be 50% of marketing (6) See Amortization Schedule.

Table 4. Return on Assets (ROA) under Different Assumptions.

			Year										
			−5	−4	−3	−2	−1	0	1	2	3	4	5
Marketing percentage of SG&A	75%	Assets	\$1,700	\$1,844	\$1,967	\$2,051	\$2,096	\$2,117	\$2,132	\$2,141	\$2,132	\$2,123	\$2,114
		Net income	\$295	\$255	\$202	\$167	\$200	\$96	\$94	\$124	\$154	\$186	\$166
		ROA	17.4%	13.8%	10.3%	8.1%	9.5%	4.5%	4.4%	5.8%	7.2%	8.8%	7.9%
	25%	Assets	\$1,580	\$1,628	\$1,669	\$1,697	\$1,712	\$1,719	\$1,724	\$1,727	\$1,724	\$1,721	\$1,718
		Net income	\$175	\$159	\$120	\$111	\$170	\$82	\$84	\$118	\$160	\$192	\$172
		ROA	11.1%	9.8%	7.2%	6.5%	9.9%	4.8%	4.9%	6.8%	9.3%	11.2%	10.0%

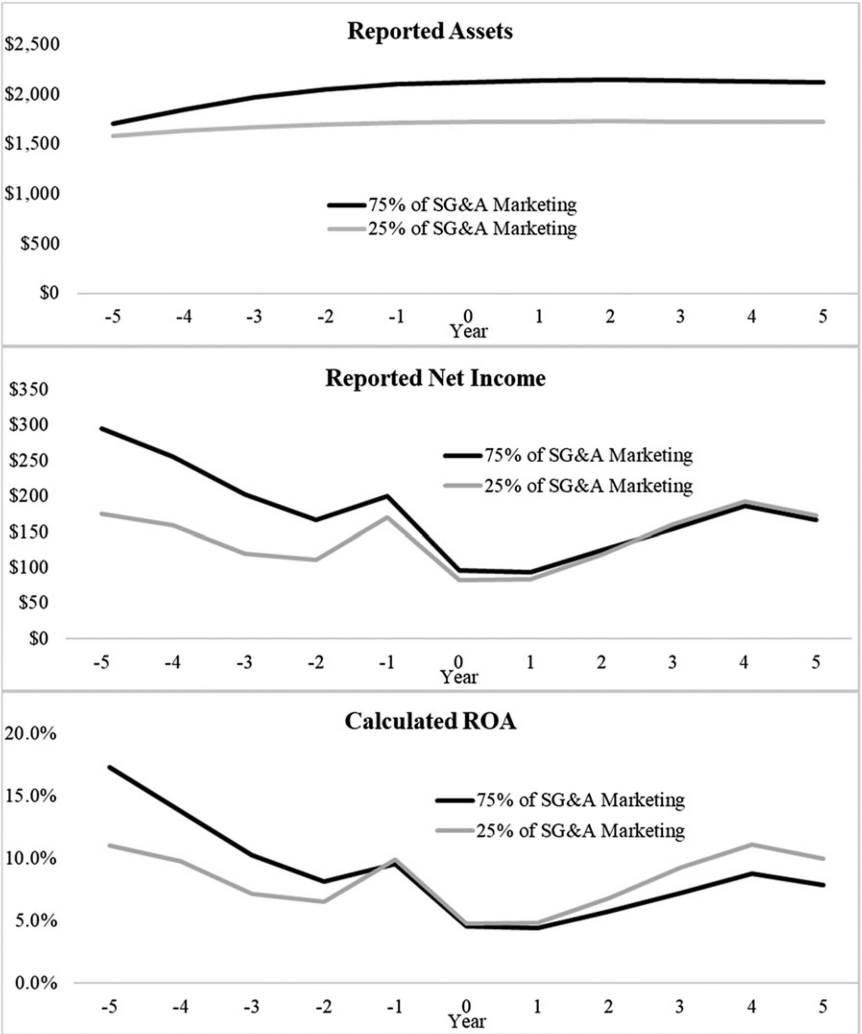

Fig. 1. Comparison of Assumptions about Marketing and Impact on Key Metrics.

performance. Using financial accounting data as key variables (whether independent or dependent) in academic research means choosing to accept the decisions made by financial accountants in generating that data. Given that the assumption of financial accountants is that marketing is simply an in-period expense and not an investment, marketing academics studying market-based assets should find it problematic to conduct empirical research using data that reflects this assumption. To be clear, there is no perfect answer – allowing changes to published data brings in a lot of subjectivity but ignoring market-based assets is hardly better especially for marketers. We would argue that everyone should at least all understand the weaknesses involved in the assumptions used by financial accountants and academic marketers. We urge more clarity about the limitations of financial accounting numbers and how they are used.

This hypothetical case example clearly demonstrates the value of adjusting the published financial accounts to provide a more accurate representation of economic reality. The adjusted accounts show

(1) Considerably increased values for the level of assets (because more market-based assets are recognized) – recognition of intangible assets narrows the gap between the market value of the equity and the book value of the equity
(2) Increased charges per period (in respect of amortization of the newly recognized assets) – better representing the economic reality of how the firm's performance leverages activities that were performed in previous time periods
(3) A reallocation of net income between periods (with higher income during periods of higher marketing spending).

Limitations of the Adjusting for Market-based Approach

Although an improvement on current practice, our approach still suffers from three significant limitations. The first is the omission of analogous adjustments to nonmarketing spending such as HR and R&D. As with marketing spending, it can be argued that a portion of the annual spend on these activities represents an investment that is expected to pay off in future time periods. Assumptions about the proportion of the annual spending that represents an investment and the appropriate amortization period for HR and R&D assets may differ from those used for marketing-based assets. The validity of the assumptions should be argued on a discipline-by-discipline basis. For example, work on innovation and marketing (Srinivasan, Pauwels, Silva-Risso, & Hanssens, 2009) will almost certainly need to consider how adjustment should be made to correct for external report bias given research and development is mostly expensed rather than capitalized.

A second major problem is that marketing investments are designed to create intangible assets that exceed the amount spent on creating them. Otherwise there is little reason to make such investments. The procedure we outline capitalizes marketing investment spending (rather than attempting to estimate market value). It recruits the approach that financial accounting rules generally adopt for the valuation of internally generated assets whenever these are allowed onto the balance sheet (such as certain forms of R&D). The approach is to value the asset based on the cumulative historical spending on creating the asset. Given historic cost is not the same as the economic value at the end of the period in which the asset was created, this is at best a weak proxy for the value created even in the period when the marketing expense is incurred.

A third problem is that asset values change. Accounting regulations treat assets in different ways. Some are revalued – which is generally used when there is an active market for these assets and the asset's value is relatively stable. This process has many advantages but can be time-consuming and requires judgment. Other assets are reduced in value at a fixed value, known as depreciation (for tangible assets) or amortization (for intangibles). Often this reduction is a fixed percentage of the total asset value when it was added, but alternative schemes are used. Other assets are not automatically reduced in value but are subject to an impairment review. Whether impairment happens depends upon how the asset value is assessed at regular periods. In such cases it is important to note that the asset value does not rise, it can only remain unchanged or get "written down." The method we outline below adopts an approach inspired by accounting procedures, leaving the question of its appropriateness and the precise amortization method to be used to be argued for dependent upon the specific context of any research being conducted.

For the second and third problems, it would be correct to argue that adopting a principle of adding the asset at its true market value and adjusting this (up or down) each period would be theoretically more justifiable. Following the model we outline, adjustment for market-based assets leads to a new version of what has been dubbed the "moribund effect" in financial accounts (Sinclair & Keller, 2017). This is where assets appear on accounts with values that are consistent with accounting practice – i.e., based upon historic cost with mandated write-downs where appropriate – but which have little independent meaning. A firm certainly could adopt estimates of market values (adjusting per period as necessary) in internal accounts avoiding this problem but it is not permissible to do this in the external statements. Clearly, the approach we use suggests that marketing academics use the simple ways pioneered by accountants, namely historical values and periodic adjustments, yet we know these approaches are far from perfect. As such, we would encourage work to test the validity of this approach. Its key benefit is that of practicality – it can be done with information at hand. Revaluing all the (often unreported) assets of firms in a large, multi-year data set is simply impractical. Our approach, while far from perfect, at a minimum, should adjust accounting numbers to something closer to the economically meaningful numbers that marketing academics need for their analyses.

Of course, any adjustments made by academics inject a potentially new problem, namely that the reported results are more influenced by the adjustments made than the underlying performance. (This is an especially large risk with ad hoc yearly adjustments.) As such when adjusting accounts, the marketing academic should be expected to detail the impact of the adjustment, but reporting the robustness of results to a variety of models is nothing new to this area of research.

This chapter outlines an approach, though far from perfect, for how one might adjust book value to capture the value of assets related to marketing. This approach might also be adopted by the HR and R&D communities to ensure that the "assets" to which their activities give rise are similarly represented so that the balance sheet begins to approximate the true resource base of a firm.

Beyond showing a new method, we hope that this will both illustrate the challenges accountants face while also making more concrete the problem marketing has when using accounting data that has not been debiased in any manner.

While this adds extra work when using accounting data in marketing questions, we suggest that it allows for new questions and the revisiting of old questions. Do previous results hold when accounting data are debiased in this way? Do any new areas of research become more plausible avenues for investigation? How can we validate and improve this method? Perhaps most importantly, how can we use the increased knowledge of accounting developed by marketing academics to drive more accountable marketing (MASB, 2018).

IMPLICATIONS

Implications for Senior Marketers

There may be challenges in the way marketing is accounted for in financial reports but what are the consequences of this for senior marketers?

Firstly, we advocate for marketers developing better knowledge of professions beyond their own. A greater understanding of the problems of accounting will give the CMO, or other senior marketer, the ability to be more persuasive when advocating for marketing and to allow better relations with key members of the C-suite. In an ideal world, those keeping the score, i.e., the accountants, would fully understand all the limitations of their score-keeping system. However, many accountants will need help from marketers in seeing the problems to which current accounting approaches give rise. While accountants may have limited discretion when producing external financial reports, they are largely free to produce internal managerial reports on whatever basis is most useful to help managers make effective decisions. Unless accountants have become sensitized to the differences between marketing investments and expenses, they will naturally default to using GAAP when producing managerial reports. CMOs should advocate for managerial reports that better represent the contribution of marketing to the success of the business and that provide a basis for greater accountability for marketing. To have a productive dialogue that moves internal reporting away from GAAP, senior marketers will need to understand how they can present the ideas in terms that make sense to the accountants hearing them and whose support will be required for the adoption of a revised approach.

Similarly, we would note that many metrics used to assess marketing performance may not be fit for purpose. Specifically, here we suggest that marketers should be aware of the problems that GAAP reporting rules create for metrics. They should be able to provide background information on the metrics in use by their organization to note when they do, or do not do, what they claim. This is quite different from complaining about accounting more generally, in that it provides specifics of the complaint in a language that accountants can understand.

Many of these challenges derive directly from not counting marketing investments as investments but instead treating them as expenses. Take the commonly used metric ROE. Treating all marketing spending as an expense means understating the company's true economic return in that period (assuming that there is a lag between the brand building activities and the revenue impact of them). Given firms operate similar policies over several years marketing investments that were expensed in prior years should, if we applied the accounting principle of matching, be charged in the current year. This means the return may be higher or lower than actually reported depending upon whether investments in marketing are increasing (in which case return is likely to be underreported) or being cut (in which case return is likely to be overreported). It is easy to see why marketers might be wary of any metric that typically looks better when marketing is cut regardless of this decision's true economic impact on the business. EBITDA, a popular way of assessing performance from the financial statements, is a variant on return and a similar logic applies. As such EBITDA will be distorted when firms make marketing investments, but the impact will depend upon whether investments are increasing or decreasing.

Further in any "return on" calculation, one needs a denominator against which the return is being assessed. Clearly if assets are understated – e.g., economic assets not treated as financial accounting assets – the asset figure will be lower. ROE will increase with no improvement in performance, as equity mathematically falls when assets are understated given assets minus liabilities provides equity, a mere balancing figure.

Accounting-based approximations of Tobin's q are popular metrics with academics that also suffer from the fact that market-based assets are unreported. This adds bias to this metric and it should not be used as a performance metric to consider the impact of market-related decisions (Bendle & Butt, 2018). Market-to-book/price-to-book metrics also are heavily impacted by accounting conventions, meaning that care should be taken when using such metrics.

CMOs should be careful that there are predictable distortions in metrics driven by GAAP rules (see Mizik & Nissim, 2011 for more information). Gaining a thorough understanding of what is happening and being able to articulate the impact for marketing decisions is vital to building credibility with C-suite colleagues and arguing for strategies that increase the economic competitiveness of the firm (rather than boost its reported earnings).

The ISO standard relating to brand evaluation (ISO 20671:2019) calls for regular audits of the value of brands. The discipline this ISO standard advocates, if followed, would allow for more professionalism in management of brands and facilitate the collection of information that could provide vital detail to the managerial commentary and notes part of the accounts. A similar discipline would be useful for the management of other market-based assets.

Implications for Academic Marketing Researchers

Firstly, academic marketers seeking to identify how marketing impacts corporate success (Rust, Ambler, Carpenter, Kumar, & Srivastava, 2004) require an understanding of at least three different disciplines. For descriptive ease, we will refer to them as marketing, finance, and accounting (although clearly academic disciplines are not monolithic, nor do they have neat boundaries). That marketing knowledge is required to study the impact of marketing is hardly surprising – but a considerable amount of insight has come from adopting the perspective of other disciplines on marketing's impact. The profusion of work in the broad area of Marketing Meets Wall Street (Hanssens, Rust, & Srivastava, 2009) has led to marketing academics paying significant attention to finance (although this might more accurately be termed "financial economics" as what we are describing relies on economic analysis of financial markets).

While there is a significant benefit to marketers using the same financial metrics as the companies whose performance they are interested in enhancing, these market-based metrics implicitly assume that the market is efficient (that is, the share price directly reflects true economic performance). The validity of this assumption is subject to debate and there would be value in marketers digging into the assumptions more – especially as marketers are keenly aware that humans do not behave the way economic theory thinks they should. Raising the problem of imperfect decision-making by individuals in markets is not to automatically dismiss the idea of market efficiency – but it does raise questions as to whether stock price impact is necessarily the ultimate measure of performance in all situations. It is quite possible to defend market operations while recognizing that humans do not make ideal decisions (see Smith, 2003, 2008). Instead our point is that marketing academics need to explicitly recognize the strong assumptions they are making when embracing financial market measures. The key point being that financial market measures are not a costless panacea.

The third discipline for understanding firm performance is accounting. We would argue marketing's link to financial accounting has been underresearched despite some activity (Roslender & Wilson, 2008). Many scholars have argued, with justification (Aaker & Jacobson, 2001; Luo & Donthu, 2006), that accounting measures are inadequate for assessing marketing performance. This argument is correct but this has hitherto fueled the interest of marketers in financial market measures, more than in the reform of accounting measures. We believe that this is an oversight and that marketing researchers need to pay more attention to financial accounting.

As previously noted, marketers often dismiss the value of financial accounting information by claiming market-based measures give a better estimate of performance. This may well be reasonable but the researchers then typically use the same financial accounting information they are mistrustful of, sometimes as controls, sometimes as a key input to the dependent variable (Bendle & Butt, 2018). They inject the bias from accounting that they are explicitly using financial market measures to try to avoid. We have some sympathy. It is hard to perform marketing research that focuses on financial markets without drawing on at least some financial accounting data. Given this when doing research on firm performance marketers should be aware of the strengths and weakness of financial accounting data. We would hope for more robust discussions of assumptions in academic marketing research. What is a good proxy for marketing? Is SG&A (Markovitch, Huang, & Ye, 2020)? Is the total assets figure a good proxy for firm size?

We know all accounting numbers are biased by accounting rules, but how severe is the bias? The severity of bias depends upon precise conditions of the investigation so marketers need to understand and argue for the assumptions they make when using financial accounting data each time they use them. We argue that marketing strategy researchers need to better understand the metrics they use and always supply a justification for their use (Katsikeas, Morgan, Leonidou, & Hult, 2016). The choice of metric should be informed by a thorough understanding of financial accounting as well as marketing and financial theory.

To aid academic research we have noted that it is possible to adjust accounting figures given certain assumptions to remove some of the bias. This may prove useful in providing some of the justification needed to use accounting data.

CONCLUSION

This paper argues that it is important for marketers, both academic and practitioners, to develop a better understanding of the principles underlying financial reporting. Most importantly, this involves understanding what criteria need to be met for something to be recorded as an asset in the financial accounts. Clearly, different disciplines have different conceptions of what constitutes an asset, but there is no reason for marketers to accept definitions from financial accounting in their research when those decisions go against economic realty.

We argue that the misrepresentation of marketing has two forms of negative impact for marketers: external and internal. External financial statements are not especially useful at assessing the value that marketing generates or supplying a true portrait of the company's economic resources. Internally, marketers cannot point to valuable assets that they are creating, nor be held accountable for errors in managing nonrecorded assets. Accountants typically have defensible reasons for their actions and we have highlighted the reasons behind their thinking in order to identify the considerations that influence the likelihood and the direction of any reform. For the reasons identified above, we believe that radical change to financial reporting, such as balance sheet recognition of many more market-based assets, is unlikely, certainly in the near future. That, however, does not mean that marketers should not push for reforms to the managerial accounting systems, perhaps enlisting the support of colleagues in HR and R&D, so that the management accounts provide a more comprehensive view of the company's true asset base.

The goal of this chapter was to clarify how marketers might want to think about the goals of accounting and the issues to be addressed in arguing for the inclusion of marketing assets. Specifically, we have outlined a simple and practical procedure, the adjustment for market-based assets, for how researchers tackling marketing questions might wish to adjust accounting data. This method, despite its simplicity and limitations, should help to address some of the problems with using accounting data in marketing-related research.

NOTES

1. NYSE data on Coca-Cola Co. (KO), accessed September 22, 2020.

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