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Recognising and Evaluating Brand Equity in South African Business to gain Financial and Operational Benefits

by

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A research report submitted to the Faculty of Commerce, Law and Management for the degree of Doctor of Philosophy

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Submitted: March 2002

ABSTRACT

This thesis presents a new approach to the measurement of consumer brand equity outcomes. The approach links financial performance with consumer behaviour to acknowledge the true source of a brand's strength. The methodology developed can be used to value brands for a variety of purposes ranging from corporate accounting, to taxation, to trademark protection and to capital market analysis. Its most significant application might well become the re-positioning of marketing as the leader of a company-wide activity that contributes to and protects shareholder wealth.

The study concludes that the function of marketing has become too introspective and is in danger of allowing its essential role of building and maintaining brands to be taken over by the company as a whole. Brands today are becoming the responsibility of the board and marketing is increasingly seen as a function that deals with certain external agencies and buys their services.

The author has studied the extant valuation methodologies and has found that they avoid incorporating consumer perceptions of brands: the main reason why brands exist and thrive. The explanation for this is to avoid what the financial community call the "soft issues". And yet it is these so called "soft issues" that determine the value of the brand. Brand equity is defined as the value a brand adds to a non-branded, or commodity, version. This value is invested in the brand by its users and to ignore this in a valuation methodology is to omit a key variable.

The methodology presented in this thesis deals with this fundamental requirement and departs from the conventional approaches in four substantive ways:

- It uses the Capital Asset Pricing Model to estimate the cost of capital which acts as a proxy for the commodity or non-branded version.

- An adapted Delphi approach iteration survey isolates the super profits attributable to the brand from the other profit generating resources.

- By analysing the category in which the brand sells according to four defining variables - longevity, leadership, barriers to entry, and vulnerability - time markers are set for notional category dominant and marginal brands.

- Survey based consumer data provides quantitative statistics that are reduced to Brand Knowledge Structure (BKS) scores. These are substituted for the dominant and marginal brand markers to establish the Brand Expected Life.

The brand value, captured by this approach, is the capitalised present value of the future cash flows.

In developing a valuation approach that incorporates consumer behaviour a metric has been developed that links marketing activities directly with shareholder value; which raises the status of the marketing function and which provides the company with a tool to measure return on marketing investment and monitor the value of what in many cases is the firm's most important asset.

DECLARATION

Except where it has been explicitly stated in Chapter Six, I declare that this thesis is my own unaided work. It is submitted for the degree of Doctor of Philosophy in the University of the Witwatersrand, Johannesburg. It has not been submitted before for any other degree or examination in any other university.



ROGER NEVILLE SINCLAIR

20th March 2002

DEDICATION

To Stella Ellen and Dol
who made me want to do it
and knew, before I, that I could.

ACKNOWLEDGEMENTS

I do not like to remember the moment in the late 1980s when I had to tell my academic mentor a truth I had kept hidden. He was initially upset and angry, but then dealt with it in a way that has resulted in this work, and much more in my life. Today it does not matter what the source of that anger was, suffice it to say that I owe a great deal to Professor Duncan Reekie for inviting me to teach at Wits in 1985, for encouraging me in my studies, for dealing with what now seems a minor problem and for agreeing to supervise my doctoral work. I have been, and remain, extremely fortunate. Professor Reekie agreed to my request in November 1995 and warned me that it would be a long and hard task. And so it has been ever since the build up to presenting the proposal to the Higher Degrees Committee in May 1996. I owe a great deal to you Duncan and wish to state publicly how much your friendship, knowledge, experience, motivational ability and humour have meant to me over many years.

I have a similar feeling for my good friend and associate Professor Johann de Villiers. As a colleague at Wits and more latterly at Stellenbosch University, he has been significantly influential in the development of this methodology. I wish to acknowledge here the vital role he has played in this work specifically the part which, as I have declared earlier, is directly attributable to him. It would not have happened without him. I am glad to have been able to repay him in some small way.

Over the eight years, since 1993, that I have been thinking and working on brand equity there are many others who have contributed. Among these are Professor Bob Charlton, the ex Vice Chancellor, whose chance comment in a meeting sparked the idea. Steve Burgess was always challenging, as was Dan Leach and Dimitri Kapelianis who once nearly undid me. Those who listened to my BERG presentations and argued important points include Dave Solomon, Matthew Grossett, Rob Venter and Greg Lee. More recently, our new colleague MengsteabTesfayohannes gave me good advice on finishing the thesis. My thanks as well to Zenobia Ismail for acting as a final check.

Over the years many masters and honours students have conducted their research under my supervision and some have contributed to this work. I would like to mention in particular S'thu Zungu, Steven Endersby, Helen Duh and Gabi Kuhn. Mary Johnson is so much a part of our lives at Wits that we are in danger of taking for granted her "no problem" attitude to all of us and her work. Thanks as always, and again, Mary. Few people recognise the role played by people in the Faculty office, such as Madeleine Skewis, in the post graduate process, which I do here.

In Chapter Seven I summarise the valuations conducted on a number of brands. This was made possible by the permissions given by Bradley Aigner of BDFM; Sandi Krige of TML; Andre Naude of Langeberg; Zahn Matthee of Eskom; Dwayne Alexander of NBS; Itseng Mogorosi of Liberty and Glen Marques of M-Net. It was a pleasure working with each of them and I am extremely grateful that they allowed me to feature their brands in this work.

Finally my family have been wonderful. They have encouraged me when I felt I should give up, put up with my bad temper when interrupted. And they have each shown interest in my work. Vix has contributed to finding the clients on whom valuations could be conducted and then helped in the process. Patrick unravelled some basic maths and stats, and has used his persuasive manner to keep me focused. Stella has constantly kept Father Christmas in mind. This is for all of you with my very deep love and gratitude.

Postscript

I wish to add to my acknowledgments the extremely thorough contribution made by one of my external examiners. This second version has been substantially edited to take account of the corrections indicated and revisions suggested. The entire work has benefited from the exacting requirements of this independent reviewer. I am grateful for the effort and commitment and wish to record my thanks to that person. I also wish to thank the librarians at UCT GSB and Wits Business School and others who assisted with the revisions and the invaluable proof reading, editing and typing aid from Stella and Vix.

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> *" ... I have the sense that the field of marketing is in trouble, on the academic side and on the practice side."*
>
> *Dave Reibstein speaking at the Marketing Science Institute (MSI) Spring Board Meeting (2001) to mark the completion of his two year executive directorship.*

1.1 A Recent Focus on Brands

Since the end of the last century, marketers have been legally protecting their trade names (Van den Heever 1993). While the use of the word brand (goods was the preferred noun) was rarely applied, manufacturers recognised the value of creating a recognisable symbol to facilitate consumer identification and repeat purchase. Early marketers such as Beecham, Lever Brothers, Proctor and Gamble, Kodak, Coca-Cola, and the Ford Motor Company, among many others, placed considerable value on the names and reputations of their products. They invested money in advertising to communicate the message of the brand, and to confirm performance consistency to regular users. The uncertain outcomes of advertising expenditure on bringing about product preference caused Lord Leverhulme to make his biting, but telling, comment about not knowing which half of his advertising allocations was wasted (Harris and Seldon 1959). They spent the money nevertheless, because without it their product names might fade from consumer memory (Casson c. 1920; Harris and Seldon 1959)

Such was the importance attached to brands by Proctor and Gamble that they created the position of product manager. Since 1927 (Kotler 1997), product managers were given custody of one or more brands and theirs was the task of nurturing and caring for their ward/s. The expression:

> *"If the firm was to be broken up, you can take the buildings and machinery, I'll take the brands," (p.52)*

usually attributed to Stewart (Herremans and Ryans 1995), makes the point that the real value of a manufacturer lies in the brands it owns, not the equipment that makes them. For over seventy years product (and more recently, brand) management has been invested with this responsibility: to build and protect the value of the brand.

The paradox is that while the importance of brands has long been recognised it is only since the late 1980s that monetary value has been attributed to them. Only in recent years have brands become central to marketing theory and practice.

In a review of ten leading books on advertising (and closely related subjects) written between 1920 and 1985, brands are either not mentioned at all, or the word is used in a context far removed from its 1990s meaning.

Table 1. Analysis of Brand Mentions in Literature 1920 – 1985

TITLE/DATE	AUTHOR/S	COVERAGE OF BRANDS
A Complete Advertising Course -	Casson (c1920)	No mention of brands. Products referred to as "goods"
Scientific Advertising My Life in Advertising	Hopkins (1966) Hopkins (1966)	Brands are not mentioned. What they eventually became are referred to as goods.
Advertising Copywriting	Burton et al (1950)	Brands mentioned in terms of naming. No comment on building or that they are any more than a title used for identification.
Madison Avenue USA	Mayer (1958)	Brand Image mentioned in text by David Ogilvy who, through "brand image", placed vital emphasis on

		brands. No other mention.
The Shocking History of Advertising	Turner (1965)	Only mention of brands is associated with David Ogilvy (a single mention)
Marketing: An Introductory Text	Baker (1979)	Branding is treated in one section covering about one page. It is almost incidental to the main flow of the text.
Advertising Management	Aaker and Myers (1985)	Brands mentioned in association with naming, attitudes, image, loyalty; but not a focus of the text, as they have become (largely due to the subsequent work of this author).
Positioning: The battle for your mind	Ries and Trout (1981)	Brands not mentioned although naming products is a feature subject. Subsequently, in 1998, Ries wrote a book that dealt exclusively with: The 22 Immutable Laws of Branding,
The Advertising Association Handbook	Bullmore and Waterson (1983)	Brands are featured and given prominence, but are not central to the text.

The so-called brand debate of the 1980s and 1990s placed a new focus on brands. As a result of the importance attributed to them by large British, Australian and American companies in a series of enormous acquisitions and mergers, brands were elevated to a new status (see for example Farquhar et al 1991) Books on advertising published after 1990 had sections devoted to brand equity. Belch and Belch (1998); Engel et al (1994), and Shimp (1997) (all authors of noted titles on promotions), revised their texts between editions to cover the fast emerging topic.

A small work first published in 1973 and re-published in a revised second edition in 1983 is Stephen King's Developing New Brands (King 1983). In the preface to the first edition he opens with the sentence:

> *"What makes companies succeed is not products, but brands."*
> *(p. III)*

In making this statement, this J Walter Thomson (London) Director of Research and Development was about a decade ahead of his time. Brands did not take on a centre stage position until the end of the 1980s.

Two contiguous 1988 and 1989 events raised the level of debate while placing prominence on the newly coined expression: "Brand Equity".

a A series of three (1988, 1991 and 1995) seminars on the subject, sponsored and hosted by the Boston based Marketing Science Institute (MSI) were held. At the first of these the subject of the seminar, Brand Equity, was awarded "Capital Topic" status" by the organisation; meaning that a research investment in it would add to the long-term capital of marketing knowledge.

b In Britain, the Barwise report (Barwise; Higson; Likierman and Marsh 1989a), commissioned by the Institute of Chartered Accountants in England and Wales, was published. This study examined the possibility and desirability of brands being admitted on the balance sheets. The need for this arose from the inclusion of brands on balance sheets by several notable companies; a practice with which the accountants could not agree. In a thorough review of the background to brand valuation and the approaches developed at the time, the report reached the conclusion that it would not be desirable, nor possible, for brands to be valued in a

way that would satisfy the requirements of the accounting profession (see Chapter Three, pages 92- 95).

A third event that was to draw attention to the value of brands was the publication of Aaker's (1991) book on the subject. For the first time the term brand equity was defined and a framework proposed explaining its antecedents, dimensions and flows.

1.2 Cause of the New Interest

In the 1970s King (1983) was promoting the value of brands. His belief was that it is brands that make a company prosperous, and that most new brand failures are failures of management. The evidence above supports King's view that companies were too preoccupied with the development of products, not of brands. The difference is now well understood. In King's own words:

> *"a product is something that is made, in a factory; a brand is something that is bought by a customer. A product can be copied by a competitor; a brand is unique. A product can be quickly outdated; a successful brand is timeless". (p. III)*

It will be argued later in this thesis (Chapter Two) that this failure to recognise the role of the brand has contributed to the failure of both marketing and advertising to find acceptance among the general management of companies and especially among the financial management function. The authors of Vision 2010 (EIU 1997) acknowledge the power of brands and state that strong global brands make it difficult for regional rivals to stay in the game; that the equity inherent in a strong brand is a powerful barrier to competitive entry; and that valuable brands have unique opportunities to exploit the name and reputation they have created.

Implicit in the Vision 2010 text is the probability that protection of brands will no longer be entrusted to marketing people. That function, the authors suggest, could beneficially be outsourced allowing:

"CEOs to focus on competitively critical issues." (p.26)

Thus brands are thrust into the centre of strategic business decisions, while the marketing function is down-graded (Moorman and Rust 1999).

The decision by the MSI to elevate Brand Equity to "Capital Topic" status pre-dates this view. It resulted in a flow of research between 1989 and 1995 much of which focused on brand valuation (Farhquar; Han and Ijiri 1991; Kamakura, and Russell 1991; Mahajan, Rao and Srivastava 1993; Simon and Sullivan 1992). Each of these working papers were subsequently published in refereed journals (Farquahar and Ijiri 1993; Kamakara and Russell 1993; Mahajan et al 1994; Simon and Sullivan 1993). Strangely as it is pointed out in Chapter Five, few of the methods proposed are widely used commercially. They did however add considerably to the body of knowledge that underpins contemporary theory and practice.

The failure of marketing people to take what these researchers produced and apply it in practice has created a serious gap between the financial and marketing functions. The concept of brand value arose from the need by financial management (initially in Australia, Britain and subsequently in the United States of America and elsewhere) to account for acquired brands on balance sheets. This replaced the option of writing off the goodwill portion to reserves in the year of purchase, or amortising it over long periods with the annual depreciation debited to the expense column in the profit and loss account.

The financial aspect of brand equity has evolved to become an important lever in taxation, borrowing, stock exchange value, mergers and acquisitions and more recently in trademark legislation and litigation. The marketing corollary has not been widely adopted by the marketing fraternity, and is cynically viewed by financial people.

In research conducted by the British Institute of Practitioners in Advertising (IPA) and reported in an Internet discussion between the author and Tim Ambler [i] (July 3 1998), it was found that:

> *"Most financial managers think that most marketing managers are business amateurs."*

This attitude is relatively common. The financial function is commissioning brand valuations and recognising the value of the brand as an intangible asset of the company; simultaneously the ability of the marketing function – using communications tools such as advertising to build the brand – is being questioned.

This raises two questions:

a What is the most effective way to measure the value of a brand?

b Is there a relationship between brand value and the actions taken by the marketing department to build it?

1.3 Valuing Brands

Prior to 1988 the valuation of brands had not been an issue. Power (1990) records the desultory development in Britain of accounting principles regarding goodwill. In fact had it not been for the actions of

Rank Hovis McDougall (RHM) and Grand Metropolitan (renamed Diageo) in 1987/88 (Power 1990), the issue may have remained low key.

These two giant British companies responded to the extant British accounting conventions by having brands valued for balance sheet inclusion. In the case of Grand Metropolitan this was only for acquired brands. RHM went further and had all its brands (acquired and internally developed) valued for balance sheet purposes.

The steps taken by these two companies were motivated by the effect recent acquisitions had on their balance sheet. British (and South African) accounting conventions required that they treat the goodwill element of these purchases (the difference between the net tangible assets and the market price) in one of two ways. Either the goodwill amount had to be set off against shareholder funds in the year of purchase, or the amount could be amortised over a maximum of forty years and taken yearly into the income and expenditure statement. Both approaches were in contradistinction to the event that had brought about the need to make such accounting decisions. The one reduced shareholder wealth whereas the purchase was designed to increase it. The other punished the income statement by increasing the pre tax expenses by the annual amount of depreciation.

In the case of Grand Metropolitan the purchase of a brand asset such as Smirnoff Vodka should have boosted the balance sheet value of the company not reduced it.

While there are many reasons other than merger and acquisition for which brand valuations are needed, it was the actions of these two British companies that sparked what became known as the brand debate.

At the same time American companies (R. J. Reynolds bought Nabisco; Unilever bought Cheseborough Ponds; Philip Morris bought General Foods and Kraft; and Proctor and Gamble bought Richardson Vicks) were involved in acquisitions in which they were paying premiums for intangibles far in excess of the net asset, or book value of the company being bought (Mahajan; Rao and Srivastava 1993) This MandA activity (in which the giant Swiss company Nestlé was also involved), placed an unprecedented focus on brands and their values, brought about the coining of the term brand equity, and generated a surge of methodologies for brand valuations.

This activity focused primarily on the financial use of brand valuations. While the marketing aspect of brand value was acknowledged, Haigh (1996) draws a distinction in this regard between brand value and brand evaluation, the methodologies devised used financial mechanisms such as price: earnings ratios, discounted cash flow and royalty relief. They avoided any marketing inputs because it was thought they had to be "auditable."

Sampson (1998) summed up the rejection of marketing inputs into these models in these words:

> *"No, you don't measure brand value by listing wishy-washy things such as the strength of brand knowledge that resides in consumer memory measured in terms of attitude. This is the sort of statement that quite rightly generates howls of derision from the financial world." (p.8)*

The so-called soft issues were rejected because they were not thought to be auditable and would be unfamiliar to financial people; and yet they are fundamental to the process. Without there being awareness of the brand name associated with beliefs that bring about its usage, there would be no

numbers to measure. It is this link that has been the focus of research and development in marketing circles and which must become integrated into the valuation methods that eventually become universally accepted.

Central to the work that follows in this thesis is the belief that:

> *Strong brand knowledge will reduce marketing risk and lengthen the franchise run (see Chapter Six, section 6.8) period; weak brand knowledge will increase the marketing risk, and shorten the franchise run period.*

1.4 Object of the Research

From the above discussion it is clear that brand valuation has been developed in response to the needs of the financial community to compensate for the inadequacy of accounting conventions and standards that purport to deal with assets acquired in mergers and acquisitions. The brand valuation methodologies that are most frequently used avoid recognising brands for what they are: perceptions lodged in the memories of the consumers who buy and use them. The focus of this study has been to understand the nature of brands from both a financial and consumer standpoint and examine the way they have been characterised and measured. In so doing the concept of brand equity becomes central as it is the device that the marketing community created in response to the debate about brands.

There are two core objectives to this study:

a To examine the available brand valuation methodologies in the light of the expanding needs for which they are, and will in the future be, needed.

b To develop an alternative approach that is suitable for South African use, which merges marketing inputs with financial and accounting frameworks, which can withstand academic scrutiny, is acceptable to formal bodies such as the tax authorities, accountants, corporate financiers, and which bridges the divide between marketing and finance.

When the proposal for this study was presented in May 1996, the London based International Accounting Standards Committee (IASC) was in the middle of a lengthy process of consultation to devise new accounting standards to deal with goodwill and intangible assets. These were subsequently finalised and issued in 1998 and adopted in South Africa in 2000 (see Chapter Three). The flaws in these standards (see Chapter Three) have not been acknowledged by the accounting profession, but it is significant that the newly formed International Accounting Standards Board (IASB), has included two of these standards (in South Africa they are A.C 129; and A.C. 131) for review.

The probability that brand values will become integral to the financial statement, in some form or another, within the foreseeable future, is now almost certain. The importance of this research and its conclusion in a unique, integrated valuation model, is at the very least, timely.

1.5 Organisation of the Thesis

After this introduction the report is divided into seven chapters:

Chapter Two. The theme of this chapter is that marketing is undergoing severe and radical change. From a conceptual framework developed by several renowned marketing academics in the 1950s and 1960s, the discipline is losing focus. A number of reasons are put forward for this but the central one is the recognition of the value of brands. Even though

they are not, as yet, acknowledged by the accountants as balance sheet assets, the investment community, tax authorities and legal profession are increasingly conscious of their role in the development and maintenance of shareholder wealth. It will be shown that marketing is in a state of flux with changing structures and divided opinions as to its central purpose. Several aspects of marketing and branding, including brand equity, are examined and in the process a new way of evaluating the promotional needs of brands is proposed.

What emerges clearly from the discussion, is that there is a need for a single number metric by which the effectiveness of marketing can be measured and which links it to the creation and maintenance of shareholder wealth.

Chapter Three. The conflict between accounting and economics is fundamental to the disciplines and is explained to university commerce students studying economics in their first year of study. Essentially it is to do with the backward looking accountants who concentrate on counting and recording historic costs, and the forward looking economists who believe that the value of assets are the future income streams that they will generate. It is this problem that is inhibiting the accountants in acknowledging that brands, whether they are acquired in a business combination or generated internally by the firm, are indeed assets.

In this chapter the reasons for holding these respective views are examined and understood. The conclusion is that until the accountants are prepared to adopt what will in all likelihood be a complementary value based approach, the conflict will continue and brands will suffer by not appearing on balance sheets as assets.

The perspective of the marketers is also important because they fail to contribute to the evolution, by learning the language of finance and

accounting. It is proposed that marketers could improve their standing in the company hierarchy by communicating their goals and targets in a language more acceptable in the boardroom than that with which they have traditionally conversed.

Chapter Four. Apart from the subjective nature of some of the tools used in the major valuation methodologies, the most glaring omission is that they do not include any measure of the strength of the brand in consumer memory. The reason for avoiding this is that talk of consumer behaviour and how consumers think, is characterised as "soft." But to deny the vital importance of consumer perceptions in the success or failure of brands is to ignore the fundamental source of their value. Address and location are important to property value. Shares rise or fall on sentiment. Political parties are voted in or out according to the attitudes towards them of the electorate. Opinions are crucial. The same applies to brands.

This chapter examines the latest evidence of how brands are perceived and stored in memory. Understanding how people think about brands, how their beliefs can be changed or modified and how they can be persuaded to change their preferences is the bedrock of brand management. Integrating this understanding into a valuation model is basic to a credible valuation approach.

Chapter Five. The Marketing Science Institute (MSI) drew the attention of the marketing world to brand equity and its valuation in 1988. It did so with the first of three seminars on the topic at which it was decided to elevate the subject to what it calls a "Capital Topic". This ensures that researchers will focus their attention on the subject and the marketing discipline will benefit from their efforts.

In the review of the 1991 seminar Maltz (1991) recorded the consensus that:

"By failing to address these issues, marketers would be passing the buck to financial analysts and accountants." (p. 1)

The issues were concerned with how brands should be managed to enhance shareholder value; if brand equity could help overcome the emphasis on short term planning at the expense of long term brand building; whether brand equity could become a measure of what managers do to protect and build the brand and if it could contribute to the process; how managers should determine the allocation of marketing expenditure; and, what is the financial value of a brand.

In Chapter Five these matters are investigated as are others such as the methodologies that arose as a result of the MSI initiative and the two major valuation approaches offered by commercial companies are analysed and assessed.

Chapter Six. Chapter Six describes the valuation methodology developed over an eight year period in the School of Economic and Business Sciences at the University of the Witwatersrand.

Chapter Seven. Since 1998 the valuation methodology has been applied to a number of companies for commercial reasons. It is important to draw lessons from these valuations in order to strengthen the model over time. In this chapter two recent valuations are fully explained and one partially. In the balance of the chapter aspects of the model are discussed using case material as a foundation. In each case lessons learnt are highlighted.

Chapter Eight. This chapter contains the conclusions, limitations and proposals for further research to extend the findings of this study and methodological development.

End notes

i Tim Ambler is a Senior Fellow at the London Business School. Janet Hull of the IPA conducted the research.

Chapter Two - Brand Equity: Meaning and Definition

2.1 Introduction

The marketing environment from which brand equity and brand valuation have emerged is very different from the circumstances that prevailed when marketing was developed in the early part of twentieth century. While branding can be traced back to medieval times, it was Proctor and Gamble which introduced a formal approach to the care of brands when it introduced the product manager title in 1929 (Kotler and Armstrong 1997). Since then marketing has developed and evolved through a number of phases (Tybout and Carpenter 2000; Brown; Fisk and Bitner 1993).

After seven decades marketing is at a crossroads. The nature of the consumer has changed as have the demands being placed on marketing by management. The discipline is having to cope with changing perceptions of what it is; trends in consumption; technology driven product equivalence; a loss in power as manufacture has given way to service and retailer domination; calls for greater accountability of marketing expenditure; changing status for brands as they become balance sheet assets; and, a redefinition of why consumers buy brands: is it because of their attitudinal predisposition, or because the brand has a significant presence?

This chapter contains a series of essays on a number of aspects of marketing. They show how marketing is changing and how it is enveloping, and being enveloped by, the entire organisation. The chapter lays a foundation for the discussion and proposals in the balance of the thesis.

2.2 Market orientation

During the decade of the 1990s marketing academics paid considerable attention to market orientation (Kohli and Jaworski 1990; Narver and Slater 1990; Webster 1992; Menon and Varadarajan 1992; Jaworski and Kohli 1993; Slater and Narver 1995; Hurley and Hult 1998; Han; Kim and Srivastava 1998). This refers to the need for modern firms to focus their attentions on delivering products and services of a consistently high level of quality. This might appear to be a *sine qua non* but is in fact a subtle change of emphasis. In a review of the development of marketing since the start of the 20th century, Webster (1992) explains how early scholars defined marketing more in terms of social and economic processes than in any sense a managerial function. They were concerned with describing how goods move from the factory through wholesalers and brokers to the markets. It was only after the Second World War that writers such as Kotler and McCarthy, among others, began to define the field in terms of a business activity directed at the consumer.

More recently as competition has become more intense not just from within a single country but on a global scale, businesses have had to train their sights on the market and the consumers who comprise it. More specifically market orientation has been described as a three-component concept comprising: 1) an organisation wide generation of market intelligence pertaining to current and future customer needs; 2) dissemination of this intelligence across departments within the firm, and 3) organisation wide responsiveness to this intelligence (Jaworski and Kohli 1993).

The distinction is that market orientation is viewed as a firm-wide activity and not just a series of actions designed and implemented by a marketing department.

As long ago as the 1950s it was suggested that marketing was the principal purpose of the firm because as Drucker (in Han, Kim and Srivastava 1998) explained:

> *"There is only one valid definition of business purpose: to create a customer ... it is the customer who determines what the business is ... " (p. 1)*

Webster (1992) in his review says that:

> *"Marketing can no longer be the sole responsibility of a few specialists. Rather, everyone in the firm must be charged with responsibility for understanding customers and contributing to developing and delivering value for them." (p. 14)*

But, in terms of Drucker's comment, this is what should always have been the case. It seems that in its effort to create a marketing concept and theory based profession, the early academics and practitioners lost sight of this purpose. Instead they established for themselves a specialised function that was supposed to carry out a process that was indeed the task of the entire firm.

What forced change is the simple fact that it is the link between the firm and the market that creates and sustains profitability and that link is the responsibility of everyone in the firm, not just the marketers. Narver and Slater (1990) carried out an investigation among senior managers of a single firm in the forestry business. The Strategies Business Units (SBUs) that they surveyed sold commodity products (physical products such as timber, plywood and chipboard). These SBUs must add value to the generic products by satisfying their customers through service thus reducing non-price costs. Other SBUs sold non-commodity products of a speciality type such as roof trusses, doors, and cabinets and so on: products they have been able to adapt to offer added value.

They posit that greater profitability will arise from a market orientation approach that encompasses the three behavioural components of customer and competitor orientation, and inter-functional co-ordination. This means that the business should be driven by a deep understanding of customer needs and how these relate to competitive offerings and the entire approach to the marketing of the product range should be conducted on the basis of inter departmental co-ordination.

Their conclusion is that:

> *" ... for both the commodity and non-commodity businesses, market orientation is an important determinant of profitability." (p. 32)*

This focus on market orientation, which was selected in 1995 as a "Capital Topic" by the Marketing Science Institute (MSI), had wide ramifications prompting Coca Cola President, the late Roberto Goizueta, to say:

> *"When you understand that marketing is what you do to sell stuff, then the money that you lay out is an investment instead of an expense." (Zyman 1999:13)*

Goizueta believed that marketing was what the company did, every day and went so far as to state that:

> *"Marketing is far too important to be left to the marketing department. It is what we all do, every day of our lives." (hearsay)*

It is doubtful that marketers have taken this comment and other similar signs shown later in this a text sufficiently seriously.

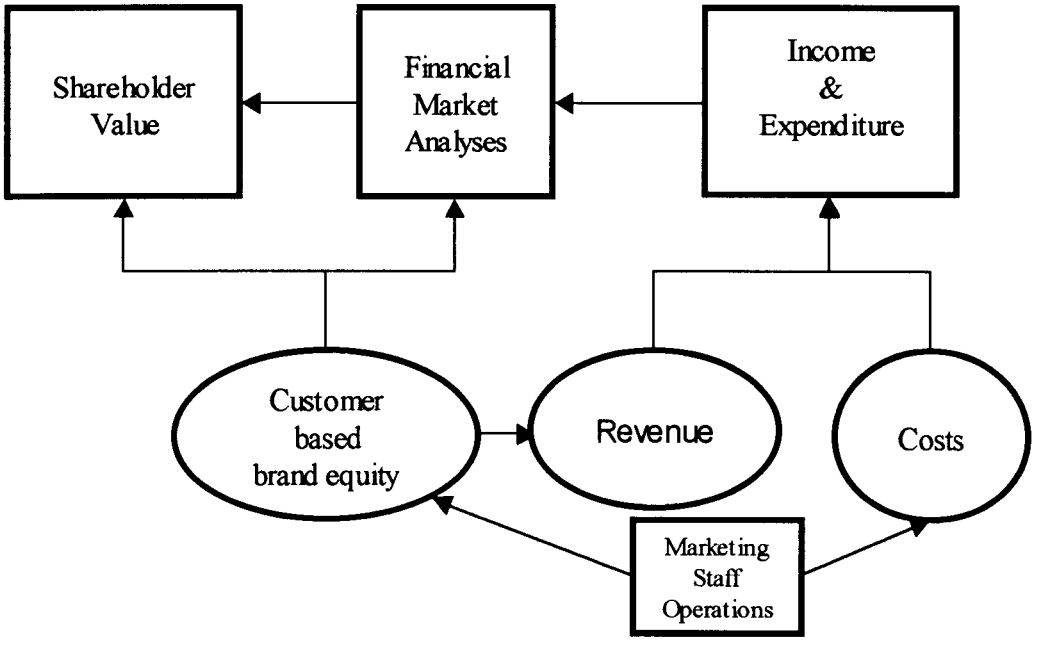
2.3 Brands Bridge the Divide

The future of the marketing function and its re-positioning as one of the major drivers of company worth will depend on general management and financial management in particular being convinced that marketing skills are directly responsible for the future fortunes of the firm.

This will require marketing people to re-think their role, and for them to accept the challenge of being measured by the growth in value of the company's brands. Shocker et al (1994) capture the extent to which marketers will have to change in these words:

> *" ... brand managers should convey to Wall Street analysts information about the brand's quality image as well as financial information, to better depict the long-term prospects for their brands." (p. 154)*

Figure 1: A Model of the Company Valuation Process



The vital importance of this, and likelihood that it can be achieved, is illustrated in Figure 1. This model shows, in the top row, the conventional approach to valuing companies through financial ratios based on share prices, earnings, dividends, present values and financial statements. Financial analysts are now showing interest in the contribution brands make to the intangible assets of a company (see for example Hudson and Sayers 1999).

In reality marketing is responsible for the revenue line in the income and expenditure statement (Workman et al 1998) argue that sales is a component within the marketing concept). Revenues are derived from customers, acquired and retained by marketing techniques. Customers buy brands owned by companies. Loyal customers buy more of the brand than non-loyal customers, do so more frequently, and are frequently willing to pay a premium price for the brand they favour. They are loyal because they perceive the brand to satisfy their needs more so than a competitor. This belief was developed through the brand's performance and because successful marketing made the brand available to them at an acceptable price, and communicated a message and image about the brand that was appealing. [i]

This model places marketing in a central role, directly linked to brand equity, customers and valuations of the company's worth. To operationalise this model requires a brand valuation approach that has both financial and marketing performance inputs and which produces brand valuation outputs. The approach must be highly sensitive to variations in the measured marketing inputs. Existing models could be used for this purpose, but most do not have the degree of sensitivity to measured marketing inputs that would suit them for this role. They tend to focus on behavioural aspects of the brand's performance and fail to take account of the true source of brand equity – consumer attitudes and memory (Keller 1993).

2.4 Brand Loyalty

The brand equity literature makes frequent reference to brand loyalty as a cornerstone dimension of the construct. Quite often this is associated with the alleged ability for a brand with high levels of loyalty to charge a premium price. Moreover, it is routinely suggested that brand loyal customers cost marketers less to retain than is incurred in acquiring new customers. Other benefits are that brand loyal customers are less price sensitive than those who are not and that proven loyalty provides the firm with trade leverage and time to respond to competitive moves (Mellens, Dekimpe and Steenkamp 1996). Therefore there are multiple benefits arising from brand loyalty that make it a major source of a brand's equity.

If it were possible to develop brand loyalty in its purest, man's-best-friend sense, marketing would be uncompetitive and stereotyped: each consumer would buy only one brand. In reality the term loyalty is probably the wrong word to use because it implies emotional attachment whereas people buy brands repetitively because they satisfy their expectations and needs, at the time, or for reasons of routine or convenience. [ii] There is little doubt that consumers do buy some brands more regularly than others; that they tend to buy more of the brands to which they are most committed; and are willing to pay a premium price for these (Cunningham 1956; Jacoby and Kyner 1973; Johnson 1984, Dekimpe et al 1996).

The life-time customer value concept that was popular in the last half of the 1990s is another way of thinking about the level of brand loyalty (e.g Sewell 1992; Peppers and Rogers 1993, 1997; Shimp 1997). Under this label marketers attempt to create relationships with customers on the basis of mutual respect and trust, the result of which is the ability to reckon up the net present value of customers who will be buying the brand to some distant horizon in the future.

The value of a brand is based on the net present value of what its buyers purchase over time (Chapters Five and Six). Brand equity researchers are therefore very interested in loyalty. The number of customers a brand has over time, the frequency with which they purchase the brand; and the price they are willing to pay for it are the bedrock of brand equity which, in turn, is the value of the brand to the company that owns it. We need therefore to understand what loyalty is; what is its relationship to price, and is brand loyalty a game for brand leaders only, or can small brands play too?

2.4.1 What is brand loyalty?

Kotler (1997) makes it clear that brand loyalty is not strictly what the name implies. He lists a number of reasons that explain what appear to be loyalty purchase patterns including habit, indifference to the category, low price, high switching costs, and the non-availability of alternatives. With the qualifications implied by these alternative explanations, he identifies four loyalty segments: hard-core loyalists; split loyals; shifting loyals and switchers.

This classification is the key to understanding the concept of brand loyalty. Marketers should not be wooed by the idea that consumers are attached to brands like a dog is to its master. They must be constantly aware of the fragility of the relationship they have with their customers. Since there is evidence that price, brand name and perceived quality are related (see Rao and Monroe 1989), they need to understand the nature of loyalty and strive constantly to shift their customers into its highest order - and then keep them there. This not only increases sales and market penetration, it has the additional benefits of increasing the brand's profitability, and contributing to the brand's value - its equity.

Kotler's list above implies that the first three named (hard core, split and shifting), contain varying degrees of loyalty to brands. In other words

these consumers would prefer to buy a particular brand but are, to varying degrees, subject to other pressures to buy alternatives. This thinking is suspect in the low involvement, Fast Moving Consumer Goods (fmcg) category because it does not stand to reason that consumers set out with a favourite each time they buy. A study conducted by Kollatt and Wilett (1967) indicated that at least 50% of supermarket shoppers make selection decisions at the point of purchase. Their purchases are not pre-considered. What is probable is that they make their choice from a portfolio of brands (Ehrenburg et al 1994) that they find to be acceptable. Engel et al (1995) give substance to this idea by reporting a BBDO study that showed:

> *"nearly two-thirds of consumers worldwide believe that there are no relevant or discernible differences between rival brands across a broad range of products." (p. 24)*

The authors conclude that if brand loyalty (or preference as they call it) did exist, it is a declining phenomenon that is being superseded by price. To a large extent this situation has been brought about by the change in balance from long term, brand building advertising, to short term, sales winning in-store promotions. Marketers have virtually habituated consumers to being buyers by price: from brand to price loyal (Mela et al 1996).

In an extensive study of panel data, Meer (1995), in constructing a segmentation of shoppers, concludes that two categories of consumers have either no strong brand preferences or interest in price (13%), or are only interested in buying brands that are on deal (28%). Thus in this study 41% of the sample made in-store brand decisions based on random, brand insensitive selection, or were motivated by price. Further the category he calls "system beaters", have brand preferences but will only buy them if the price is right (29%). The balance (30%) are the brand

loyals. Thus 70% of shoppers are influenced, to a greater or lesser extent, by price.

Are there consumers who remain unquestioningly loyal to a brand? The answer is yes but they can be explained in a number of different ways, only one of which is close to the original idea of unflinching emotional loyalty.

2.4.2 Patterns of purchase

Most researchers of the loyalty concept conceptualise a continuum with non-loyals at the one end and loyals at the other. Most are agreed on the low-order, random purchase end (ABCBCACBA): consumers who are deal-prone, or brand insensitive, and who buy primarily on price (for example: Blattberg et al 1978; McAlister; 1986; Meer 1995).

Higher up the continuum, matters become slightly less clear. There are some loyal customers (AAAAAAA) and, in Kotler's language there are those with split loyalties who move between one and three brands (AABAACAABAAC), and others willing to shift if the inducement is high enough (AABACABAAC). It is very much to the marketer's advantage to minimise the number of non-loyal customers and increase those who are more regular buyers of the brand. The reasons are concerned with economies of scale, lower marketing costs to retain repeat buyers, the contribution it makes to brand equity; and, according to Anschuetz (1997), the leverage effect on the brand, across the continuum, of being weighted towards the loyal heavy buyer end. What Anschuetz demonstrates is firstly that all brands have a mix of users that range from non-loyal, occasional purchasers, to the truly brand loyal. Second, the market leader that has superiority at the top end will usually mirror this pattern down the continuum.

2.4.3 Mar' ' pe..trration and brand leader advantage

Some researchers believe that the loyalty benefit is the exclusive domain of brand leaders. Called the "Double Jeopardy" effect (Ehrenberg 1990 and 2.14 below), it is thought that brand leaders have more buyers and that these buyers buy the brand more frequently. Conversely, small brands not only have fewer purchasers, but those they do have, buy fewer units: thus Double Jeopardy.

Fader and Schmittlein (1993) support the concept of Double Jeopardy in their multi brand, US and Japan based study, and claim that there is a third market leader benefit as well. Not only do buyers of product category market leaders buy more units, more frequently, they are responsible as well for an "excess" of loyalty (see 2.5). This is the additional purchase advantage a category leader has through having high levels of distribution, and being in the portfolio of brands, or the "evoked set" (Engel et al 1995).

Baldinger and Rubinson (1996) try to confound this set of theories by introducing into the discussion one of consumer behaviour's classic debates: the question surrounding attitudes and its linkage to behaviour. Double Jeopardy, and much of the brand loyalty literature, they claim, is based on consumer behaviour. It uses scanner panel data and other measures of repeat purchasing to count the number of customers a brand has and what they are willing to pay. It pays scant attention to the psychological attitudinal antecedents to buying behaviour. It does not make the simultaneous connection between a consumer's behaviour and attitude. Dekimpe et al (1996) acknowledge this bias and explain it in terms of behaviour being what consumers actually do, and that behavioural information is less costly to acquire than attitudinal data.

Baldinger and Rubinson (1996) make the same assertion stating that the reason for this omission is that marketers, in their scramble for short term

sales and market share gains (the above and below the line balance), focus their research on behavioural measures such as brand share, penetration, trial, repeat, profit and sales. Less research is now being conducted on attitudes towards brands, and even those marketers who do use both tend to buy the two types of data (quantitative and qualitative) at different times, thus losing the ability to link these two aspects.

This provides further support to the "excess" loyalty idea proposed by Fader and Schmittlein (1993). Being in the evoked set of three or four brands means that these brands have achieved a high order affective acceptance by consumers, or in Fishbein and Ajzen (1975) terms, the subjective evaluation consumers attach to brand consumption outcomes (Petty, Cacioppo and Schuman 1983; Shimp 1997). Because they are the favoured brands, even the non-loyal segment will buy them because they are known and have implied quality.

Baldinger and Rubinson (1996) sum up their hypothesis as follows:

> *"The key concept is that buyers who are behaviourally loyal to a brand are expected to rate that brand attitudinally much more favourably than brands they either never buy or buy less often." (pp. 23)*

In a series of tracking studies conducted over time, they established the nature of the link between consumers, who are behaviourally loyal, and the attitudes they hold towards the brand. They hypothesise that buyers who are behaviourally loyal (have a 50% or greater probability of buying the brand) and will hold a more favourable attitude towards the brand. This attitude is what ties them to the brand. Those displaying the highest level of attitudinal attachment are called the "Real Loyals". Other groups of consumers who display similar behavioural patterns, but whose attitude towards the brand is less favourable, are vulnerable to competitive attraction. They are therefore called the Vulnerables.

The significance of this survey, insofar as this work is concerned, is that the percentage of respondents who they describe as High Loyals (with a 50% likelihood of repeat buying) was as little as 12%. Moderate loyals, with an increased propensity to shift, accounted for 14% and low loyals with a high likelihood of changing brands was 74%. Even High Loyals shift after one year. The researchers found that 53% of High Loyals had changed their status during the period under review to become either Low Loyal or Moderate. This, they claim, is the opposite to the Double Jeopardy effect because while the bigger brands they tested showed higher retention rates than smaller brands, the correlation between market share and loyal buyers, was relatively low at 0,53. Due to the variation in patterns they discovered, they conclude that, contrary to Double Jeopardy theory, there is scope for small brands to develop a core loyal franchise.

The research they conducted has far more value than merely trying to devalue the theory of Double Jeopardy, which clearly is an objective of their paper, but which is not argued convincingly. What they do accomplish is a valuable explanation of the pattern of consumer behaviour regarding both large and small brands and the important connection between the way people think about brands and their actual behaviour. What they do not so is devalue the findings of thirty years of study into the benefits of being a big brand.

2.4.4 What is a loyal consumer?

For two decades there has been talk of the decline in brand loyalty. Johnson (1984) called this a myth, but failed to show that there were not fewer loyal consumers than there had been. He concludes that levels of loyalty have not reduced but that marketers do not fully understand what they mean by a loyal consumer (now explained by Baldinger and Rubinson 1996).

More recently Dekimpe et al (1996) conducted extensive tests to determine the current health of brand loyalty. They concur with Johnson's findings that the decline of brand loyalty is a myth. They too however suggest that it is a matter of interpretation. When the mean trend in repeat purchasing is examined over time, they find that variations around the mean have increased. In their terms two classes of consumer cause this: the loyal and the switcher. Both are repeat buyers, but whereas one class remains more or less loyal to a single brand, making occasional forays into alternatives (the effect of sales and price promotion or distribution), the others make a habit of being more eclectic in their choice of brand.

Consumers like brands because they provide a purchase choice; they solve consumer problems and meet needs by adding value (functional and psychological); they provide reassurance of reliability; and they simplify decision making (Ambler 1997). Consumers are however less loyal than has been believed. Many will switch due to price benefits, some have no allegiance to brands at all, and those that do, are vulnerable to promotional offers to try an alternative.

The link between behaviour and attitudes is important because human decision making is less closely connected to the rational parts of the brain, and is associated more with the neural sector where feelings and social considerations are integrated (Ambler 1997).

Marketers have to understand the category in which they market their brands to be able to segment the buyers by loyalty. Considerations are whether the category itself is prone to loyalty or not (Meer 1996); what the proportion of non-loyal, brand insensitives is; what portion of the buyers repeat buy, and why they do this. Are they seeking the assurance of a well-known, always available brand; is repeat buying a matter of habit or preference; and how does price enter the equation?

2.5 The Advantage of Being a Brand Leader

Fader and Schmittlein (1993) suggest that there is a third jeopardy (or advantage, arising from brand leadership), to being a market tail ender. Their proposal is that brand leaders gain excess sales due to fuller distribution and being in the evoked set or brand portfolio. A fourth variable, not included in the Double Jeopardy benefits (or disadvantages), is price. A brand leader that has more buyers who buy more frequently, and which benefits from the evoked set phenomenon and fuller distribution, will also sell at a higher mean price than a brand that falls outside these conditions. Conversely, a small brand will have fewer buyers, who buy less frequently from fewer outlets at lower prices.

Considering the volume of discounting that takes place in supermarkets, and in most types of retail outlet via price related promotions, to what extent are marketers gaining by this activity? Surely the (now) Quadruple Jeopardy principle is indicating that brand leaders need not put their brands on deal, because they are selling on consumer momentum and preference.

The reason marketers still discount their brands (and evidence in Sinclair 1997 is that South African marketers will, against global trends, do so at an increasing rate), is that they lack the courage to stop (Ehrenberg et al 1997).

This is exemplified in Shimp (1997) who sums up a detailed discussion on sales promotion as follows:

> *"It is concluded that sales promotion is unprofitable if a brand's market is composed of promotion-insensitive or brand loyal stockpilers, sales promotion is always profitable if the market contains consumers who buy only on deal; and sales promotion may be profitable if the market consists primarily of consumers who*

switch from brand to brand depending on which brand is on deal." (p. 457)

Thus if a key target of brand management is to create brand loyalty, cutting the price is contrary to what they are attempting to achieve.

The reduction in the price of Marlboro cigarettes on the infamous Marlboro Friday did not kill the brand; Coca Cola does not cut the price of its product, although it does offer value deals; and Procter & Gamble's Every-Day-Low-Pricing (EDLP) has established constant low pricing for most of its brands. (Sinclair 1997). It is illogical to give away money that could go to the bottom line, but marketers continue to do so. The authors of the book on category management published by Nielsen (Nielsen 1992) underline this in a table that shows how the balance of marketing expenditure shifted between 1981 and 1991 (see also Sinclair 1997). In 1981 43% of advertising and promotional expenditure was spent on advertising; 23% on consumer promotions and 34% of trade promotions. Ten years later trade promotions had increased to 50%, consumer promotions remained at 25% and advertising had declined to 25%.

The authors state:

"In essence, manufacturers are looking at trade promotion spending as a strategy for providing a short-term lift in volume and not necessarily as a way to enhance brand equity." (1992:100)

Ehrenberg et al (1994, 1997) have conducted studies into the phenomenon of brands and pricing for many years. Using scanner panel data in both the US and UK, he and his team/s have recorded consistent evidence that when a brand is made available at a discount, the reduction in price is taken, with gratitude, by regular purchasers who would have paid the usual price. This is consistent with Shimp's analysis and

conclusion that discounting a brand for people who are brand loyal is not profitable. Only non-loyal brand switchers benefit.

Ehrenberg et al have recorded levels as high as 70% of those taking advantage of a deal being consumers who have bought the brand in the previous half year. The percentages increase as they look at one year and two year users. What's more the same studies show that while regular users of the brand dominate participants in a deal they represent only 10% of all the brand's users. In other words a minority of the brand-on-deal's loyal customers were the largest beneficiaries of the deal.

If this is so, marketers are allocating large amounts of money to reward a small portion of existing customers for buying the brand.

In addition there is strong evidence that many consumers do not even know what price they paid for their brand, so the discount (and reward) passes, unheeded and unappreciated, over their heads. Evidence from successive studies shows that brands do not, contrary to conventional wisdom, attract new triers. Buyers within the evoked set may shift from their regular brand when a competitor is on deal, but they will not be tempted to buy an unknown brand just because it is on deal (Ehrenberg et al 1994, 1997).

What are we to make of this? On the one hand, we learn that the majority of brand users are either split loyal, shifters or non loyal, and yet, on the other hand, there is no benefit in discounting the brand.

Two messages emerge. First, that in most product categories, price is not the major issue it is thought to be (In the US less than 3% of the billions of coupons distributed each year, are redeemed (Shimp 1997)). Second, that consumers are loyal within a category to a number of brands. This is best explained in DuWors and Haines 1990):

" .. indicate that brand loyalty is transitory and time dependant. That is, almost all families after a period of habitual purchasing of a single or a few brand/items enter a period of trying other brand/items." (p. 491)

2.6 Price and Promotions

Price and promotions are synonymous in that promotions to the trade and to the consumer are usually concerned, either with offering a direct cash discount on the normal price, or offering added value through a competition, in- on- or near pack promotion or other device. Consumers have come to anticipate in-store promotions and expect these to contribute to a reduced shopping cost. So used are they to the idea of promotions that consumers construct a zone of price insensitivity around a brand or product category. In other words if the price moves around the mean of what they consider to be normal, they will pay that price without changing their price perceptions of the brand (Kalwani and Yim 1992, Mela et al 1996).

Only when the price is set outside the zone will they attend to the change. If the price is above the ceiling of the zone, they will consider switching to an alternative brand; if it is below they may take advantage of it, but it will affect their price perception of the brand - loyal consumers will come to expect future promotions that reduce the price.

The potential damage to long-term sales and profit appears to be greater from continuous promotions than price hikes above the zone - although care must be taken in the latter case (Kotler 1996). Continuous promotions have the effect of habituating both loyal and non-loyal consumers to be more price sensitive and to watch out for marketplace deals. Mela et al (1996) found that this effect of increasing price sensitivity was four times greater among non-loyals than loyals. Ambler (1997) found that this effect is brought about as well through what he calls

price advertising. That is advertising that features brand pricing as opposed to the development of brand values. He states that an increase in price advertising leads to higher price sensitivity and to lower prices. An increase in non-price advertising leads to lower price sensitivity.

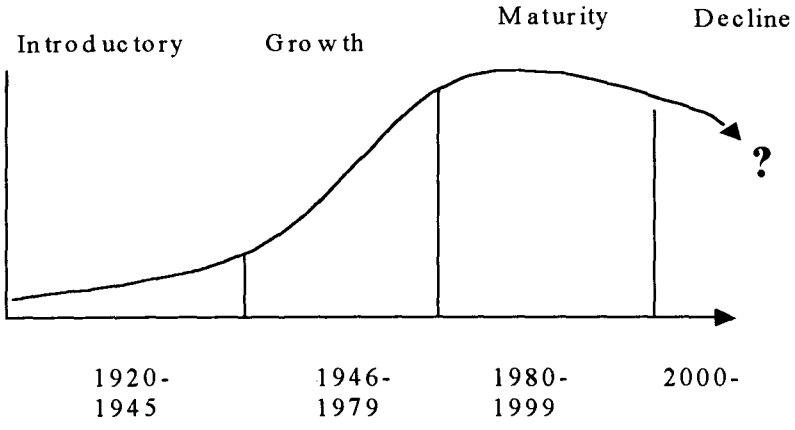
What should concern marketers is that the population segment most prone to reacting to deals is the very one they would want to be loyal. In a study that contributed significantly to our knowledge about loyal and non-loyal consumers, Blattberg et al (1978) found that households that owned material possessions such as their house and a car were more likely to be deal prone than those who, theoretically, most need low prices. Of the households who owned the material possessions included in the study, 34,4% were classified as deal prone, compared to only 20,5% of those who did not possess these household resources. So not only are marketers losing valuable customers by creating a non-loyal segment, the customers they are losing are high worth families who probably buy the most.

2.7 Is Marketing Adapting to the Changes and Demands?

In order to understand the changes that are occurring in marketing, one has to look at its history and pose the question that it might have become victim to its own invention: the Product Life Cycle (PLC).

Having had a slow and long drawn out introductory phase, the industry experienced rapid growth through the 1950s, 60s and 70s. The maturity phase of the 1980s and 1990s was characterised by extensions in the form of services, relationship, global, one-on-one, business to business; internet marketing and the emergence of the professions from behind their restrictive codes. But, has marketing now reached its apogee. Is it now in its period of decline?

Figure 2: Marketing's Product Life Cycle



The environment in which marketing has thrived has changed. It is generally accepted that Proctor and Gamble was the first major organisation to embrace the concept when it introduced product management to the business world in the 1920s. After the last world war manufacturers could sell almost all they could make to a population trying to adjust to peace, and a different economic regime (Stanton et al 1992). But soon the spending slowed and ways had to be found to take up capacity. Academics such as Ted Levitt of Harvard, Jerome McCarthy of Michigan State and Philip Kotler of Northwestern University started the process of formalising what became known as the marketing concept.

Marketing as a formally defined and studied discipline is only half a century old. It was after the second world war that the marketing academics noted above started creating a marketing theory; born to suit a particular economic climate. As that climate changes the concept defined by these visionaries could become defunct. As Achrol (1991) points out:

> *" ... marketing's strategy concepts remains rooted in the historical evolution of functional approaches to a customer orientation. In the post-industrial era, unusual forms of marketing organisation ... will be needed to cope with complex and dynamic task environments." (p. 93)*

There is ample evidence of change to the concept, if not its decline, in the volume of academic papers on the topic and in articles that define the economies of the future. (Piercy 1998; Workman et al 1998, The Economist Intelligence Unit (EIU) and Andersen Consulting 1997).

2.8 Marketing in Decline

Accenture is talking about the business world in general relying increasingly on electronic means to conduct the exchange process. Kotler is defining marketing – a subset of business.

This is not a distinction that is being missed by the world's biggest consulting firm. The value of the marketing end product is fully understood and appreciated. In the joint EIU/Accentue report (Vision 1997), in a section titled "The Power of Brands", the authors state:

> *"Their (multi-national Fast Moving Consumer Goods (fmcgs) companies in support of their brands) investment in advertising, distribution and promotion may have to be increased, and their own strategies must take that into account." (p.26)*

There is no mention of marketing, just the implicit belief that management will take charge of brand building and the exchange process using what have been known for at least fifty years as the tools of marketing. The report goes further in establishing the authors' understanding of what they are saying:

> *"Such investment in a brand builds up its equity, the intangible value of consumers' recognition and memory of the product – which can actually last for years after the product has been withdrawn from sale." (p. 26)*

A light-hearted platform comment doing the rounds recently is that marketing is far too important to leave to the marketing department. But the president of Coca-Cola was not joking a few years ago when he said that: "marketing is what we do". He was suggesting that the entire company devote itself, each day, to satisfying the needs of clients. Protecting the world famous old brand is not something that is left to a department. It is the job and role of every member of staff.

This distinction is receiving support from marketing academics too. Workman et al (1998) distinguish between the applications of a marketing orientation as being either functionally or activity based. The marketing department conducts the functional aspects of marketing while the entire company is concerned with marketing as an activity.

The concern is that marketing, the acquiring and keeping of customers, in the emerging world economy, will be the domain of company management – if that is not already the case. Marketing trained people will work in a department co-ordinating the promotional activities of the firm, and commissioning marketing research.

This could be laughed off (for marketing people) as scare tactics – like the "advertising is dead" slogan that did the rounds a few years ago. But there are too many discouraging signs that drive home the reality. For example:

a At its second conference on Brand Equity in 1991, having invested research funds in the concept since 1988, The Marketing Science Institute (MSI) reached the following conclusion:

"By failing to address these issues (issues relating to the valuation and management of brands) marketers would be passing the buck to financial analysts and accountants. In the process of abdicating

their responsibilities, marketers would lose control of their immediate task environment." (p. 1)

b Ambler (1998), of the London Business School, reporting on the survey commissioned by the British Institute of Practitioners in Advertising (IPA) summed up a key finding in the damning statement that:

"Most financial managers think that most marketing managers are business amateurs." (an email communication with the author)

c The British Financial Times promoted a conference to be held in May 1998 in London. It was called "Reflecting Brand Value on the Balance Sheet". This title, admittedly, does not signal a conference at which marketing will play a core role. But the subject was brands and marketers are supposed to invest brands with their intrinsic value. It was disturbing to discover, therefore, that of the thirteen speakers, not one was billed as a marketing specialist. The speakers were accountants, management consultants, lawyers, chief executives and brand valuation consultants. Considering that there is no brand value unless successful marketing establishes and maintains it in consumer memory, this is a serious omission - or a significant snub.

d The joint report by the Economist Intelligence Unit (EIU) and Andersen Consulting (1997) that received broad media coverage is about the structure of organisations in the new millennium. It covers the power of brands, but does not suggest that marketing will develop and protect them. Even though the most important driver of change right now and in ten years will be:

"Customer demands for higher quality and service", (p. 4)

there is no mention of marketing, the discipline most concerned with building customer perceptions of these evaluative criteria. In fact, in one section of the report it suggests that design, production, marketing, advertising, distribution, accounting and human resources are candidates for outsourcing. It goes on to say that firms of the future might comprise a small head office team building and using its knowledge of: "market demand and consumer requirements ...". This appears to be either a misunderstanding of what marketing is, or a deliberate usurpation of its role.

e In South Africa patent attorneys and firms of accountants, until a 1999 change in the Tax Act curtailed their activities, once dominated the brand valuation market. This should always have been the domain of marketing orientated companies. While global brand valuation companies are now emerging and reclaiming this area, there was a danger that it could have slipped from the grasp of the marketing community.

f In a special edition of the Journal of Marketing Research dealing with changes to marketing, the compilers wrote:

" (Brand management) ... typically, has been left in the hands of relatively young, inexperienced managers, overloaded with analytical skills and often short-term focused." (Shocker, Srivastava and Ruekert 1994)

g At the same time our South African marketers have indicated that they will continue to buck the global trend of shifting marketing communication funds from brand building advertising, to loyalty-destroying sales promotions. (see Sinclair 1997 for a survey of South Africans marketers; and Mela et al 1996 for the destructive effects of this action).

2.9 Marketing Metrics

Each year companies budget for capital and operational expenses. They may plan to invest in new machinery, new branch offices, additions to the fleet of motor vehicles, lorries or aircraft and they may decide to invest in a new brand. The capital expenditure budget is set to finance the acquisition of new assets. The firm will also budget for expenditure on the maintenance of existing assets.

The two types have different accounting treatments. The first is a capital expense on an asset the cost of which will be amortised over a period of time and taken annually into the income statement until the original cost is fully absorbed. The second is a tax-deductible expense from pre-tax profits.

Management decides on which capital projects to invest in by examining the expected cash flows from the proposed project and accepting those that have a positive Net Present Value (NPV) or Internal Rate of Return (IRR) and rejecting those that do not. While it is recommended that new products should be treated in this way (Kotler 1997; Lehmann and Winer 1994), the reality is that they frequently are not.

> *"Correctly applied, good financial analysis complements rather than contradicts good marketing analysis. In practice, though, the analysis usually falls short." (Barwise, et al 1989; see also Lehmann and Winer 1994:405).*

New product introductions are evaluated using methods such as breakeven analysis. Analysts estimate the point in time when a quantity sold at a given price equals the start up costs (Keegan at al1995: 419). The factory required to house the plant and the machines needed to produce the product will be evaluated according to established rules of financial decision-making.

Similarly, requests for additional capital investment, plant improvement, replacement, or in branch network expansion are motivated by reference to finance tools. Marketing requests are justified by reference to the need to increase sales or market share; expand the number of dealers handling the product; create awareness of the new product among a specific target market; and, change consumer attitudes (Kotler 1997; McDonald 1984).

Because marketing and its tools such as advertising, promotions, public relations, market research and design, are viewed as expenses against revenues and not investment, the financial decision process is pushed down the company hierarchy to levels beneath the boardroom where cash is raised to finance the purchase of assets (McDonald 1984).

The financial manager is integral to this latter process (Brealey and Myers 1985) and is always represented on the board of the company. The marketing department is represented on the board of South African companies in only 28% of cases (Hudson and Sayers 1999) and in British companies in 22% (IPA and KPMG 1996). This contrasts with the finding that marketing is viewed as being more important than Research and Development, production; information technology; human resources and training; accounts and administration (Hudson and Sayers 1999). Additionally, according to the same study (1999) marketing is reported in the annual report to a greater extent than the other functions listed above.

2.10 Marketing Accountability

Sales targets, market share and reference to profit have been central to marketing objective setting for many years (McIver 1972). Sales targets by both volume and value are aggregated and combined with other sources of revenue such as fees, interest, dividends and royalties (Faul et al 1999), to produce the company's annual budget. Costs of sales and operations are then deducted to produce the operating profit. Actual

sales by volume and budget are the measure of the extent to which the budget is met. These metrics are therefore essential to the planning and performance of the firm.

However the true worth of the firm is not the sales level achieved or control of expenses, but the value of the company's assets at the end of the period compared with the reported value at the start. The accounting definition of an asset (see pages 82 - 83 for an explanation of A.C. 0000 and the definition of an asset) assumes that assets have the potential to contribute directly or indirectly to the enterprise's flow of cash and cash equivalents (Faul 1999). From this discussion it would seem that the marketing function is the link between the firm's intangible assets and its ability to generate future economic benefits. It is a resource. Yet, marketing effectiveness is only indirectly measured by the extent to which it adds value to the firm's assets. It is measured by achievement of gross sales revenues; gains in share of market; and, at a lower level: perceived product quality; customer retention and satisfaction and number of complaints received.

The effectiveness of marketing in South Africa, is judged by reference to sales volumes (75-80%) and market share (55-60%). The most commonly used metrics for objective setting are sales volumes (70-75%), market share (65-70%), profit (60-65%), consumer satisfaction (55-60%), brand image (40-45%), and brand value (10-15%) (Hudson and Sayers 1999:43-44)

These findings are consistent with the findings of a survey conducted by Ambler and Riley (2000). They established that the main measures of marketing performance in the UK and in Spain were, in ranked order: profit; sales value and/or volume; gross margin; awareness; market share (volume and value). These were cited by 78% to 92% of the sample. Strong relationships were found between the importance of each and the extent to which these metrics are considered by the "top board".

What this implies is that marketing effectiveness, primarily, is measured by its ability to achieve greater volumes, sales value and margins. Seen in this light it is the conduit between the consumers of the firm's goods or services and the owners' assets. Marketing literature has long supported this approach (see for example Kotler and Armstrong 1997; Perreault and McCarthy 1996).

The Marketing Science Institute (MSI) which selected Brand Equity as a "Capital Topic" in 1988 and again in 1991 (see section 2.12 below) identified Metrics/Measuring Marketing Performance as the "Gold Topic" for period 2000 – 2001. The first item under the heading encourages academics and researchers to address the subject of metrics:

> *"... linked to marketing effort, measures such as satisfaction, customer lifetime value, brand equity, loyalty, and awareness." (MSI 2001:2)*

Ambler and Riley (2000) conclude their MSI co-sponsored research with the words:

> *"For most companies their reputation, or brand equity is their most valuable asset. We should now be moving to an age where this is recognised, professionally measured and managed." (p. 25)*

In this thesis it is asserted that a move from the current practice of measuring the marketing function and marketing performance by the conventional means of profitability, sales value to volume, gross margin, awareness and market share, would allow management to judge marketing effectiveness directly by its influence on its assets, rather than on second tier measures often confined to the marketing function.

2.11 Brand Equity

The first mentions of brand equity in the literature occur in 1988 (Tauber 1988; Leuthesser 1988). Tauber refers to the term being used by marketers interchangeably with brand image and brand personality. There is no direct reference in the literature as to the origin of the term or when it was first coined, but it clearly emerged during the 1980s as companies started to recognise that brands established equity in the minds of consumers and that this equity could be used to leverage added benefits such as line and range extensions (Morein 1975; Ries and Trout 1981;Smith and Park 1992). As Tauber points out brand line and range extensions are not in themselves new - the idea of using a brand name as an umbrella under which to introduce new, related products had been a marketing strategy for many years. But never before had it been used with the intensity of the 1980s. He states:

> *"Recognition of the value of established brands has reached such heights that almost half of all new packaged goods are brand extensions." (Tauber 1988:26)*

A clue to the origin of the term brand equity emerged in an article quoted by Tauber that appeared in Advertising Age in October 1985. Referring to the unprecedented activity of financial markets that saw about $15 billion spent in just a few weeks by companies buying some 400 brands owned by other companies, the journalist wrote:

> *"The brand name has suddenly emerged as the most coveted corporate asset of all. Brands no longer are merely products competing for market share; they're annuities being plugged into the big-money equations of corporate acquisitions. It has become wiser to grab someone else's established brands and extend the lines than spend $80 million or more trying to get a new name into the mix." (p. 26)*

Speculatively, the term would have emerged from financial markets during the 1980s when brand values first appeared in financial statements as intangible assets. It is an easy conclusion to reach that with brands assuming the mantle of asset they would be seen as equity items.

Leuthesser (1988) edited the summary of the first conference to be held on the subject. In the introduction the president of the Marketing Science Institute (MSI) which initiated and hosted the event, said of brand equity:

> *"The concept of brand equity has been used broadly for a long time, but there has been no precise definition of it – not even common agreement on what it is." (foreword)*

The delegates to the conference had various suggestions as to how it should be defined but the MSI (Leuthesser 1988) published the following:

> *"Brand Equity is a set of associations and behaviour on the part of a brand's customers, channel members, and a parent corporation that permits the brand to earn greater volume or greater margins than it could without the brand name; brand equity gives the brand a strong, sustainable, and differentiated advantage over competitors." (p. 31)*

The MSI decided at this 1988 conference to designate brand equity a "Capital Topic" for the 1988 – 1990 period thus funding academic research into areas such as how the potential equity residing in a brand could be assessed and measured; what factors that underpin brand equity could be controlled and maintained; and, the extent to which brand equity could be used as a vehicle for brand extensions. Much of the research that was stimulated by this decision is reviewed in Chapter Five of this thesis.

As long ago as 1958 Mayer (Mayer 1958) wrote on the economic effects that advertising has on brands. In searching for a theory of what advertising does, he concluded that at the very least it adds value to the existing values of a product.

> *"The value of a product to the person who buys it is not limited to the physical use he makes of it." (p. 294)*

From the financial stand point the definition above has been refined. Simon and Sullivan (1993), whose work on decomposing the intangible asset component of goodwill was an important contribution to the MSI sponsored research stream, defined it as:

> "... *the incremental cash flows that accrue to a branded as compared with a non branded product." (p.29)*

Srivastava and Shocker (1991) conclude that Wall Street and academics embrace this definition, and versions of it.

The definition implies future cash flows for both a branded product and one that is not branded. A brand must have equity for it to be able to generate incremental cash flows over and above those that an unbranded version would earn.

Shocker and Weitz (in Leuthesser 1988) explain that these incremental cash flows arise from the ability a branded product has to:

a increase the brand's market share;

b attract a premium price;

c reduce promotional expense.

This explains the question posed by Srivastava and Shocker (1991:2) as to whether brand equity adds anything new to the heavily researched concepts of brand loyalty, customer franchise, competitive advantage and positioning. By considering a brand as an asset that provides equity for its owner, its user, and the trade that stocks it, the construct subsumes these and other theories and links the marketing that creates and builds the brand to the added value that attracts investors.

This was Mayer's theory. It helped him explain why consumers were willing to pay a higher price for brand A that in reality was the same as brand B. The difference lay in the added value given to the product by its advertising which was sufficient to:

> *"make the brand seem worth a little more money ... "*
> *(Mayer 1958:295)*

In examining the concept the MSI was recognising the implications of brands as assets and the positive and negative outcomes that would result.

For example the introduction of brand equity and its measurement for balance sheet purposes would impose greater pressure on marketing managers to account for their investments in marketing strategy in terms of increased brand equity and value. This would make them directly accountable to the financial function (and shareholders) for the effectiveness of their actions. If companies buy rather than create brands and use external financing to achieve this, marketers may be placed under severe pressure to meet short-term debt coverage and the consequence of short-term revenue generation. In addition the need to maximise earnings will lead to reduced marketing expenditure which will weaken brands (Srivastava and Shocker 1991).

The emphasis that the MSI placed on brand equity and the stream of research that followed, contributed to limiting the brand damaging reality of these warnings (see for example Mela, et al 1996). The MSI achieved this by elevating the concept to "Capital Topic" status and funding the research referred to above.

The composite definition that the MSI applied to the concept was as follows:

> *" ... the set of associations and behaviour on the part of brand's customers, channel members, and parent corporation that permits the brand to earn greater volumes or greater margins than it could do without the brand name; brand equity gives the brand a strong, sustainable, and differentiated advantage over competitors." (Leuthesser 1988:31)*

2.12 Is Brand Equity an Appropriate Title?

Companies apply brand names to products in order to differentiate them in the marketplace. If a brand is to have any value it must satisfy at least two requirements: buyers of the product group must be aware of the brand name, and they must associate with the awareness attributes and benefits that are important to them (Aaker 1991 and Keller 1993). When consumers are aware of a brand and make positive connections to it in their memories value is created. In this context, value has different meanings. (Hofmeyr and van der Walt undated). For the consumer, having knowledge of the brand provides them with an assurance of what to expect from the product.

The value to the company is that consumers are likely to become regular buyers of the brand they know and with which they have favourable associations. Brand equity theory takes these brand-building requirements and weaves them into a developing body of literature.

Brand valuation procedures require that marketers have done their job in creating a franchise in the marketplace for the brand: hence consumer driven brand equity. Keller (1993) proposed that brand equity has two clear aspects: financial and consumer. This important contribution arose because he believes marketers need to take a strategic view of brand equity development. To do this they must understand how the consumer behaves in relation to brands and brand marketing. This is the source of brand equity. The value of a brand is based on its sales and these occur because consumers have knowledge of the brand: the brand equity outcome. It is the quality and extent of this knowledge and the marketer's ability to influence it that he uses as a framework to describe consumer based brand equity.

But, while in its financial sense the word equity has clear meaning, is it correctly applied to the customer-driven aspect of this theory?

In its original sense the word refers to the quality of being fair and right. In Britain, Ireland and the United States it also has a legal status, but its usage by the investment community to mean the ordinary shares of a company is the one that is relevant to this discussion (OED 1999).

Equity capital is the funding raised by a company from investors who are willing to make their money available to the firm and risk losing it in return for a share of the firm's profits. It therefore means the net worth of the company after all liabilities have been accounted for. This is known as the owner's equity (Faul et al 1999).

Calculating the value of owner's equity has, in recent years, been complicated by the need to include in the inventory assets which have no physical form such as brand names, copyright and the value of brands that the company owns. The core of the argument has been the difference between stock market valuations of companies and the

balance sheet valuation prepared by conservative accountants. The former tend to take account of the value of brands and other intangible assets, while the latter do not because accountants cannot find a suitable method of measurement (see for example Aaker, 1991 Keller 1993 and IASC 1994)

The term brand equity was coined, not by the financial community but by marketers. In fact it is possible that the term has no meaning for the financial community and certainly is not mentioned in the accounting standards concerned with intangible assets (AC 129 and A.C 131). Nevertheless, its original conception was to provide a valuation procedure for balance sheet purposes. Keller (1993) calls this the outcome of brand equity. The second area of development is the use of the word to describe the consumer driven aspect that underpins financial brand equity, and here there may be a definitional problem. This, according to Keller, is the source of brand equity.

The application of the name equity to the latter area becomes problematic when one looks again at what the word means. In its strict sense it is the value of the ordinary share of a firm (OED 1999). Therefore it is what the shareholders own. This implies that what the shareholders own, they could loose. They are at risk in owning the firm's equity.

Consumers are not, at first glance, in such a position. They are not in a position of financial risk in using the brand. Apart from paying the price asked for in the distribution channel, they own no part of the organisation and only own the brand - if it is a tangible product, as opposed to an intangible service - until such time as it is consumed or sold. With services they never take possession of it. They pay a price to experience the service (see for example Lovelock and Wright 1999).

This calls to question the correctness of using the term to describe something that it clearly is not. Consumers do no hold equity in the brand because they never possess it in the sense that equity implies.

Lassar et al (1995) develop a definition for customer-based brand equity as a foundation on which they develop a brand equity measurement device. Drawing on previous work, they describe it in the following terms:

> *"Customer-based brand equity has been defined as the differential effect of brand knowledge on the consumer response to the marketing of the brand. Thus brand equity is conceptualised from the perspective of the individual consumer and customer-based brand equity occurs when the consumer is familiar with the brand and holds some favourable, strong, and unique brand associations in the memory." (Kamakuru and Russell 1991 quoted in Lassar et al 1995)*

They use this definition to create a framework which forms the basis of their measuring instrument. The four considerations that arise from their analysis are that customer based brand equity refers to:

a Attitudes rather than objective behavioural indicators;

b that it refers to a global value (overall attitude) associated with the brand - not its individual attributes;

c the global value stems from the name itself as well as from the brand's physical aspects, and that,

d brand equity is not absolute, but draws its strengths (and weaknesses) from its position in relation to the competition.

Resulting from this they provide a statement which summarises their conceptualisation of brand equity. It is:

> *"the consumers' perception of the overall superiority of a product carrying that brand name when compared to other brands."*
> *(p. 13)*

There is a link between the way Lassar et al (1995) see customer brand equity and the financial orientation of the concept in that the intangible asset referred to by the accountants has value mainly because the customer has given the brand value. However, that is like saying there is a link between petrol and motorcars, therefore petrol is a motor car.

Previously used terms such as brand value and brand image described this concept reasonably well, but in the stream of literature and research that has developed since the late 1980s on brand equity, these terms have been subsumed into the varied definitions and growing use of brand equity. They would resist rehabilitation to distinctive and exclusive meaning. The questions that arise therefore are:

a Is the use of the term brand equity to describe the customer-driven foundation of a brand incorrect, and if so, is it so misleading that it should be replaced?

b Could an alternative term be devised that would describe the concept better than brand equity (as it is presently understood and used) and would it be possible for this new term to be promoted into universal acceptance in the marketing field?

Let us examine the first question.

Earlier it was stated that consumers do not stand to lose anything through their repeated use of familiar brands, whereas in the financial sense, if

equity is owned in a company, the investor is at risk because the company could fold and money could be lost.

This argument implies that consumers take no risk when they buy a brand. Lassar et al explain that in their conceptualisation, brand equity is based, not on behaviour related to the product but on perception. In other words brand values and associations are perceptual interpretations of brand-generated stimuli and are not objective evaluations of physical attributes. The concept of perceived risk has a long history of research in marketing literature (see for example Cunningham 1969; Guseman 1981; Murray and Schlacter 1990). Perceived risk is defined as:

> *"a person's expectation that a loss will occur," and " the greater a person's certainty for the loss, the more that person is a risk taker." (Engel et al 1993:362)*

It could be argued, therefore, that it is misleading to say that consumers of a brand are not subject to loss. The distinction is in the psychological difference between loss as a behavioural occurrence and loss as an internal, perceived event. The degree of perceived risk experienced by individuals is often expressed in terms of involvement: a marketing theory based on the amount of perceived risk associated with the selection and acquisition of a product or service (see Engel et al 1993:). The higher the perceived risk that there will be a financial, ego, performance or time loss if the product does not work as expected, the higher the so-called involvement. This equates to investor circumstances where the size of the investment relative to the investor's wealth will determine the extent to which the investor feels at risk. The difference is that if the investor is wrong, he or she will lose something material ... money. The buyer of a good or service is subject to a broader range of possible losses from money, to loss of time to embarrassment in the eyes of peers.

Thus the outcome of the brand purchase is associated with risk. While the concept of buying a high quality brand, such as a Rolls Royce, has the effect of reducing risk in that the possibilities of a performance or ego failure are accommodated in the quality promise of the brand, a rare but feasible conspicuous breakdown, would be exceedingly embarrassing; a risk not inherent in a lesser motor car.

The other component of the definition is ownership. In the definition of equity above, ownership is a primary element. Clearly, when a product is bought the consumer takes ownership of it. It is this investment in the product that causes the risk to occur. While the distinction between consumer acquisition of products and services (products are owned; services are experienced) could be used to limit this argument, the counter is that the experience is acquired. A bank account is acquired, as is a ticket to sit in a seat on an aircraft while being transported and this can be extended to the advice given to a client by a lawyer or financial consultant; the client takes possession of the advice.

Brand equity is a term that is used by marketers and some businesspeople to describe brand value. In its financial sense it refers to the contribution a brand makes to the overall value of a company. In the customer driven sense it is the value consumers place on the brand. In both interpretations ownership and risk are implied. If ownership and risk are the determining components of the definition, this argument implies that equity passes the test. It is no different from the purchase of equities or equity in a business venture. That too implies risk and ownership and is subject to the volatility of the share market, business decisions and the economy. The price of reduced risk is to pay a high price and receive a low return. Even then the price can fall and the solid company can be destroyed by a bad decision or investment. Consumers pay a premium price for high quality brands in order to protect themselves against failure.

2.13 Brand Salience or Image?

Brand marketers are having to look hard at traditional ways in which they manage their brands. In an article in *The Economist* (2000) the sub-headline reads:

> *"business is awful for producers of branded goods." (p. 78)*

And in the body of the article the writer describes current market conditions (for branded goods) as "horrid".

The problems being faced by companies such as Unilever, Sara Lee, Danone, Heinz, Kellogg and Campbell Soup, Coca-Cola, McDonalds and Levis (see also Tybout and Carpenter 2000) have been brought about by a multitude of problems among the most insidious of which are challenges from generics and private label products; falling prices; squeezed margins; markets crowded by competitors both national and private label; the need to innovate to keep ahead and the change in channel power over the past few decades from manufacturer to retailer (Kotler 199).

These obstacles are, according to Tybout and Carpenter (2000), evolutionary in that they result from a change in buyer needs. What they call the "classic" brands grew from a consumer need for assurance of quality and reliability. Particularly after the Second World War, consumers were inward looking and concerned largely with re-building their personal lives. The core change between then and now is that previous generations saw brands as a means to an end. Brands symbolised achievement and peer group acceptance. They stimulated the concept of "keeping up with the Joneses." Big brands were built through mass media advertising campaigns that aligned brands with consumer end-goals. Manufacturers created powerful brand images that forced retailers to stock brands because they were in demand by

consumers. These brands satisfied the psychological, economic and functional needs of consumers (Ambler 1997).

Tybout and Carpenter (2000) suggest that functionality is no longer a key brand requirement. Consumers have moved beyond buying a brand to solve a specific functional need. All detergents clean clothes - they are functionally equivalent - and claims to clean better or whiter are generally redundant among modern consumers. Brands are bought to satisfy a wider variety of goals now such as that the detergent should be environmentally friendly, that it should be particularly efficient, or that it should not cost too much.

For twenty years Ehrenberg has been developing and publishing theories that support this change of consumer response to brands. He has, for example, long questioned the role of advertising in building brands (Ehrenberg and Goodhardt 1980). His weak theory (Sinclair 1997) proposed that advertising is a weak force that at best generates awareness of a brand name, encourages trial and reinforces knowledge of the brand. In rejecting a more powerful role for advertising Ehrenberg and his associates reject also the idea that marketers are able to modify attitudes and that it is attitudes that cause shifts in brand sales and in market share. The Ehrenberg school of thought promotes two beliefs:

a Brands that are big have more customers buying them than small brands simply because they are big. This phenomenon, mentioned earlier, is called Double Jeopardy (Ehrenberg, et al 1990) [iii];

b Salience is a broad based concept that explains why big brands remain big. It is not, according to Ehrenberg, due to the strong and positive attitudes people hold of the brand. It is a function of the size of the buyer market, how many people in the market are aware of the brand, the amount of shelf space it commands, its promotional impact; number of sales people, more advertising,

more media mentions and greater word of mouth mentions. The sheer weight of presence of the brand is its mark of success.

The theme he has been promoting over this time is that brand success is not based on an ability to maintain a distinct and sustained product difference. Innovation is ephemeral. If a brand is differentiated by some unique and newly discovered formulation benefit, it will hold that advantage for a short period as competitors who have been researching and developing under similar pressures to innovate, match or overtake the benefit (Ehrenberg at al 1997). Innovation is important and benefits the consumer. Some early mover advantage might be retained depending on initial resources captured by the innovation pioneer, plus additional capabilities and resources subsequently developed which are superior to the quality of those held by later entrants (Lieberman and Montgomery 1998). But Ehrenberg insists that innovation is insufficient to sustain long-term market leadership. At best it is a leveller in that it ensures each brand is not left behind in the category evolution. It also does not justify the large advertising and marketing budgets that are allocated to promoting an innovation. The response from competitors with similarly large advertising allocations cancels out the effect. Ehrenberg believes that brands succeed because they penetrate deeply into the market. They achieve brand salience.

Baldinger and Rubinson (1997) challenge the Ehrenberg view that there are no strong or weak brands only big and small brands (Ehrenberg 1997). They contend that the Ehenberg view of market penetration in order to create greater salience is not only incorrect but also dangerous. Market penetration implies gaining a greater presence at the point of sale, a tactic usually achieved through the use of trade incentives and in-store promotion. Market penetration strategies have always been at the expense of image building. Mela et al (1996) demonstrated the futility of this approach.

Price orientated promotions have significantly larger effects on consumer price and promotional sensitivities compared with the good effects of brand advertising. In fact Mela et al report that in the early 1990s various leading packaged goods companies announced that they were cutting back on advertising in order to increase their expenditure on promotions. Just four years later these same companies were reversing the trend and returning to conventional advertising. [iv]

There is not complete agreement as to what brand salience means. Miller and Berry (1998) contend that "most advertising and research professionals" would use the term differently to that described above. They use the term to explain the circumstances in which brands sell because consumers are aware of the brand. Brands do not sell because of what consumers think about them. In other words this opposing view removes the attitudinal component that it believes is captured in the Ehrenberg "halo effect". In this, brands with greater salience than others obtain superior scores on a variety of variables some of which include attitudinal aspects. This alternative school of thought holds that brands sell simply because people are aware of them – not because they hold attitudes towards them.

The weight of evidence is against this view however. As Kahn (2000) explains:

> *"Observations of consumer shopping patterns reveal that consumers spend an average of 12 seconds from the time the shelf is approached to the time the item is placed in the trolley. They examine only 1,2 brands on average. The rapidity with which consumers decide suggests that they rely primarily on memory in making their choices." (p. 4)*

The conclusion that marketing academics draw from this is that knowledge placed in memory by advertising and other means of

communication has created the consideration set (Engel et al 1995:216-217). Consumers select from alternative brands stored in long-term memory when confronted by the need to make a buying decision.

Engel et al (1995) report on a study which suggested that consumers think of a limited number of all the brands of which they are aware when making this decision. The consideration set could be as small as 2,2 brands of air fresheners to 6,9 brands of beer. The brands in the consideration set are those that best match the evaluative criteria that each consumer uses to differentiate one brand from another.

Ironically, Engel et al (1995) use the term salience to reflect this choice process. To them salience is the potential influence that each brand dimension may exert on the consumer during the evaluation process. Ignoring, for the present, this lexical confusion, it is clear that both image and salience contain varying degrees of attitudinal components.

Market penetration (Ehrenberg's salience) is achieved by promotional activity balanced in favour of trade discounts and in-store promotion. Image building is accorded the opposite weighting; the balance of the marketing budget being allocated to brand building media advertising. Salience is not, therefore, an alternative construct to image, it is the opposite of brand image (Farr and Hollis1997; Miller and Berry 1998). Salience and image are polar opposites and marketing managers must decide which is appropriate for their brand and adopt a suitable strategy.

2.14 Changing Behavioural Patterns

The implication from the point of view of marketing management is that each choice requires a different balance of marketing expenditure. If salience is concerned with presence at the point of sale, the balance will be in favour of trade and consumer promotions. If the balance is towards

the image end of the spectrum the weight of expenditure will be in classical, above the line advertising.

During the period following the Second World War when big brands were establishing their dominance and new media such as commercial radio and television were available the choice was clear. This was the era during which the orientation changed from sales to marketing and the focus of manufacturer attention shifted from selling products to the consumer to marketing products that reflected consumer wants and needs (Brits and Reekie 1985). The rise of the supermarket chain reduced the power of the manufacturer. When distribution was to many small shops the manufacturer could dictate the terms. As consumer purchasing moved to the cut price supermarkets and manufacturers had to deal with chain store management to ensure their goods were available through their outlets; hence the advent of a range of discounts and contributions that manufacturers have to pay to gain distribution and retain it.

According to Shimp (1997) marketers allocated 42% of their promotional budgets to advertising in 1977. By 1994 this had fallen to 25%. Half of the budget was allocated to trade promotions and the balance to promotions aimed at consumers. In South Africa a similar trend has been noted (Sinclair and Barrenblatt 1993). In a detailed discussion on the reasons for this, Shimp concludes that it is due to six factors: balance of power shift; increased brand parity and price sensitivity; reduced brand loyalty; reduced media effectiveness; short term orientation of brand management; and, consumer responsiveness.

a Balance of power shift. Three reasons are advanced for manufacturer power. Firstly the power of classical adverting created a pull through pressure with consumers being persuaded to demand products of their choice. This forced retailers to stock brands that were in demand. Second the only research available

to retailers was that provided by the manufacturer. Therefore the retailer had scant knowledge of whether a new brand or variation would be successful or not. Third, manufacturers employed large sales forces who were able to convince store management to stock brands and brand extensions. The fall off in mass media effectiveness, the availability to retailers of consumer data through research sources such as A C Nielsen and scanner data, have placed brand and consumer knowledge in their hands. The knowledge they now have permits them to dictate terms to the manufacturer.

b Increased brand parity and price sensitivity. It was once possible for a manufacturer to launch a product with a distinct benefit and to maintain this superiority until the brand reached maturity. This is no longer possible as competitors are able to match advances before an entrenched market position can be achieved by the brand with the innovation. This has focused attention on in store dealing which in turn has habituated consumers to price and price incentives.

c Reduced brand loyalty. The trend to trade and consumer promotions had the effect of sensitising the public to deals to the detriment of brand loyalty. Shimp (1997) reports an international study which demonstrated that no strong gains were achieved by companies giving promotional incentives, because the extra sales that the promotion generated came mainly from the brand's existing users

d Reduced media effectiveness. Changes in consumer lifestyles have impacted on the effectiveness and homogeneity of media. It is more difficult now to reach groups of consumers who are highly segmented by lifestyle and therefore product preference. This has

pushed up the cost of targeting segments and made in-store promotion the more attractive option.

e Short-term orientation of brand management. Various pressures on companies have shortened the horizons of brand management. Today the need to produce results for quarterly reports has made the long-term effects of advertising unappealing. Sales promotion generates fast results and serves an internal, political problem.

Commenting on these changes in emphasis, Keller (1998) states that:

> *" ... many (respondents in a survey among top US marketing executives) believed that the use of coupons and discounting negatively affected a brand's long-term image and positioning." (p.240)*

He notes that in recent years there has been shift away from promotions and back to traditional forms of advertising the purpose of which is to regain brand loyalty and preference through the communication of image building brand knowledge.

There are two main reasons for this change:

a The emergence of brand equity and the recognition of brands as assets;

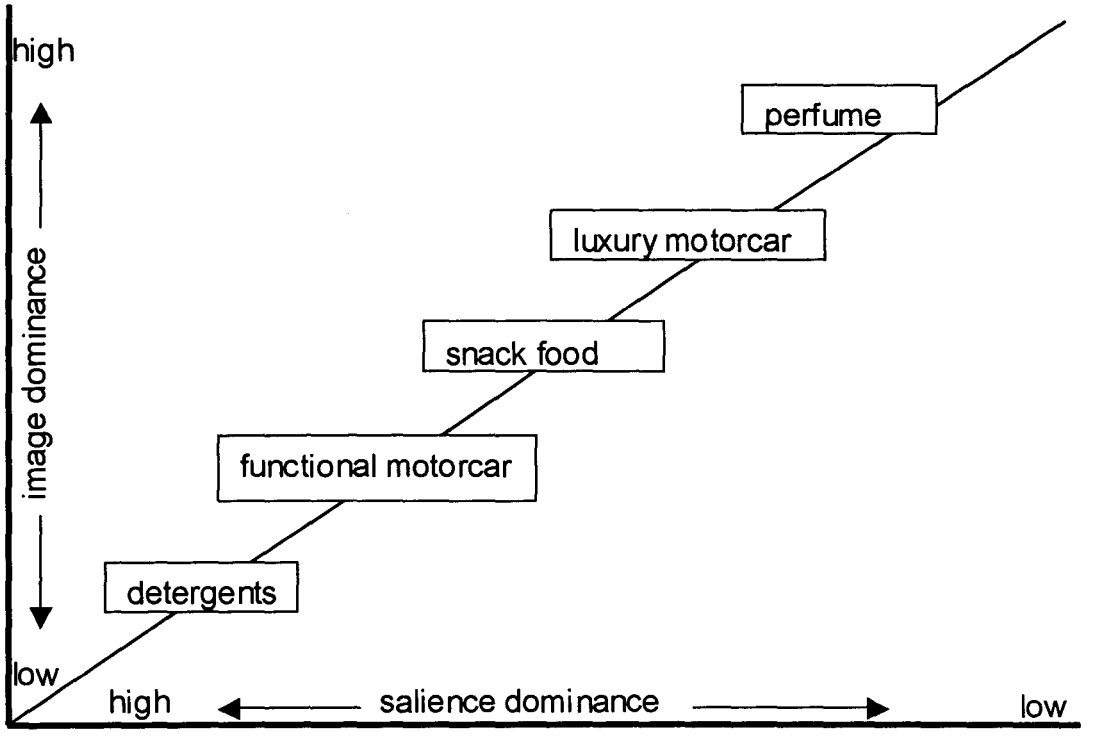
b Research that has demonstrated the long term damage that is done to brands by constant sales promotion at the expense of brand building advertising (Mela 1996; Ambler 1997)

2.15 Setting the Balance

Viewed as a continuum anchored by salience at the one extreme and image at the other, brands would be positioned along it according to some measure that reflects their characteristics: are they bought because of their presence or are they bought due to consumer preference.
The illustration below is a hypothetical construct of how some product categories would lie along the continuum. Those low in image qualities would lie below the line at the salience end; those high in image would lie above the line towards the image end of the continuum. Others would fall elsewhere along the line with either high or low image/salience characteristics. Within categories there will be brands that are vertically positioned. Some will be higher than the average in image or salience, some lower.

The detergent brand leader, for example, will have high brand awareness and associations that act as a guarantee of performance. It will however be in a category that is positioned at the salience end of the spectrum and heavily dependent on in-store exposure and promotion. Conversely, perfumes are sold primarily on the images of their corporate and product brand names. They require constant image reinforcement but contain a level of salience due to the heavy competition in the category and the propensity of consumers to try new fragrances and make occasional changes. They will be positioned at the image end of the continuum and its top end brands will be almost exclusively dependent on image and consumer demand.

Figure 3. : An Hypothesised Salience/Image Continuum



This approach is consistent with consumer behaviour theory. Engel, Blackwell and Miniard (1995) discuss consumer choice and the existence of a consideration or evoked set of brand alternatives from which consumers will make their brand choice. They state:

> *"Gaining entry into the consideration set is a top priority. Failure to so do means that a competitor's offering will be purchased." (p. 216)*

Consumers construct consideration sets either by recalling from memory a brand and its associations or by recognition at the point of sale: the brand is familiar and triggers recall of associations. The brand characteristics are embedded in long term memory by previous experience, word of mouth or advertising and are either recalled when the consumer is presented with a problem for which the product category offers the solution, or the brand is recognised as the consumer scans the shelves.

Whether a brand is recalled or recognised and the extent of elaboration that takes place around the choice decision, depends on whether there are significant differences between the brands on offer or if they are equivalent in their offerings. It also depends on the extent to which consumers consider the purchase to hold some degree of risk. The greater the perception that the intended purchase has financial, performance, temporal or ego risk, the more the consumer will search for additional information from memory or external sources to justify the choice. The opposite holds for purchases for which there is little perceived risk or which have become routine choices (Kotler 1997).

Ensuring that the brand is firmly established in the consideration set of the largest possible segment of existing and potential consumers is the task of marketing and specifically the promotional component of the mix. As Jain (1993) comments at the start of a section of his text on promotion strategies:

> *"The amount that a company may spend on its total promotional effort, which consists of advertising, personal selling, and sales promotion, is not easy to determine." (p. 505)*

He goes on to state:

> *"... decisions about promotional blending must necessarily be made subjectively." (p. 505)*

2.16 Guidance from Finance Theory

Confronted with the task of building and protecting their brands, marketers are faced with a range of choices which as Jain (1993) has pointed out are hard to make and are often subjective. The stakes are high and there is risk involved in taking the wrong decision. Similar to finance

theory the solution lies in spreading the risk. The marketing mix for each brand must comprise some image building advertising and salience creating sales promotion. But, as Mela et al (1996) have proven, getting the balance wrong is damaging to the long term health of the brand.

Peckham (1978) showed that brands that achieve an ideal mix in what he called the six wheels of marketing, were more successful than those that do not. Brands that under spend on their promotional support lose market share; brands that are given optimal levels achieve market gains. This type of response is recorded as well by Gale and Buzzell (1987) and Reichheld and Sasser (1990) who demonstrated the link between customer perceptions of quality, brand loyalty and profit. Brands that have focused too much attention on consumer and trade discounts have allowed their loyal users to become more sensitive to price (Mela et al 1996). They have destroyed the image qualities built up through advertising and usage. Ehrenberg would argue that brands that invest in brand image building lose the promotional key to market penetration. Marketers need guidance on how to achieve the correct balance and reduce the risks implicit in domination of their strategy by either salience or image.

Markowitz (1952) showed how investors can reduce the risk associated with the return on their investments by spreading the risk. Marketers need to balance the use of promotions to protect the return generated by their brands. They must manage their brand equity (Kotler et al 1996)

Sharpe, Lintner and Treynor (1964) developed a method to assist investors in making similar decisions. The Capital Asset Pricing Model (CAPM) is a tool that relates the return on a given security to the returns generated by the market portfolio (see Chapter Six, 6.5 for the CAPM equation). The beta (β) which is used in CAPM to estimate the cost of equity, is a measure of the sensitivity of the security to movements in the market and also highlights the extent to which the security has unique

characteristics that make it move independently of the market. It is calculated by regressing the equity's return (dependent variable) against the return of the market portfolio (independent variable). CAPM also results in a calculation of the weighted average cost of capital for each share that is included in the portfolio, taking account of its balance between debt and equity, adjusted for risk.

Marketing needs are less complex than those that prompted the development of CAPM. What is needed in marketing is a device that will assist marketing management in a) determining what mix of promotions the brand requires, and b) selling this promotional portfolio and its cost implications to management.

Conceptually there is a similarity between a security that trades in a defined market and a brand that sells in a product category. Each are influenced by the overall movement of the market, and they influence the category. Some will have their own idiosyncratic characteristics that make them move independently of the market.

The element of the CAPM methodology most applicable to the problems confronting marketers is the beta coefficient (β). Equities achieving high beta's are highly sensitive to market movements. When the market goes up, they rise at a faster rate. When the market declines their downward movement is quicker. Presumably this is a function of investors sensing the chance of higher returns by investing in a high risk equity and who dispose of the share when losses are signalled by a downturn.

Equities with low betas are the solid unexciting stock that achieves a constant and reliable but unexciting return, relatively unaffected by market swings.

Brands should be similar. Some brands are bought when disposable income is high and lose their glitter when money is tight. Others will sell

because they are thought to be essential and will survive regardless. The latter, and detergents are an obvious example, need a promotional balance that favours salience. They must be kept in sight and available at the point of sale. The same would apply to a functional, inexpensive but reliable motorcar and public transport. Conversely, brands such as luxury bath soaps, exterior house paints, luxury cars will exceed the market in good times, and fall below when belts are tightened. They would have high betas and would require image support to draw attention to the reason for use.

Our hypothesis is therefore:

> *Brands with high betas require an image dominated promotional mix. Brands with low betas require a salience dominated promotional mix.*

2.17 Concluding Discussion

Marketing is in need of a sharp focus if it is not to become progressively irrelevant. Over the past four decades scholars have concentrated their efforts on creating a marketing concept, and fleshing out the framework they developed with a number of distinct streams of theory. These range from the concept itself; an adoption and adaptation of social psychology to understand consumer behaviour; modifying the rules of scientific research and statistical analysis to measure markets, consumption patterns, media usage, product acceptance and the effectiveness of communications through marketing and media research; to more specific areas such as services; brand management; business to business; global; and strategy.

And yet, with all this knowledge and background marketing does not rank with the other business functions such as operations, finance, manufacturing and even human resources, as a board appointment (Hudson and Sayers 1999). This is not just a South African phenomenon

but is prevalent as well, at least, in the United Kingdom (Ambler and Riley 2000; Ambler, Barwise and Higson 2001).

Ambler has been actively researching this matter over the past few years, but his solution appears to be the adoption by companies of a range of metrics which will be judged by the board to evaluate the success or otherwise of marketing. Metrics suggested in his recent study with Barwise and Higson (2001) include market share, marketing investment, relative end-user satisfaction, relative price, customer perceived quality, customer loyalty and retention, sales to new customers, share of turnover represented by products launched in the previous three years, and availability/distribution. But these are the same measures that substantially have been available for decades and which the board has eschewed.

The call for companies to become market orientated and to introduce inter functional coordination began over ten years ago. Leading companies such as Coca Cola recognised this and reduced their investment in tangible assets to concentrate on building and maintaining the brand. For them marketing is not a function it is what the company does.

That marketing is in trouble is apparent from a number of the trends reported in this chapter. Brand loyalty is being questioned and measures show that even high loyals change brands at a startling rate. The marketing function, largely through the use of the brand management system, which failed to adapt to the growing power of the distribution channel and the call for market share, sales and margins by management, has itself damaged the asset that belongs to the shareholders by extensive price-cutting and promotional activity at the expense of brand building advertising. The advent of the category manager was a direct result of major marketing companies giving way to the power of the retailer and placing their brands on continual promotion at the expense of brand loyalty.

Marketing the firm's brands to the customers, who generate the firm's revenues, should be a core focus for most companies. Brand equity is a way of expressing the source (the consumer) of this equity, and the outcome (financial) which is the value of this equity to the company and its shareholders.

Ambler and his co-researchers are wrong to suggest a range of metrics. The measures they propose are substantially those that have been suggested by leading marketing authors for over five decades (see for example Kotler and Armstrong 1997; Perreault and McCarthy 1996) They reject the idea of a single measure such as brand value because it is subjective and captures only one aspect of what, in their view, brand equity means. Bearing in mind that Barwise (who publishes with Ambler) was the author of the report (Barwise et al 1989) in which the notion of treating brands (both acquired and internally generated) as assets was rejected or highly qualified, it is unsurprising that he now rejects the use of brand valuation as a board level metric.

Given a robust and reliable methodology to achieve brand equity measurement, which would combine the sources of brand equity with the brand's financial performance in a way acceptable to the accountants, marketing would have a direct and vital link to shareholder wealth. The current fragility of marketing as a function needs such a measurement of its effectiveness to give it relevance and to provide it with a way of communicating its efforts in a language commensurate with that used by investors.

Endnotes

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[i] This is common marketing wisdom, but support for the various statements will be found, *inter alia,* in Perreault and McCarthy, 1996, and Peppers and Rogers 1993.

[ii] These expectations include emotional attachment as Fournier and Yao (1997), and Aaker (1997) have shown. But this tends to be related to brands reflecting self image as opposed to a powerful emotional bond.

[iii] See the discussion on Double Jeopardy on pages 26 of this chapter

[iv] Mela et al (1996) cite the Wall Street Journal in 1992 and 1996 for this information. They do not quote edition dates.

Chapter Three - Perspectives On Brand Value

3.1 Introduction

It was neither the marketing nor the accounting function that first highlighted the issue of brands as intangible assets. It was the financial community. The problem was concerned more with the preservation of shareholder funds and balance sheet manipulation than simply recognising the intrinsic value of brands. However, the impact of the mergers and acquisition of the 1980s described in Chapter One had wider ramifications than just the financial reporting, taxation and shareholder wealth that inspired the so called brand debate. Specifically there were three major outcomes:

a The accounting profession was motivated to develop standards that dealt with intangible assets and goodwill.

b The marketing profession responded to the debate by introducing the concept of brand equity and inspiring a fast and rich stream of research that created an instant body of literature on the topic.

c Possibly coincidentally, the corporate finance field conducted research and published papers on links between goodwill and share prices; the gap between the net asset value of listed firms and their market price; and the role of brands in driving profits in excess of the cost of capital.

Some of these concepts could be found in previous literature, but they were given greater relevance and importance by the sudden emergence of brands as financial instruments.

After a decade of vigorous debate there are still divisions between the way intangibles are viewed by accountants, economists, corporate finance and

marketers. The source and cause of these differences are investigated in this chapter.

3.2 The Accountants

3.2.1 Early development

The basis on which the modern accountant works was first written down about six hundred years ago. Even then it was not new. Double entry bookkeeping, in which there must be a debit for every credit, and vice verse, and which, algebraically, requires the sum of the balances to be zero, was extensively described and explained by Italian mathematician Luca Paccioli in 1494 (see Yamey 1992 and Bernstein 1996). Of passing interest is that the concept was originally proposed by employees at the London branch of an Italian firm in a book published in London in 1305 (Bernstein 1996).

Double entry bookkeeping does not itself explain changes to the asset basis of companies, nor does it dictate how such assets should be measured. It is the mechanism that checks accounts for accuracy. If the two columns do not balance, there is an error of recording or omission somewhere in the entries. Of course should the columns balance that is not to say there are no omissions or errors.

Accounting records are the basis of the financial statements that accountants produce and double entry bookkeeping refers to the manner in which these records are recorded in the various books of account. They are the source of data for the trial balance. It is not the only system of recording financial transactions and determining if the entity has ended the period in a debit or credit situation, but it is the most universally applied and has survived six centuries of capitalistic development (Yamey 1996)

The need for such records arose from the division of business into those that provide the capital for commercial ventures and those which manage the enterprise. These two groups, less so then than now, can be different people. The investor requires assurances that his investment is being profitably applied. The manager is required to attest to this fact. Financial statements are the instruments of communication for this purpose.

During the years of the industrial revolution up to the third decade of the last century, because the provider of funds was primarily concerned with the company's solvency, accountants produced balance sheets to attest to the solvency of the company. Investors had little use for income statements but needed to be assured that the assets in which they had invested exceeded the company's liabilities and that their capital was being effectively employed.

This is the origin of the concept of accountants performing a role of stewardship. Owners of a business employed managers to maximise their investment. The managers were in effect in a stewardship position regarding the owners' funds. They were required annually to illustrate the way in which they had used the capital employed in the business. While it was the manager's job to maintain adequate records, they were required by the owners to employ accountants to attest to the accuracy of these records. Thus while accountants are employed and paid by the manager, they are in effect, working on behalf of the owner or investor (Lee 1974; Whittington 1987; Dye 1998).

During this early period accountants were employed by the company to produce balance sheets at the conclusion of each accounting period. Owner managers, bankers, lenders and creditors, the main providers of finance and the Receiver of Revenue, obtained their assurance of the solvency of the company from these documents (Lee 1974).

This situation changed as capital markets started to develop in response to a rapidly increasing source of finance that was beyond the capacity of traditional financiers to provide (See Brockington 1995 for a full discussion on stewardship and its limitations).

3.2.1.1 From balance sheet to income statement

As capital markets developed as the primary source of company financing, to the extent that separation occurred between those who own the company and those who manage it, the nature of the financial reporting called for, changed.

Whereas the purpose of accounts, historically, was to show the proprietors of the business how their funds had been utilised and what profits were derived from them, the contemporary view shifted somewhat to include the need to provide meaningful information to permit the investing public to appraise the company's performance (Myddelton 1995). Thus the emphasis changed from the balance sheet to the income statement.

In the modern economy, financial statements which include both income statement and balance sheet, are used for, among other applications: to make management accountable for its efforts on behalf of the owners of capital invested (the stewardship function); to compute and minimize taxation liability; allow potential investors to assess the potential risk attached to investing in the company; to provide potential lenders or suppliers with information so they may test the creditworthiness of the enterprise; and for government to use, for example, to evaluate the worthiness of projects for support from the fiscus. In addition, shareholders use the information to see if the dividend they anticipate is fully covered by the available income (drawn mainly from Lee 1974; and Myddelton 1995).

The extent to which accounts are useful in performing most of these functions has been the subject of intense debate. The problem arises from the historic cost basis of the accounts. Once published, normally some weeks or months after the year-end to which they refer, the relevance of financial statements to all decisions outside the role of reporting on managements' deployment of the funds under its command, is questionable. Particularly, in the modern environment, in which information is so freely and quickly made available through communication channels such as the Internet and e-mail, there are many alternative sources for the above users to tap in order to acquire the information they need (Myddelton 1995). Investors and fund managers underline this in the extent to which they are prepared to rate favoured shares at premiums over book value. On the New York Stock Exchange the ratio of tangible to intangible assets as recorded by companies in the Dow Jones Industrial Index 1997 year was close to 400% (See Figure 5) and on the Johannesburg Stock Exchange the premium of price paid to net asset value paid by acquiring companies in merger and acquisition activity during the year ended December 1998, was 323% (Ernst and Young 1999:41)

3.2.1.2 Historical versus current cost accounting

The use of double entry books of accounts as the basis for the development of modern financial statements has given rise to the pragmatic concept of historical cost accounting. All entries in the financial statements that are produced at the end of each accounting period are drawn from the recorded transactions performed during the period. Accountants favour the continued use of this approach for two main reasons:

a. The entries are verifiable because they are the record of what took place within the entity during the period. By following the trail of records a second accountant could attest to their

accuracy. The historical cost basis is therefore deemed to be objective.

b. Assets are recorded at their original cost and are not re-valued over time even if their value has increased. The historical cost basis is therefore deemed to be conservative. (based on Whittington 1987)

In the interest of minimising inflated estimates of the value of assets and of reducing the ability of managers with questionable motives to manipulate them, the historic cost approach is preferred by many. However in an economic environment in which prices tend to increase and in which many assets, especially intangibles, are long lived, there is an argument for an alternative approach.

Current cost accounting was initially promoted in the United Kingdom as a viable alternative to the historic costs approach in the 1960s (Edwards and Bell 1961). The principle on which it is based is concerned with what constitutes profit. Profit, as this theory suggests, is the surplus that remains at the end of an accounting period after the assets purchased at the beginning of the period have been liquidated and fully replaced. The difference between this and the historic cost principle is that the assets, in the latter case, would appear in the accounts at their original cost, while in the current cost approach they are shown at their replacement value. The point of difference is in the application of the surplus. In the historic cost approach the profits have to be used to replenish stocks before they can be distributed as dividends. In the current cost approach the profits are available for distribution because the replacement has already occurred (Brockington 1996).

Even though this approach was the subject of debate stimulated by the publication by the British Accounting Standards Committee (ASC) in 1976 of Exposure Draft (ED) 18, it was never adopted. Its withdrawal was

caused by the majority vote of the Chartered Accountants of England and Wales. Its members voted in favour of a motion that current cost accounting should be an option rather than be mandatory. Due to their inherent conservativism the preference of the accountants was inevitably for the more traditional historic cost approach and the ASC eventually withdrew the proposal.

Had the standard been adopted it would have provided a vehicle to accommodate intangible assets, including those which were internally generated. The proposal contained three ways in which the value of an intangible asset could be established:

a Replacement cost. This is the amount the company would have to spend to recreate the asset.

b Net Realisable Value (NRV). What could be obtained for the asset if it were to be sold on the open market.

c Economic value. The discounted net present value of future expected returns that the asset would generate.

The benefits that would have been gained had this current cost approach been adopted include the presentation of more realistic accounts that more accurately reflect the true worth of the business.

3.2.1.3 The Goodwill problem

While accountants are not unhappy with the two approaches, historic and current cost, (preferring the superior objectiveness and conservatism of the former) they have considerable problems with the matter of goodwill. In accounting terms, goodwill occurs when a firm is acquired and the price paid exceeds the fair value of its net identifiable assets. This includes such intangibles that can be separately and objectively valued. How

this difference is handled in the balance sheet has troubled the accounting profession since the start of the nineteenth century (McCarthy and Schneider 1995).

The trouble centres around whether or not goodwill is an asset. When a company agrees to pay a premium over net assets for a company it wishes to buy, it is paying for the future economic benefits that the acquired goodwill will generate (Everingham and Watson 1999). This is a reasonable conclusion because intangible benefits such as the favourable location of the firm, the existence of a strong sales organisation, and an established customer list, all built up over many years of trading, are the factors that make the purchase worthwhile. To these three could be added special know how, custom written computer programs and systems, established web sites, patents, trademarks, research and development and brands.

The discomfort that accountants feel with these intangibles is largely derived from the fact that their existence is based in consumer psychology. They exist primarily in the minds of customers and the trade. Their value cannot be established like a piece of machinery or a building. There will be no recorded cost in building them or which may no longer be available. In most instances there is no active market in the item to establish what value is currently placed on something equivalent.

The value stems from the economic benefits that these intangibles will generate in the future such as competitive advantage and consumer preference. Their existence is real enough, but the degree to which they do, or will in the future, generate economic benefits resides in the perceptions and memory of buyers and associates.

Goodwill arises, normally, when a company combines with another and the price paid is in excess of what the balance sheet shows to be the fair net asset value. Such a purchase is clearly the acquisition of an asset

because the firm has bought a resource, resulting from past events, that it now owns and which will generate future economic benefits (Everingham and Watson 1999).

Everingham and Watson (1999) make the point that to deny that the goodwill portion of the purchase price is an asset would create an inconsistency in the treatment followed by the holding company in terms of the accounting statement AC 131. Until January 2000 when AC 131 came into effect, it was possible to write off acquired goodwill against shareholder funds. But this practice is no longer permitted which leaves the treatment of acquired goodwill as an asset the only option.

The ancient commitment of accountants to the principle of historic cost and their pre-occupation with things that have physical substance, makes it difficult for the profession to show interest in such items. But it is hard to deny the financial benefits that flow from developing customer loyalty through relationship programmes. And it is difficult to write off the willingness of customers who are satisfied with excellent product performance or good service, who are willing to pay a premium price for the brand.

The requirements for recognition of an intangible asset result in the anomalous situation that a homegrown brand is not an asset while, when it changes ownership as result of a business combination, it meets the requirements and is recognised as an asset.

(Adding to the paradox is the range of measurement bases identified in AC 000: historic cost, current cost, realisable settlement or fair value, and present value (Faul et al 1999). Ownership change establishes the historic cost of the brand asset, but the other three could be used to establish a value in the absence of such a change of ownership.)

a. The asset must be identifiable and non-monetary;

b. It must be demonstrated that future economic benefits will flow from the asset to the enterprise;

c. A reliable measure must be applied to the asset;

d. The asset must be identifiable as an independent item that could be sold on its own without involving other aspects of the organisation. (Summarised from A.C 129 paras: .08 – 18; .20 and .21)

Since it is improbable that these conditions could all be met to the satisfaction of auditors, few intangible assets, including brands, are likely to find their way into the financial statements of companies; a frustration felt by owners of companies who would like their balance sheets to be a closer reflection of the true value of their enterprises. Most brands, of course, are developed or acquired to provide companies with improved income potential not, in most cases, as a bargaining chip for when the company is for sale. Nevertheless, companies are sold and brands do play a role in the negotiations (vis. Nestle/ Perrier; Philip Morris/Kraft). Also when brands are included in the balance sheet as intangible assets, the value of the stock is enhanced as Grand Metropolitan PLC (now Diageo) has proved (see for example Munson and Mainz 1990; Moorehouse 1990).

In this section of Chapter Three the nature of intangible assets will be examined as will the contribution of brand equity to that accounting term.

3.2.2 The accounting concept

Clarkson (1977) develops a powerful argument in favour of accounting practices to be changed so that capital invested in intangible activities

such as the cost of establishing trade investments; the training of a work force and outlays on research and development will be capitalised and amortised over a determined number of years. The core of his argument is that whereas these costs are treated as current costs by accountants, schooled in the habit of conservativeness, they are costs expended for the future benefit of the company. The reason for the conservative treatment of these costs is that the accounting concept which guides the way accounts are created, states quite clearly that the purpose of accounts is to:

> *"...fairly present the state of affairs of the company and its business as at the end of the financial years concerned (Cillier et al. 1992: 5)*

Thus while the basic objective of financial statements is to provide information useful for making economic decisions (Brockington 1995:3), the accounting concept is a restraint to achieving this goal. It is, according to the above definition, historic and not forward-looking. Not only is there a conflict between what the users of the financial statements would like (see, for example, Rayner 1992 and Allen 1992) but in its attempts to deal with intangible assets by the introduction, in South Africa's case January 2000, of new accounting standards, the profession continues to go against the recognition of brands as assets.[i]

A.C 000 is the founding accounting standard in the series that underpin Generally Accepted Accounting Practice (GAAP). The South African profession is represented on the board of directors of the London based International Accounting Standards Committee (IASC),[ii] which develops the standards that are progressively being adopted in terms of the country's policy to harmonise with global practice.

A.C.000 sets the framework for the preparation of financial statements and contains definitions and explanations that guide the work of the auditor. In clause .53 - .55 an asset is described. It is:

> *"a resource, controlled by the company, arising from past transactions or events, from which future economic benefits are expected to flow to the company, and has a cost or value that can be measured reliably."*

This definition presents a central conflict between what auditors will accept in financial statements and the recognition of brands. While they accept goodwill as an asset (A.C 131 clause .42) they propose that homegrown brands will rarely meet their criteria (A.C. 129 clause .52) and that acquired brands will be recognised only if they can be reliably separated from acquired goodwill (A.C 129 clause .12).

The cause of the conflict can be readily understood and has to do with the framework that underpins modern auditing methods and approaches and the perceived unreliability and subjectivity of existing brand valuation methods (See Tollington 1995).

3.2.3 The Accounting concept and brands

Tollington paraphrases the British Accounting Standards' Board (ASB) definition of an asset as follows:

> *"The assets shown in balance sheets are: 'a storehouse full of future economic benefits' as yet unrealised." (p. 58)*

Traditionally these assets have primarily been tangible in nature for which accepted methods of valuation, amortisation and depreciation are used. Over time the locked up value is released through the

profit and loss account until the asset's value has been fully absorbed.

This is the historic cost approach that is the basis of accounting practice. If brands are to be treated in the same manner as tangible assets, their value must be established either by the cost of their acquisition, or through the aggregation of historic costs expended on them. This value must then, over time, be realised through the profit and loss statement.

The new accounting standard, A.C. 129, takes a step forward in that it allows for acquired intangible items to be recognised as assets and brought into the balance sheet. They must then be amortised over a maximum period of twenty years and depreciated according to a consistent method to be noted in the accounts. [iii] The period of twenty years is rebuttable in recognition that some intangibles may have lives longer then twenty years. In these cases the asset is subject to an annual impairment review (A.C.128) to establish if the recoverable value of the asset value has fallen below the amount being carried in the balance sheet (see A.C 129 definitions, clause .08). [iv]

The key is initial recognition of the asset and value ascribed. Once it has been recognised as an asset and its value calculated by its cost or by other methods cited in the standard as being acceptable for this purpose (A.C 129 clause .31), options are available as to its future treatment.

Discrete treatments are described in the standard for intangible assets that are separately acquired or are acquired as a part of a business combination. If the purchase consideration is in the form of cash or some form of monetary asset, the former is straight forward as the cost of the acquisition is the cost that is ascribed to

the asset (A.C 129 clause .24). In the latter case the situation is somewhat ambivalent. The standard states that the cost of the intangible is based on the fair value of the asset at the time of its acquisition (A.C 129 clause .28). However it then states that:

> *"judgement is required to determine whether the cost (i.e.fair value) ... can be measured with sufficient reliability for the purpose of separate recognition" (A.C 129 clause .29).*

It recommends that reference be made to active markets in the asset to establish the appropriate price. If, however, no active market exists for the asset:

> *"... its cost reflects the amount the enterprise would have paid, at the date of acquisition, for the asset, in an arms length transaction between knowledgeable and willing parties, based on the best information available" (A.C 129 clause .30).*

This view is consistent (in the South African context) with the judgement given in Novick v Comair Holdings Limited 1972. At 140D-E the court stated:

> *"[A]ccountancy is not an exact science. It is a system of recording the transactions of business enterprises, and of presenting accounts and financial statements relating to those transactions, and to the affairs of the enterprises, in accordance with certain conventions which are professionally recognised, and reasonably well known in the world of commerce." (in Cillier et al 1993:6)*

The standard then goes on to acknowledge that certain enterprises have developed techniques to estimate fair values. It further permits

the use of these techniques for initial measurement of an asset acquired in a business combination, if the objective is to:

> *"estimate the fair value as defined in this statement and if they reflect current transactions and practices in the industry to which the asset belongs" (A.C 129 clause .31).* [v]

Given the judge's view in the Novick v Comair Holding's case that accountancy is not an exact science and the recognition standard setters themselves claim that judgement has to be used in establishing the value of an acquired intangible asset, it is contradictory to then forbid the use of the techniques cited in clause .31 of A.C 129 for establishing the value of separately acquired assets or those that are internally generated.

And yet the standard is firm on this point:

> *"Internally generated brands, newspaper mastheads, publishing titles, customer lists and items similar in substance, should not be recognised as intangible assets" (A.C 129 clause .52).*

The explanation is that expenditure on homegrown intangible assets cannot be separated from the costs of building the business as a whole. If the standard setters were prepared to allow the techniques described above to be used for establishing the cost of an intangible asset acquired in a business combination the same technique should be allowable to establish the cost to be paid for an asset that is to be separately bought, or which has been internally generated.

The most popular brand valuation methodologies and the one described in Chapter Six of this thesis, specifically deal with

separating the stream of profits attributable to the brand as opposed to the business as a whole. Further, in the light of the definition of an asset (see page twelve above), it is difficult to understand why brands do not conform:

a Brands are a resource.

b If it has legal title to the trademark, the company controls them, unless they are franchised or licensed, in which case the franchisor or licensor controls them.

c They arise either from internal generation and the investment in them of marketing and other development funds (past events); or they are acquired (past transaction).

d Most brands are expected to generate future economic benefits for the company.

e If acquired the cost has been established by the transaction. If internally generated the value needs to be calculated and this can be conducted by reference to present value, current cost of replacement or realisable value (see Chapter Six). [vi]

In order to gain some insight into the origins of this confusion, one must re-visit the debate that brought the matter of goodwill and intangible assets to the fore.

3.2.4 The brand debate

Rutteman (1990), arguing in favour of brand accounting identified five probable accounting requirements that would ensure that brands are unlikely to appear on the balance sheet:

a the asset must be discretely identified,

b its characteristics must be clearly distinguished from those of goodwill,

c the cost can be measured independently both of goodwill and of the earnings of the business or a significant business sector,

d if identified and meeting a and b, the asset will then have to be amortised over a period not exceeding twenty years – the same requirement are set down for goodwill, of which brands are considered to be a part,

e that in the context of historic cost accounts, the practice of valuing intangible assets according to current cost, will not be allowed.

Rutteman (1990) felt that the tendency would be to treat both intangible assets and goodwill in the same way and that both would be capitalised and amortised over a laid down period. He quotes from the Canadian Accounting Standards in Evolution in which the author, Ross Skinner, states:

> *" ... so called identifiable intangibles are often little more than goodwill to which a different name has been attached." (p. 67)*

In terms of A.C 129 and 131, this has become the reality. A.C 129 deals with intangibles. A.C 131 deals with acquired goodwill and refers to A.C 129 for many of its requirements. But this is anomalous.

A.C.131 is primarily concerned with Business Combinations, but covers the question of acquired goodwill. Goodwill is:

> *"... the excess of the value of a business as a whole over the fair value of its accountable net identifiable assets, including identifiable intangibles such as patents, licences and trademarks." (Everingham and Watson 1999:228)*

Thus, goodwill is an arithmetic difference between the net tangible assets and any excess established by a price placed on the company by, for example, a purchaser or stock market capitalisation. And yet, the standard states that goodwill "(should be) recognised as an asset (clause .42). "

That in itself is anomalous because it is difficult to see how it would be possible to estimate what future economic benefits will flow from goodwill (Tollington 1998) because it is generally understood that the intangibles that will generate this future income are subsumed within goodwill, for example brands. It is they that must be valued and described as assets, not goodwill itself.

This distinction is important because recognition of the components of goodwill reduces the amount of goodwill by deducting those portions that are identifiable as assets. Goodwill becomes the residue after intangibles have been identified and separately valued. Prior to the adoption of A.C. 129 and 131, it was the accounting convention to write off acquired goodwill to shareholders' funds (Holgate 1990). This often had the effect of reducing these reserves quite drastically. By stripping brands (and other intangibles) out of the "difference" and treating them as assets on the balance sheet, the goodwill component was greatly reduced, preserving shareholder funds, and the balance sheet reflected some of the company's most valuable assets (see for example Moorehouse 1990).

3.2.5 The effect of the new standards

In terms of the new standards this convention may no longer be applied. Intangibles must be valued and amortised through the profit and loss statement. Therefore it is only possible to amortise an asset whose future cash flows are known or can be estimated with some degree of accuracy.

The standards themselves provide guidance in this respect. In clause .31 of A.C 129 it acknowledges that:

> *"certain enterprises that are regularly involved in the purchase and sale of unique intangible assets have developed techniques for estimating their fair values indirectly."*

These techniques may, the standard continues, be utilised for establishing an initial measurement of an intangible asset if the measurement if for the purpose of establishing the fair value of the asset. According to the standard the techniques include those that apply multiples that reflect current market transactions to certain indicators that drive the profitability of the asset. Or methods that estimate future, net cash flows from the asset may be used.

Among the techniques are those described in Chapter Six and are universally utilised in valuing brands that are both acquired and internally generated. (See the detailed descriptions of the Interbrand method in its original form and as it has been re-stated, in Chapter Six; Haigh 1996 and Trevillion and Perrier 1999).

3.2.6 An accounting anomaly

Goodwill has been examined by the accounting profession since the early part of the century. The search has been to determine its nature and how it should be valued. It has pursued this goal without resolution (Holgate 1990) The unprecedented merger and acquisition activity in America and Europe in the 1980s brought this quest into sharper focus because answers were needed to two key questions:

a Why were companies paying large premiums over net asset value for the firms they were buying? (see Chapter One, and Farquhar et al 1991:3)

b What accounting approach would allow equity depletion caused by current accounting rules and conventions to be repaired or pre-empted?

Led by British companies that included Rank Hovis McDougall and Grand Metropolitan PLC (now known as Diageo) a solution was to capitalise the value of brands and place them on the balance sheet. By treating them as assets as opposed to acquired goodwill, the need to apply the goodwill component of the purchase price was ameliorated. [vii]

The response by the accounting profession to the treatment of brands as assets was to issue an instruction to cease the practice. This was given form by the publication by the Accounting Standards Committee (ASC) in Britain in February 1990 of ED 47 titled Accounting for Goodwill (Power 1990). The effect of this, according to Power (1990), was to discontinue the option of eliminating purchased goodwill against shareholder' funds. In South Africa this practice continued until the adoption of A.C.129 in January 2000.

A.C 129 is emphatic that internally generated brands (and other intangibles) will not conform to the criteria and therefore should not be recognised as assets. This view is in line with the findings of the commission established in 1989 by the The Chartered Accountants of England and Wales and carried out by the London Business School (LBS) (Barwise et. al. 1989a).

It is useful to review the main findings of this report because the accounting standard on Intangible Assets that was subsequently approved and issued by the IASC as IAS 38 in September 1998 and which has been adopted in South Africa as A.C 129, is substantially in line with the proposals contained in the report. Thus, it took the IASC ten years to reach the conclusion that Barwise et.al. al. had reached in just a few months. Viz.

> *"The last few months have seen mounting controversy among UK accountants over what has become known as the brand debate (1989:5)."*

During this nine-year period the IASC issued a number of discussion papers called Exposure Drafts (i.e. E50, November 1995 arising from a draft Statement of Principles issued in January 1994 and E60 in September 1997. In addition the British Accounting Standards Board (ASB) issued its own discussion paper on Goodwill and Intangible Assets in December 1993).

At the outset the LBS team identified four issues that were relevant to any decision on brand accounting. These are:

a That any asset capable of being separately recognised as such and should not be part of a larger business entity;

b That the value ascribed to such an asset should be verifiable according to accounting principles of, for example, materiality;

c That the information in financial accounts should be useful to the reader; and,

d That the value placed on the asset is a realisable value as opposed to the current use of the economic value of the brand being valued.

The conclusions regarding these points were as follows:

a While brands that survive the introductory phase (during which most new brands fail) are likely to create value for the company that owns them, the report writers believe that major problems exist in ascribing discrete values to them. They state:

> *" In most cases the value of the brand is impossible to separate from the rest of the business, and is more than the value of legally separate property rights in the brand name or trademark under almost any premise of value." (p. 6)*

b If the valuation is to be used for accounting purposes as opposed to management use, the report concludes that it is:

> *"impossible to separate (the value of the brand) from that of the rest of the business". (section 5)*

The basis of this conclusion is the "inherently subjective" nature of the judgments that contribute to brand valuations. This, according to the report writer, creates a:

"fundamental conflict between economic validity and accounting objectivity." (section 5)

c The report makes the assumption that brand valuation is needed in the balance sheet in order to correct perceived capital market inefficiencies. This is the view that arose from premiums paid for brand owning companies that indicated that the share was undervalued. The LBS team spoke to a sample of analysts and bankers and concluded that:

" ... unless brand valuations actually disclosed real new information, they would be of no interest, except as a (highly ambiguous) signal of management insecurity or aggressive intent." (p. 7)

d The valuation methods being used at the time were based (and still are) on going concern, current use and economic value. For accounting purposes these valuations would need to reflect the break-up value of the brand, or the values that third parties might place on the brand. Therefore the report states:

"Hence, while these brand values are justified as being 'current cost' valuations, they cannot truly be regarded as such if brand valuers are unable to measure replacement cost or realisable values." (section 5)

The so-called Barwise report confirmed the feelings of the British accountancy profession that brand valuation was contradictory to the accounting framework. Brands would not meet the definition of an asset, could not reliably be measured, and it would not be possible to

separate the future economic benefits from those flowing from other parts of the business. The IASC produced its standard IAS 38 that embodied most of these considerations. Also, notwithstanding the evidence produced by economists demonstrating the contrary (Clarkson 1977; Reekie 1981a), A.C 129 states that expenditure on an intangible should be recognised as an expense when incurred with two exceptions: if it forms part of the cost of an asset that meets the standard's criteria, and if it forms part of the cost of acquiring a business combination where the item on which it was expended failed the intangible asset test. Then it is credited to goodwill.

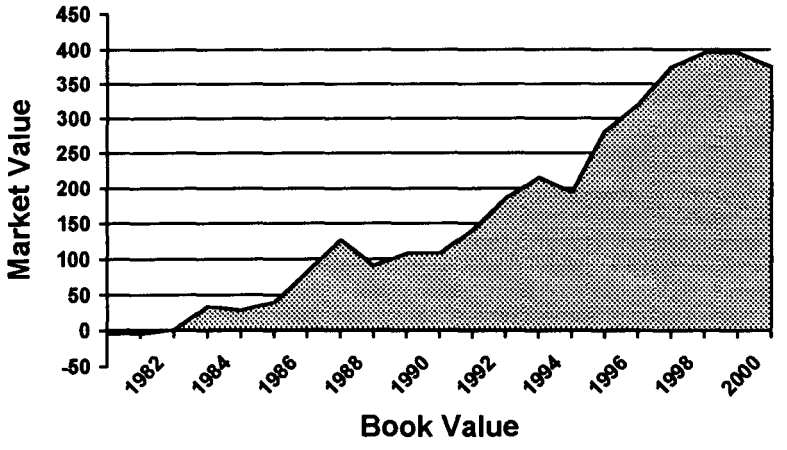
Specifically the standard states that expenditure on items such as start up costs, new product expenses, expenditure on training activities, advertising and promotion and on re-locating the organisation, should all be treated as expenses when incurred (A.C 129 clauses .57- .63). The result is that in most instances brands will not be appearing on balance sheets until a further change in standards takes place.

3.2.7 The relevance of financial statements

Sveiby (1997) has analysed the Dow Jones Industrial Index for the years 1920 to 1997. He expresses market value as a percent of tangible assets (or book value). His chart shows that the ratio of market prices to book value have exceeded the peak last reached immediately prior to the Great Depression of 1929. Then, the sharp increase in total value was caused by a huge wealth disparity and a speculation led share chase. On this occasion the rising premium being placed on companies, since the second half of the 1980s, is due to the growing importance of knowledge based companies and the recognition of the value of brands (Sveiby 1998; Ernst and Young 1999; Trevillion and Perrier 1999).

This is well illustrated by the ratio of market capitalisation to net tangible asset value of well-known companies.

Figure 4. Market to Book ratio of companies on the New York Stock Exchange



Source: adapted from www.sveiby.com.au

At the 1997 level when the ratio of market to book stood at 380%, the chart indicates that the tangible value is substantially less than one third of the market capitalisation. Specifically, in the cases of Coca-Cola and Microsoft it is 7% and 9% respectively.

Trevillion and Perrier (1999:3) quote from a survey conducted in the United Kingdom by Interbrand and Citibank in which they estimate that:

> *" ... in January 1998 balance sheets failed to account for almost 71% of the (weighted average) market value of the FTSE 100 companies." (p.3)*

In other words the balance sheet value of companies as measured by accountants is of diminishing significance to investors.

This has been recognised by the profession, which has commenced research into alternative forms of financial reporting (Trevillion and

Perrier 1999). According to Trevilion and Perrier the International Federation of Accountants (IFAC) is examining new frameworks for managing and reporting the intellectual capital of a company and also how the accounting profession can play a role in developing that framework.[viii] The immediate objective is to devise a method by which the intellectual capital of companies can be reported alongside the conventional report that covers the tangible aspect of the business.

Early steps towards this framework come from the Society of Management Accountants of Canada (SMAC), which, according to Trevillion and Perrier, has defined intellectual assets as:

> *"knowledge based items, which the company owns, which will produce a future stream of benefits for the company." (p. 20)*

This of course is essentially the same definition as is contained in A.C 000 and which has been used to describe goodwill and some intangibles as assets. Thus the accountants recognise the paradox they have created in their attempt to deal with intangibles with the two new standards. If, as Trevillion and Perrier (1999) suggest, the new statement will in time sit alongside the balance sheet as a complementary item in order to provide users of the statement with a different view of the underlying assets of the company, there will be confusion as to which estimate of the intangibles is correct, that which follows GAAP and is placed in the balance sheet and income statement, or that which appears in the statement of intellectual capital.

In solving this conundrum the accountants will doubtless draw on economic theory, which has long been in conflict with their own in key aspects of understanding the true worth of a firm.

3.3 The Economists

> *"For all but Marxists and accountants, value derives not from cost expended but from the interaction of supply and demand ..."*
> *(Sturgess 1990:101)*

Brands are a function of the free market economy. They signal choice to the consumer and create competitive advantage for the producer (Begg et al 1984; Mankiw 1997). In this section various economic concepts are examined. They are the core differences that characterise the beliefs of accountants and economists and which are basic to understanding how brands create value for their owners.

3.3.1 Accountants' historic cost and economists view of the future

The difference in approach to profit between accountants and economists is well documented (Begg et al 1984; Reekie and Crook 1995; Mankiw 1997). Whereas accountants record the costs that are the actual receipts and payments and deduct the sum of the costs from revenue to obtain the firm's profit, the economist takes a different view.

To the economist profit is judged in terms of its opportunity cost or what is lost by not applying the resource to its best alternative use. Moreover, economists, unlike their accounting counterparts, judge the utility of capital invested in terms of whether it earns profits over and above the cost of the capital employed. Accountants differentiate between income and capital largely because the tax authorities have treated these items differently.

At the time of writing the difference is exemplified by the debate in progress about the introduction of a Capital Gains Tax (CGT) in South Africa. Previously capital gains were exempt from tax because they were not considered to be income. CGT reverses this because it treats these gains as income. As Gordhan (2001) was reported as saying:

"One fifth of the legal cases between SARS and taxpayers in the special tax courts are about the definition of revenue and capital gains" (p.1)

The pending (at the time of writing) introduction of the tax raises the interesting question of internally generated brands not being recognised as assets (A.C.129).

Suppose a company buys a building for R1 million and sells it a year later for R2 million. It will be assessed as having made a capital gain of R1 million. In terms of the CGT this gain will be considered to be income in the hands of the company and it will be taxed accordingly. The fact that the company sold an asset will be reflected in the financial statements as will the income the sale generated and on which income tax was raised.

If the same company buys a brand or a portfolio of brands in a business combination, in terms of A.C 129, the brands are assets and will be valued and placed on the balance sheet. If all or some are subsequently sold at a profit the excess will be treated as a capital gain and the proceeds will be subject to tax.

If the building suggested above is self-constructed by the company the relevant accounting standard states that:

"... a reliable measurement of cost can be made from transactions with external parties ... " (Everingham and Watson 1999:178)

These costs once recognised and identified are then capitalised and the newly created asset is placed on the balance sheet. Should this self-constructed asset subsequently be sold at more than the capitalised cost, the gain will presumably be taxed under CGT.

A self generated brand (or intangible asset) is not recognised as an asset in the same way and it will be instructive to see how any gain from the sale of such a brand will be treated by both the accounting profession and the tax authorities.

The new accounting standards are specific about treating the cost of maintaining intangible assets as an expense when incurred. The exceptions are if the expense forms part of the acquisition cost of an intangible asset that meets the recognition criteria, or, if the item does not meet the criteria the expenditure is credited to either positive or negative goodwill. Some items of expenditure are always treated as expenses and these include start up activities; training activities; advertising, promotion and costs incurred in re-locating the company.

If it can be demonstrated that expenditure on an intangible asset, subsequent to its acquisition, will enable the asset to generate incremental economic benefits, and that these benefits can be identified and measured reliably, the subsequent expenditure may be added to the value of the asset. However, the statement makes it clear that all expenditure on brands, publishing titles, customer lists and items similar in substance, whatever the circumstances of their ownership, may not be capitalised. (A..C. 129 clauses .57 to .63).

This (recognising internally generated intangible assets as assets) has never been a problem for economists who have long argued that costs associated with the creation or maintenance of intangible assets should be identified and capitalised.

Expenditure on, for example, advertising, research and development and and training has more than simply a maintenance role. It is widely known that this expenditure has both short and long term effects (Reekie 1988; Mela 1996; Vakratsas and Ambler 1996). Specifically advertising contributes to long-term brand equity by leaving residual messages in the

memories of consumers thus promoting brand loyalty (Begg et al 1984). However, accountants do not recognise this and insist that the annual advertising expense be accounted for in the income statement in the year incurred. While this is advantageous from the taxation point of view - in that profit is increased by deferring the tax liability (Reekie 1988) - it ignores the contribution the expenditure is contributing to the brand asset and hence the net asset value of the firm. Reekie believes that the accounting formula for return on capital employed is mis-stated by accountants because the profit figure includes a full charge for advertising in the expenditure statement, while the capital figure is under-stated because advertising is viewed as an expense and not a contributor to shareholder wealth.

Reekie (1981) provides guidance as to how this can be overcome, given the availability of data and given the economist's view of profit, expenditure and assets.

He proposes that advertising expenditure should be treated in the balance sheets of companies so that it reflects the rate of return on the asset it is building, or maintaining, more accurately than is the case with common accounting conventions. The basic assumption is that advertising:

> *"does and can create an asset."* [ix] *(p. 148)*

Advertising expenditure, rather than being fully charged to the profit and loss account, should be depreciated over a reasonable period and treated as an annual expense. The remaining stock of undepreciated advertising is accumulated as net advertising capital and added to the net worth of the firm. His approach is expressed in the following equation:

$$\pi^* = \{[\pi + (a - d)]/(k + g)\} \times (100/1)\%$$

where π^* is the estimated real rate of return; π is the original reported profit; a is the current advertising expenditure; d is the depreciation of the current and past advertising expenditure; k is the original net worth of the firm; and g is the balance of undepreciated advertising outlays.

A period of three years is used for depreciation in this equation. Since most companies support their brands with promotional expenditure on a continuous basis, this calculation would be conducted annually so that the undepreciated amount would be aggregated each year.

In the equation (in which the accumulated advertising stock is introduced to the balance sheet as a capital asset), rates of return on capital employed differ from those resulting from the more conventional approach. Whether the return is increased or decreased by the addition of accumulated advertising stock to the net worth of the entity, and the replacement of the annual advertising expense in the income and expenditure accounts with the depreciation cost, depends on the size of the depreciation cost which could be more or less than the annual cost of advertising.

Thus in a firm in which brands are viewed as assets and are included on the balance sheet as such, expenditure on advertising would be viewed not as a cost to be deducted from brand profit, but as a contributor to the asset value.

The problem with Reekie's reasoning is his assumption that advertising would depreciate in a straight-line manner. Also his equation takes no account of creative content. These are important considerations as Broadbent illustrates (1981) in the Kellogg's Rice Krispies (*sic*) case study. In this example successive years of consistent advertising was matched with declining market share. In 1978 a new advertising campaign supported with a share of advertising expenditure less by 0,6% than the lowest percentage in the previous seven years was matched by the first

increase in market share for over seven years. In the absence of any other variables that could have caused this increase, the reversal is ascribed to the creative content of the advertising. This example serves to illustrate that advertising expenditure does not always add to the positive brand asset stock, and when it does the creative content will have a differential influence. However Reekie's contention that advertising is not simply an expense but has an impact on the value of assets is important and calls for further attention (see also Hirschey and Weygandt 1985). [x]

Similarly Reekie (1981a) proposes that money spent on research and development (R & D) should also be treated in this way. He points out that, like plant and machinery, it too is incurred today to generate future benefits. Rather than account for it in the year the expense is incurred, it should be depreciated over a pre-determined period and the undepreciated portion added to the net worth of the firm as a capital acquisition. This has partially been recognised in the new accounting standards in which expenditure on research is expensed through the income statement but expenditure on development may be capitalised under certain conditions (A.C.129:12)

The purpose of Reekie's research was to illustrate that advertising does not set up barriers to entry which would create the opportunity for dominant firms to earn monopoly profits. But in so doing he exemplifies the divergence between the way in which economists view income and capital, resulting from their forward looking orientation, and the accountants whose approach is rooted in historic cost. CGT may bring this difference sharply to the fore.

3.3.2 Brand assets and capital markets

The replacement cost of a company is what is recorded in, or what can be deduced from, balance sheets, but this is not the value placed on

companies, in the normal course of events, by financial markets. As the chart above (Figure 4) shows, the current cycle demonstrates an increasing divergence between book and market values.

Tobin (1978) suggested a ratio to demonstrate this difference.[xi] Tobin named his conception '*q* '. '*q* ', is the ratio of replacement value to market value, which according to Tobin is:

> *"a summary measure of one important impact of financial markets on purchases of goods and services, in particular durable goods." (p. 422)*

A '*q*' value of 1.0 is interpreted to mean that the market value of the firm is equal to the replacement value and these firms therefore have no intangible value. A firm in this position is thought to lack the level of earnings that would allow it to reduce costs through scale economies, and to have established a competitive advantage in the market.

Kerin and Sethuraman (1998) conclude from a review of the literature that firms with low or negative '*q* ' values tend to be those with undifferentiated commodity products such as base metals. Conversely companies with differentiated products such as consumer packaged goods companies, have '*q* ' values in excess of 1.0.

Simon and Sullivan (1992:32) suggest that because many of the industries with the highest estimated '*q* 's contain firms that market differentiated products, a positive correlation between '*q*' and brand equity is indicated.

They provide evidence in the form of '*q* ' calculations for a number of well-known brand owning companies. For instance Coca-Cola has a '*q* ' value of 4.2; Pepsico, 2.3; Kellogg, 3,2 and General Foods was 2.1. They found that the average for primary product producers was 0.9 on average, and paper products had '*q* ' s of about 0.1.

What the chart above (Figure 4) shows is that the tendency on major stock markets is for investors to be placing increasingly higher 'q' values on listed companies and for the prices being paid in merger and acquisitions to also reflect higher '*q*' values.

This confirms the findings of McCarthy and Schneider (1995); Jennings et al (1996) and Kerin and Sethuraman (1998) who have studied the relationships between equity values and intangibles. All found the relationship to be positive.

Table 2. Evidence from the Literature

Study	Relevant Conclusion	Page
McCarthy and Schneider (1995)	"The results suggest that the market includes goodwill when valuing a company ..."	80
Jennings et al (1996)	"After controlling for other components of accounting net assets, there is a strong positive association between equity values and purchased goodwill ... " and, "These results are consistent with investors viewing recorded amounts for purchased goodwill as representing valuable economic resources."	514
Kerin and Sethuraman (1998)	"The empirical evidence confirms the presence of a positive brand value – shareholder value relationship, which is consistent with the extant literature in financial economics, financial	270

	accounting and marketing."	

Since the value placed on companies stems from the discounted future flow of profits that analysts and investors anticipate, positive 'q' values imply future economic benefits flowing from intangible resources owned by companies. These include brand values that Marsh et al (1990:88) argue will be reflected in share prices because of the efficiency of capital markets. Others have argued that analysts soon learn of new advertising campaigns, or market share increases, and share prices adjust accordingly.

At the time, the view of Marsh et al (*1990*) was that there was insufficient empirical evidence relating specifically to brands to confirm this theory, but in the light of the well-researched area of market efficiency (see Fama 1970 for a review of the Efficient Markets Hypothesis (EMH) and Market Efficiency."), this was most likely to be the case. However, since then research has been conducted, notably by Simon and Sullivan (1992) and Kerin and Sethuraman (1998), which support the contention that markets respond to new information and particularly information relating to brands.

Whether markets correctly value branded goods companies or whether they undervalue them because they are unaware of the full value of brands the one fact that is clear is that balance sheets are playing an increasingly smaller role in supplying the answer.

While investors and other users of financial statements will continue to use conventional balance sheets in order to know the replacement value of the company and its accounting profit, they will increasingly want additional information to provide them with information about the value of the firm, not explained by the financial statements.

3.3.3 Brand values and market efficiency

Tobin (1978) explicitly refers to intangible assets as a function of '*q*'. Marris (in Reekie 1995) suggests a similar ratio to explain how firms would wish to maintain a valuation ratio (q) that is high enough to avoid the prospect of being taken over. If the ratio of book to market value falls, another firm would feel compelled to take over the firm in the belief that its management would be able to restore a more equitable ratio. Thus they are implying that, for the same capital employed, they would apply better knowledge, research and development and marketing skills than the existing management. In other words they would add intangible assets to the existing tangible asset base.

This is all in the realm of the future which is where the value of most companies is located. The firm wishing to take over the firm with the lower valuation ratio would be gambling on its ability to reverse the future fortunes of its target. The valuation ratio would be positively changed if the acquiring firm could convince the investing community that their actions and skills would increase the present value of future earnings above their present level; and that this increase would represent a surplus over the company's cost of capital (Kirzner Number 133).

It has been suggested that an analysis of financial statements and particularly what the British Sandilands Committee named "operating gains" which are the excess of current sales over current expenses, would guide readers in evaluating long-run future earnings. Myddelton (1995) is clear on what he thinks of this opinion (which he characterises as "amazing") suggesting that it is unrealistic. He states:

> *"Most studies conclude that annual earnings appear to follow a random walk: hence that past earnings growth does not help predict future growth." (p.46)*

Fundamental analysts (those who seek out the latest information about companies) are said to ensure that all available information that might affect the value of the share of a company, is already impounded in the price. The analogy is the sale by auction of a painting. While the owner of the painting might be ignorant of the value of the asset, if the bidders are in possession of all available information about the painting and they are experts in the subject, the owner can be assured of a fair price from the bidding process. Short of a subsequent discovery that the painting was in fact the work of a master, the price will be efficient in that it will represent an informed market view.

The new accounting standards that deal with intangible assets and goodwill were based to quite a considerable extent on the report of the Barwise committee (Barwise et al 1989a). In this, a considerable amount of effort is expended on analysing capital markets and the possibility that they do not fully account for the value of brands. They base their discussion on two premises:

a Proponents of brand values on balance sheets suggest that this would assist stock markets in correcting mis-pricing of shares that fail to incorporate the value of brands. The argument is that brand values would provide hitherto unknown information that would ensure that proper values were accorded to branded goods owning companies.

b Brands on the balance sheet would improve the gearing of companies making them more attractive propositions for investment and loans because the book worth of the company is increased, thus improving their investment risk.

Their research is rigorous and thorough to reach the conclusion that:

> *"The empirical evidence on capital market efficiency, including maket based accounting research on the stock market's response to new accounting information, makes these views hard to sustain." (Barwise et al 1989a:97)*

The Barwise et al (1989a) research results in the suggestion that it would be improper for acquired brands to be accounted for on balance sheets. The reason for this recommendation, eventually taken up in the IASC standard IAS 38, was not entirely based on this view, but the argument did influence the proposals to the extent that it was felt that nothing would be served by changing accounting principles to accommodate a resource that was unlikely to conform to accounting requirements for recognition as an asset.

It seems that Barwise et al (1989a)(see also Marsh et al 1990) are suggesting that there would be no benefit to users of financial statements if brand values were included and nothing is lost by their exclusion. The reasoning is that analysts already know any information that might be impounded in such a valuation, and that new information would quickly be absorbed in a price change as and when it was issued.

This argument is probably correct. The EMH states that markets will react to new information. But as Brealey and Myers (1988) explain, by definition new information cannot be predicted ahead of time, otherwise it would not be new information. Therefore price changes or undervalued stock cannot be judged until such information is released. This might be new management, new distribution, a new advertising campaign, new brand extensions, new pricing. While events that make substantial changes to the fortunes of a brand are not regular occurrences, they do happen (see Simon and Sullivan 1992; *The Economist* 1994).

However the argument for brands on the balance sheet is not dependent on this aspect but goes to the heart of the difference between the

accountant's and economist's views of value. The accountant relies on historic cost and therefore cannot recognise an asset that has no measurable cost and whose value is solely its ability as a resource to generate future economic benefits. The economist recognises this value and would acknowledge that a brand is an asset (see Whittington 1992 for support for this difference)

It has been demonstrated that in many cases the balance sheet value of a company represents only a fraction of the price placed on the company by the investing community. The reason is that accountants are measuring only the tangible assets. They will measure an intangible only on their terms and then as a resource to be depreciated over a finite time period (see endnote [iii]).

Based on the Barwise argument that nothing would be gained from including intangibles such as brands which are hard to value, these assets are excluded. Barwise et al (1989a) conclude that this does not matter because the present value of the cash flows that these unrecognised assets generate is accounted for in the market price of the share. If this is the case, one might as well not include any asset values in the financial statements because the market has its own way of finding out what they are.

Kirzner (Number 133) takes a different view. In the world of disequilibrium [xii] that he describes in which enterprise is a locomotive for change and in which entrepreneurial discovery thrives ...

> *"(A)n entrepreneurial act of discovery consists in realising the existence of market value that has hitherto been overlooked. Scope for entrepreneurial discovery exists in a world of disequilibrium. This is quite different from the equilibrium world of mainstream economics where market outcomes are foreordained." (introduction – item 5)*

He clearly is not suggesting some new world order that needs to be adopted. This is a different explanation of why markets react. They respond to new acts of entrepreneurship: the new information that causes market prices to change. The difference is that whereas the Barwise school believes that markets do not require further financial statement information because it is speedily acquainted with anything that might influence the price, the Chaos Theory School would have it that markets suffer from what Kirzner describes as:

> *"imperfections of competition" or "crucial elements in the market process of discovery and correction of earlier entrepreneurial errors." (Introduction – item 8)*

From this one would deduce that users of financial statements need as much information as possible in order to be able to respond quickly to new acts of entrepreneurship, or fresh events that might influence the future earnings power of a resource. Kirzner illuminates the concept graphically by stating:

> *"Entrepreneurial profit ... is not sliced from a pre-existing pie ... it is a portion which has been created in the very act of grasping it." (Introduction – item 10)*

The flippant suggestion earlier that an extension to the conclusions drawn by Barwise (1989a)and his associates is that there is no need in financial statements for tangible assets to be recorded, received some support in Whittington's (1992) summary of the EMH. He cites Beaver (1973) whose influential examination of the EMH led him to conclude that:

> *"if the semi-strong EMH holds, there is no need for accounting standards to prescribe the form of presentation, rather than the substance , of accounting information. An efficient market will make*

full use of information wherever it appears in the accounts, whether by way of a note or as an integral part of the main financial statement." (p. 7)

Barwise et al (1989a)argues against brand values in financial statements because the valuations are subjective and non-uniform and because they will provide no new information that the market has not already impounded in the share price of the company that owns the brand.

It seems the argument rests on the provision of new information available to analysts when the value is first presented. In the light of the above discussion, it seems that the market demands a constant flow of information to confirm that there has been no change in the company's financial circumstances or that there has been a change (either negative or positive). Information that the company has embarked on a promotional campaign that has boosted sales and market share would be important information (Hirschey and Weygandt 1985). If this has the added effect of boosting the value of the brand and therefore the net asset value of the company this would also be important.

Whittington (1992) states that while the data presented in the financial accounts is useful, most abnormal returns will have been observed before the publication of the accounts. This is no reason for this information to be omitted because the accounts serve as a record of what the auditors have attested to. Thus what may have been information from secondary sources is now confirmed in fact. [xiii]

3.4 The Marketers

As distinct from the previous chapter in which brand equity and its role within the marketing mix were discussed, in this section the gulf between marketing and finance within companies is examined. Marketing's position in companies is exemplified by the survey results in which it was

found that marketers are represented on the boards of South African companies in only 29% of the respondent companies in the sample (Hudson and Sayers 1999). Ambler summed up the attitude of general management towards marketing in an e-mail comment to the author about similar findings from a survey conducted in the United Kingdom. He said:

> *"most financial managers think that most marketing managers are business amateurs."*

This attitude leads to pressure placed on marketing budgets, which are frequently the first to be cut when there is a profit squeeze. It also has led to a brand management focus on short-term sales and profit at the expense of long term strategic plans in order to meet quarterly sales and profit targets. This can have the affect of destroying brand equity which has been incrementally built over many years (Mela et al 1996).

Those marketers who are conscious of developments in the brand valuation field (far from all are), view the recognition by their financial counterparts of brands as intangible assets that belong on the balance sheet, as a major step in reducing the historic lack of confidence in marketing (Barwise et al 1989a; Herremans and Ryans 1995; Tollington 1995).

3.4.1 The finance/marketing interface

Marketers have clashed with finance people for many years. Lord Leverhulme set the scene at the turn of the last century when he said:

> *"Probably half of every advertising appropriation is wasted, but nobody knows which half." (Harris and Seldon 1995:x)*

The heart of the problem is the size of marketing budgets which regularly exceed the capital expenditure allocation (Herremans and Ryans 1995)

compared with the asymmetrical approach to evaluation of each (Barwise et al 1989b). Whereas capital expenditure is assessed using established accounting and finance instruments such as Payback Period (PB); Average Rate of Return (ARR); Net Present Value (NPV) and Internal Rate of Return (IRR) (Chadwell-Hatfield et al 1996), marketers tend to use more open ended assessments such as:

> *"this new product will open up a whole new market segment (Barwise et al 1989b:1)."*

Financial people view non-financial measures (such as those used to evaluate marketing) as qualitative and judgemental whereas financial measures are quantitative, sophisticated tools. (Herremans and Ryans 1995:58).

Herremans and Ryans (1995)conducted research into financial reporting in the USA, Canada, Japan and UK. They found a consistent trend in which marketing commentary was confined to the sections of the report in which the chairman or CEO writes a message to shareholders, employees and stakeholders, and in which the organisation's operations are reviewed. This is the non-financial section in which the past activities and future opportunities are covered; often in glowing terms.

Herremans and Ryans (1995)point out that while the auditors usually read this part of the report to ensure the content is not grossly misleading, it is not subjected to any rigorous test of accuracy or validation. In the other section of the report in which there is management discussion and analysis and the financial statements and notes, marketing is sparsely referred to. By way of example two firms, Sara Lee and Seagrams, in their 1991 reports, mentioned the word "brand" 100 times and 80 times respectively in the first part of the report, but only twice and eight times respectively in the second, financial half of the report. The authors make the point that these two companies are by no means the exception.

Herremans and Ryans (1989a) discovered that while 74% of the companies in the sample talk in the first half of the extent to which the company's products:

> *"carry leading positions in the industry; create growth; and, about the extent of their marketing activities," (p. 55)*

fewer than 30% make similar references in the financial section.

Aaker (reported in Tollington 1995) says that brands should be recognised by business and investors as the company's most valuable assets, but the Herremans analysis shows that this clearly is not the case. Reversing this situation would have a dual effect:

a It would force marketers to consider the brands under their care as financial assets owned by the shareholders and on which a financial return is expected;

b It would allow investors, shareholders and employees to understand better what resources are generating the company's financial performance and how the marketers are managing these resources.

Another benefit of dealing with marketing in a similar way to that in which capital expenditure is treated would be the adoption of longer-term views of expected returns. Since marketing is accounted for as an expense in the income statement, its managers are subject to pressures to limit costs and focus on short-term profit targets. Eccles (reported in Herremans and Ryans1995) points out that this:

> *"focus on financial rather than non-financial measures leads to the board taking a short-term view of the firm's potential." (p. 56).*

Consequently marketing budgets are often cut in order to make up expected shortfalls, and brand managers are encouraged to take a short term view of their brand's performance in order to satisfy the quarterly reporting regime prevalent in many companies.

3.4.2 Linking marketing to shareholder wealth

Keller drew a distinction between two motivations for studying brand equity (Keller 1993). The first is for financial reasons the purpose of which is to estimate the value of a brand for accounting uses, merger and acquisition or for divestiture. He terms this the outcome of brand equity (Keller 1998). The second motivation is to improve marketing productivity. To this he applies the overall term of sources of brand equity.

Rather than these two approaches being separate areas of study, they should be seen as the two sides of the same coin: marketers invest a brand with its consumer-based sources by making the brand available for purchase; and by creating awareness of the brand name and associating this with strong, favourable and unique associations. The resulting brand equity is then measured to provide financial and accounting users with an estimated value.

This is the interface between the marketer and shareholder. But it is one that has been ignored and that only in this past ten years has been studied. Moorehouse (1990) captured the need to combine these two motivations in these words:

> *" ... the brands debate ... is concerned with the motivation of managers and with reporting the performance of those managers to the company's shareholders. What better way to demonstrate this than by showing shareholders how assets as well as the profits of the company have been grown?" (p. 40)*

Kerin and Sethuraman (1998) have demonstrated the relationship between brand value and a firm's market to book ratio. Increases in brand value inevitably result in an increase in the market to book ratio (the opposite is not always the case in that firms experiencing decreases in brand values do not always display reductions in their market to book ratio). Marketing is usually measured by reference to metrics such as market share and sales increases (see discussion in Chapter Two). Rarely is it measured by the metric that is important to shareholders: its contribution to their wealth. And yet many chief executives see brands as being at the heart of the business. In 1970 in its annual report the Quaker Oats Company quoted John Stuart, its late chairman and CEO, as saying:

> *"If this business were to be split up, I would take the brands, trademarks and goodwill and you could have all the bricks and mortar – and I would fare better than you." (in Herremans and Ryans 1995:52)*

Encouragement that marketers are adopting a mindset that will bring them closer to the needs of shareholders is found in Srivasatva et al (1998). [xiv] They identify two areas in which some marketers are adopting financial measures:

a They are viewing customers and channels not just as objects of marketing actions, but as assets that must be cultivated and leveraged. This means that marketers should move beyond the paradigm of traditional marketing analysis based on organisational behaviour to fully understanding the financial implications and consequences of marketing decisions.

b They are shifting from the traditional measures used by management to evaluate their actions such as sales volumes,

market share, customer satisfaction, return on sales, assets and equity to the financially based metric on Net Present Value (NPV).

This move coincides with a move on the part of the financial community to seek out ways of measuring non-financial assets. The two disciplines meet at the point where each is concerned with the effect that operational actions have on cash flows. Srivastava et al (1998) make the point that this will require a substantial mind shift on the part of marketers who will have to set their sights on actions that optimise the assets under their control. They will have to estimate the NPV of developing new products and markets, of reaching new sets of customers and establishing new modes of brand differentiation.

Marketers are not, however, alone in having to learn new skills. Chadwell-Hatfield et al (1996)and her colleagues conclude that managers are more inclined to use accounting measures, such as IRR, PB and ARR rather than the one that stresses cash flows. The latter is the preferred method of evaluating long-term investments and the financial tool is NPV. Chadwell-Hatfield et al state:

> *"In order to be consistent with the maximisation of shareholders' wealth, projects should be evaluated by estimating the future expected free cash flow." (p. 103)*

3.4.3 A common language

In three important articles (Herremans and Ryans 1995; and Barwise et al 1989b and Srivastava et al 1998) the suggestion is made that marketers should adopt the vocabulary of finance to form a common language bond. The divide between the two disciplines is exacerbated by the different ways in which they each evaluate their activities. Herremans and Ryans went so far as to comment on the importance of intangible assets which have been at the focus of marketing and accounting deliberation for over a

decade but which still warrant little more than comment in most company's annual financial statements. They are referring to extensive use of branding and marketing in the promotional narrative, but which fail to feature in the more significant, audited accounting section.

This runs counter to the Shakespearian attitude of "what's in a name?" because the rose is known by different names in each function; in fact, it has become two distinctly different flowers.

If, as Herremans and Ryans (1995) suggest, marketing is to be taken seriously by telling its story more credibly, its actions must be reported in a language which readers of financial reports find credible. Brand equity is one of the intangible assets that are driving the ratio between book and market value. But little interest is shown in this gap because businesses have not yet adopted a way of communicating the value of these intangible resources so that they rank equally with the items that are enumerated in financial statements.

A start will be for marketers to learn the language of finance. This will not be too hard because as Barwise et al (1989b) suggest:

> *"Financial analysis also helps clarify the project's boundaries by addressing issues like the base case, the time horizon, and future strategic options – all of which are as much strategic and market based as they are financial." (p. 90)*

Srivastava et al (1998) make a similar point in the summary to their articles in which they encourage marketers to recognise that they are in control of market-based assets that, in turn, increase shareholder value. To do this they have to understand how their actions affect cash flows and in the words of Srivastava et al:

" ... marketing managers must assimilate and use concepts and vocabulary now second nature to financial and accounting managers." (p. 16)

Hunt and Morgan (1995) do not run counter to these contentions when they appeal to marketers to eschew phrases such as "assume a competitive market"; "abnormal profits"; and "economic rents". They perceive the need for a new theory to replace the established economic belief of perfect competition. They refute this basic tenet of economic theory on the basis that there is no such thing as an industry that has a homogeneous appeal to all consumers. Within any such groupings, shoes for example, there exists a disparity of tastes and demand in which no homogeneity can exist. Each shoe manufacturer makes shoes to appeal to a market segment and develops special competencies that differentiate it from others. This is in response to consumers who differ in their needs which themselves are in a constant state of flux. Markets are heterogeneous and dynamic. Those phrases from conventional economic theory are what tie marketers to the concept of homogeneity and non-differentiation.

Hunt and Morgan (19950 argue that profit maximisation is not sustainable in reality because firms do not a have access to information about their competitors to know that this is the case. They do however attempt to achieve superior financial performance brought about by either a single resource such as a trademark, or by a "resource assortment" that is unique to the firm.

Hunt and Morgan (1995) themselves are sceptical about their new theory instantly replacing extant, deeply entrenched beliefs, they nonetheless see it as a better explanation of how firms compete in the modern economy. But whether firms adopt an approach to strategy that is based on conventional perfect competition or the heretical alternative, they will need

to converse internally and with their shareholders in a single, commonly understood language.

3.4.3.1 Net Present Value (NPV)

The need, for example, to become conversant with the powerful concept of net present value has already been explored. This alone could shift the measurement of marketing from "soft" metrics such as market share, gross margins and attitude shifts, to one that is directly linked to the development of assets.

3.4.3.2 Brand expected life

Expectations are basic to both economic and financial theory (Begg et al 1984; Reekie and Crook 1995; Mankiw 1997; and Brealey and Myers 1988). Expectations of future events influences individual supply and demand and effects purchase behaviour. Expected inflation determines the short-run aggregate-supply curve. In summary, economists believe that rational expectations (as opposed to those that are extrapolated from past records), adjusted for natural under and over predictions, are important determinants of today's behaviour. In finance theory expectation also play an important role. The expectations hypothesis is concerned with term structure but is based on the same human behaviour as that which underpins some economic theory. It appears again in the theory of exchange and forward rates (Brealey and Myers 1988) .

The value of an intangible asset is its expected future cash flow generating power which, because it is intangible, is the result of the expectations of its owner. The Product Life Cycle (see, for example, Reekie and Crook 1995) predicts an introduction, growth, maturity and decline of a new product; expected economic life is similar in concept in that it is the period of time during which a brand is expected to maintain its current run of cash flows through its uninterrupted franchise run to profit decay. The

expected life of a brand differs from PLC in that there is no suggestion that the brand will follow this pattern. It recognises that brands tend to be long-lived and, depending on the strength of the brand, the expected life will be maintained, improved. In some instances it might decline (See Chapter Six for a full explanation).

3.4.3.3 Franchise run

Leibowitz (1997a + b) introduced the concept of the franchise run to describe a period of time over which a product could be expected to earn an uninterrupted flow of superior cash flows. It should be expected that at some point in the future the flow would be interrupted by an event such as a change of fashion, the expiry of a patent or royalty agreement or because a competitor drives down profits charging a price that earns no more than the cost of capital. Hunt and Morgan (1995) have shown that relative competitive advantage can be sustained and that the franchise run interruption need never be more than a future expectation (See Chapter Six). The Boston Consulting Group analysis of brand leaders remaining virtually unchanged for sixty years (Aaker 1996) confirms that strong franchise runs do not run out. But the use of expectation, or expected life, to capture the possibility that decay or decline is a constant danger to the health of brands, should sharpen the resolve of the marketing custodian to keep it continuously at bay, and to strengthen the brand so that it is pushed even further into the future. In the financial sense expectations are the basis for estimating the extension of current economic use. The longer the expected life the greater the value of the capitalised present value of those future cash flows.

3.4.3.4 Betas

Brands are similar to securities in that they are subject to the systematic risk of the market portfolio. This language is foreign to marketing people, but the principle is sound. Individual brands in many markets establish a

place within the market category and are then only able to affect small movements in market share gains. Often this is due to promotional activities which increase sales volume but reduce profitability. Rarely, is it due to a product innovation or improvement that changes the market structure. When this occurs it is often short lived because the innovation will soon be replicated by the competition who will be fast to counter the advantage with a similar innovation or something similar (see Shimp 1997; Mela et al 1996).

Brands are however subject to the movements in markets caused by fads, fashions, seasons, business cycles and unexpected events. Simon and Sullivan (1992) conducted event analysis on how the brand owning companies, Pepsico and Coca Cola were affected by three marketing events that occurred between the years of 1982 and 1985. These were the introduction of Diet Coke in 1982; the official approval of the ingredient, Aspartame for use in soft drinks[xv] in 1983; and the introduction of New Coke in 1985.

Their analysis which was based on their firm level brand equity estimate, and not at the brand level, showed that it was possible to detect changes in brand equity resulting from major events that are measured close to the event occurring. For example, the introduction of Diet Coke increased the brand equity of Coca Cola and decreased the brand equity of Pepsico. While Coca-Cola's brand equity was not adversely affected by the unsuccessful launch of New Coke, Pepsico's brand equity increased. Both companies benefited from increased brand equity which arose from the announcement that they were permitted to use the ingredient Aspatame. The authors make the point that brand equity measured at the brand level would have produced "more refined results."

The beta coefficient measures the sensitivity of a single security's return to movements in the overall market return (Reekie 1995). This is calculated by regressing the return generated by the security over a period

of time with returns for the market portfolio. The beta is the angle of the line fitted through the points: the steeper the line the higher the beta and vice versa.

The tests carried out on brand categories using data from A.C Nielsen are reported elsewhere in this thesis. They indicate that brands can be plotted against their category and that a range of apparently significant betas does emerge. There is strong evidence to the effect that brands with a high beta are image related and are demanded by their users. Brands with low betas are salience related and are subject to exposure in-store and require promotional support. High beta brands need above the line support to maintain their brand image.

3.5 Concluding Discussion

A broad gulf exists between the accounting and marketing functions. They speak different languages and play to different audiences. Accountants have the ear of top management since it is mandatory in South Africa that a legal company has an accounting officer and that it prepares annual financial statements. Marketing is recognised as being important, but insufficiently so to warrant representation on the board (except in the case of 29% of companies – Hudson and Sayers1999).

While marketing generates the revenue column in the financial statements, this stream is called income by the accountants and the money allocated to marketing is treated not as an investment in acquiring this income, but as a cost in the expenditure column of the income statement.

Accountants speak of margins and profit, marketers talk of distribution, market share, share of mind and share of voice. The financial function is under constant pressure to produce profit for the shareholders and when costs must be cut to produce this profit, the marketing budget is famously the first call.

The emergence of brands as assets during the 1980s had differing effects on each function. Marketing devised the term brand equity to describe the link between the source of brand value and the value of the brand; accountants responded to brands on the balance sheet with a prolonged investigation, which resulted in new standards restricting the extent to which brands would be recognised as assets.

Economic theory differs from accounting in a number of important ways. The notion of profit in which opportunity costs are a factor is one. But it is the economists' view on intangibles such as research and development and advertising that will probably have the greatest impact on accounting practice in the future. The idea that money spent on advertising today will be recouped by future brand sales as the lagged effect is reinforced by fresh impressions, runs counter to the accounting theory which states that all assets have finite lives and should be depreciated over a determined period of time. The accounting standards developed by the International Accounting Standards Committee (IASC) and introduced in South Africa from January 2000 went some of the way to acknowledging the long-lived nature of many brands. But, as has been explained, they fail to deal with brands as resources controlled by the enterprise from which future economic benefits will flow, and they fail to meet the needs of capital markets, analysts, and marketing.

The newly formed International Accounting Standards Board (IASB), has included the standard that deals with Business Combinations (in SA A.C 131) in its programme announced by way of a press release on 2 August 2001. This standard includes a section on goodwill and intangible assets and it is one of nine standards that will receive the attention of the technical accounting experts. The standard dealing with intangible assets (in SA A.C.129) is on the list of sixteen standards being examined by bodies and units external to the IASB.

It must be concluded from these actions that the accountants will eventually come to terms with the need to include intangibles on the balance sheet – internally generated and acquired – and that this will cast marketing in a very different light since it is that function that is responsible for building and maintaining the value of that asset.

End notes

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[i] The South African Institute of Chartered Accountants (SAICA) is affiliated to the International Accounting Standards Committee (IASC). It is the stated intention of SAICA to progressively harmonise its standards with those developed and released by IASC. A.C 129 and 131 are two standards developed by the IASC and released in 1998. SAICA participated in their development as a member of the IASC and ultimately adopted them with minor amendments to become effective on 1 January 2000.

[ii] On 1 January 2001, the IASC changed from a voluntary body to a full time unit under the direction of Sir David Tweedie.

[iii] At the time of finalising this thesis (August 2001) it was announced that the American Financial Accounting Standards Board (FASB) has approved two new accounting standards. They are FAS 141, Business Combinations and FAS 142, Goodwill and Other Intangible Assets. The effect of these two standards is to abolish the amortisation of goodwill and to allow acquired goodwill to be retained on the balance sheet subject to annual impairment reviews. These standards came into effect as from 30 June 2001 and 15 December 2001 respectively.

[iv] The IASC has issued standard IAS 36, Impairment of Assets, which sets out how an impairment review should be carried out and the mathematical procedure to be applied. This was adopted by SAICA as from 1 January 2000 under the series number A.C.128.

[v] The standard describes these techniques as including: "those which apply multiples reflecting current market transactions to certain indicators driving the profitability of the asset (such as revenue, market shares, operating profit, etc), and discounting estimated future net cash flows from the asset."

[vi] A.C 129, clause .31 allows companies to use brand valuation methodologies to assist in establishing the value of acquired brands to establish the fair value. If these techniques are acceptable for acquired brands they should also be acceptable for internally generated brands. Both of these techniques have been used for brand valuation since the mid 1980s and were the methods used to establish the values of the brands that created the brand debate in the first place.

[vii] A full discussion on this phenomenon, which became known as the "Brand Debate" is contained in the book, edited by Power (1990) and in the series of MSI working papers that flowed from the brand equity seminars of 1988, 1991 and 1995)

[viii] Towards the end of 2000 SAICA approved the formation of a Joint Technical Committee between SAICA and the Business Economics Department at Wits. This appointment was endorsed by the IASC at its November Commonwealth group meeting in Cape Town. The committee will conduct research and contribute to the identification of intangible assets and valuation methodology.

[ix] Reekie quotes Palda (1964); Telser (1968) and Weiss (1969). But more recent support will be found in Broadbent 1981:86; Aaker (1991); Gale (1992); Mankiw (1997) and Franzen (1999) summarises some recent conclusions on the short and long term effects of advertising.

[x] Hirschey and Weygandt apply econometric modelling to advertising and research and development expenses in an attempt to explain the systematic influence of these two activities on the market value of firms that are known to practice these activities. They conclude that there is a relationship and that these investments should be capitalised and amortised over a prescribed period of time at varying rates of amortisation. They suggest rates of between 10 to 20% for RandD; 10 to 20% for non durable goods and 30 to 60% for durable goods. Further they suggest a one to five year life for advertising and a five to ten year life for RandD, although they propose that further research is needed to confirm these durations.

[xi] Reekie (1995:96) explains Marris' "valuation ratio" which is the total market value of the firm divided by the book value. In this respect it is similar to Tobin's q.

[xii] Disequilibrium arises from Chaos Theory in which initial conditions evolve through a process of self-organisation. (see Parker and Stacey. Chaos, Management and Economics. Hobart Paper 125. The Institute of Economic Affairs. London.

[xiv] Their work is more closely studied in chapter six.

[xv] According to Simon and Sullivan, this ingredient: "did not pose the same health risks of saccharin. Also, it tasted better than saccharin. New soft drinks bearing recognised brand names would presumably be greeted with higher consumer acceptance."

Chapter Four – Consumer Psychology and Brand Values

4.1 Introduction

Brand Knowledge Structure (BKS) is central to the valuation methodology presented in Chapter Six. Keller (1993) introduced the concept as the source of brand equity. In this approach it has been adapted to represent the relative strength or weakness of the brand in consumer memory. While this idea has been criticised as being inappropriate for use in a financial model (Sampson 1998) most consumer behaviourists believe that brand relationships result from a learning process and the storing of brand associations in memory. These are retrieved when the consumer is confronted by or personally triggers a retrieval cue.

In Chapter Two the salience and image schools of thought were discussed and it was concluded that these are not separate ideas but polar anchors for a continuum representing the spectrum of brand relationships. Thus the existence of brand knowledge in consumer memory is a thread that runs through the consumer decision-making and brand selection process.

In this chapter the theoretical basis for brand knowledge structure is first outlined and is followed by a more detailed discussion of the underlying consumer behaviour constructs. These cover the concept of high and low involvement, buyer behaviour models, attitudes, persuasion and memory structure, in particular the associative network memory theory that explains how brands are remembered and thought about. Finally the link between the strength of a brand as measured by BKS and its relationship with the brand's economic expected life is explained.

4.2 Theoretical Background to Brand Equity

Designating brand equity as a "Capital Topic" (Leuthesser 1988) stimulated the stream of research that the Marketing Science Institute (MSI) hoped that it would. In addition to the working papers that appeared under its aegis (the most significant of which are reviewed in Chapter Five) the book by Aaker (1991) and the paper by Keller (1993) set groundbreaking frameworks for the subject.[i] It is an indication of the importance of the topic that most of the original working papers were subsequently accepted by and appeared in refereed journals.

4.2.1 Aaker

In quoting King's definition of a brand at the outset of his book Aaker (1991) sets the tone for the framework that follows. King (1984[ii]) distinguishes between a product and a brand as follows:

> *"A product is something that is made, in a factory; a brand is something that is bought, by a customer. A product can be copied by a competitor; a brand is unique. A product can be quickly outdated; a successful brand is timeless." (Preface to first edition)*

This definition excludes services because it talks only of products made in factories. Nevertheless the sentiment implied is that the core offering, whether a physical product or an intangible service, is replicable and sensitive to the changes of fashion and fad. Successful branding rises above this. It may be represented by a name, a logotype, a design or a slogan, but it elevates the product or service to a new level. As King (1984) points out:

> *"For their (the manufacturer) product they will get the commodity price, giving them a fairly low margin, and then only if they are efficient. For*

their brands they will get the commodity price plus whatever the brand is worth beyond the product. That is, the level of profits will depend on the value added [iii] by the brand." (p. 7)

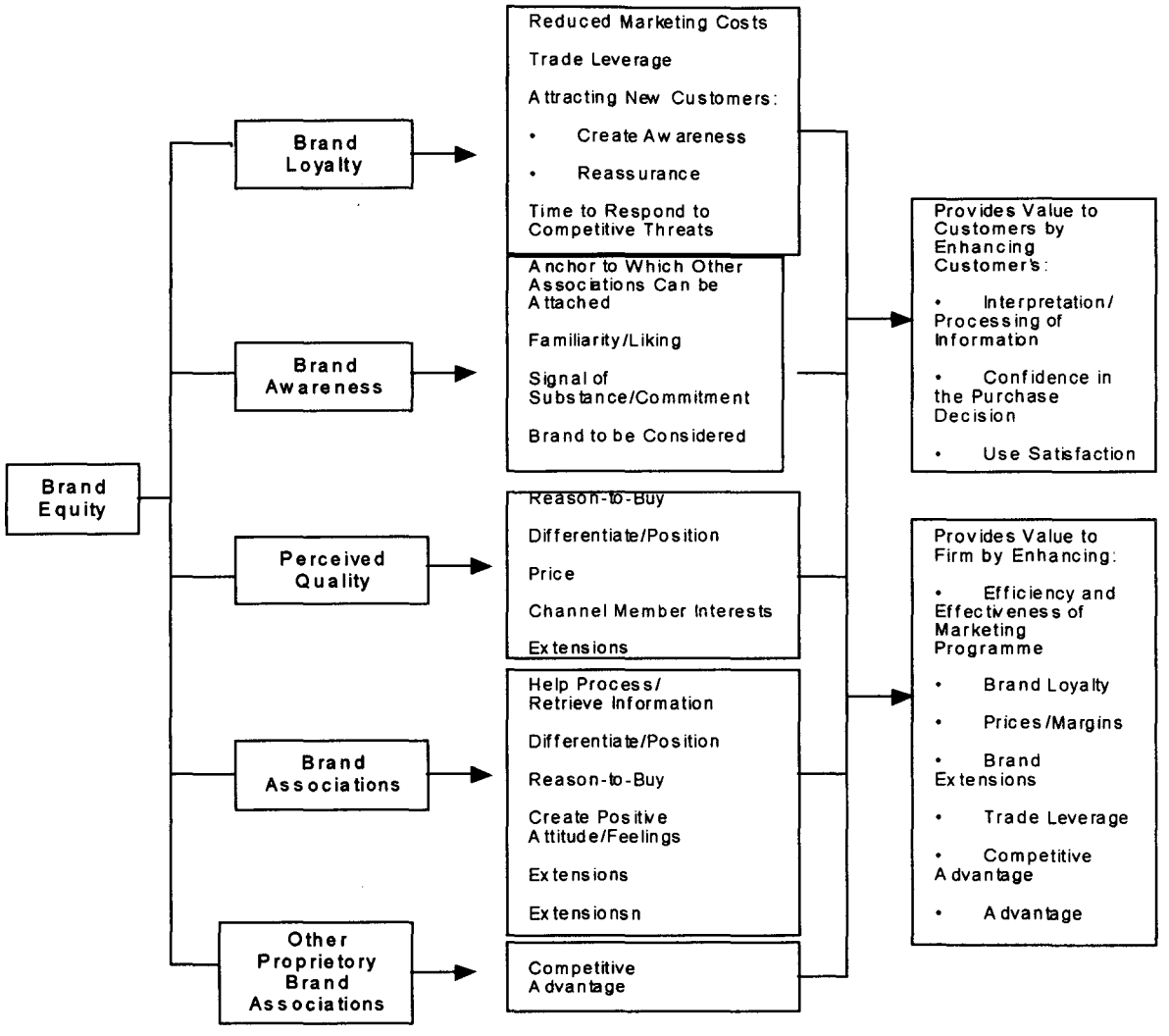
The added value referred to by King is now called Brand Equity which Aaker was the first to model (1991). He postulated that brand equity is the sum of a brand's assets and liabilities that when linked to the name or other brand elements have the ability to add to or subtract from the brand's value. The categories into which these assets and liabilities fall are brand loyalty, awareness of the name, the market perceived quality that the brand delivers, the associations that are attached to the brand in consumer memory and a general group of other proprietary brand assets such as the registered trademark, patents, tied brand, as opposed to company, distribution channels.

Aaker's book was published two years after the first MSI conference (at which he was a participant). It can be inferred that the author drew on discussions at that seminar quite heavily. For example Shocker and Weitz (in Leuthesser 1988) separated the firm and customer perspectives of brand equity. In discussing the consumer aspect, they highlight variables such as associations in the consumer's mind, loyalty which creates a barrier to competitive entry and a sustainable benefit to the firm; and image that, when clearly differentiated nudges the brand to higher levels of brand preference.

Aaker incorporates some of these variables in his model (Figure 5) notably loyalty and brand associations. As an outcome from the model he states that brand equity has benefits to customers, because it aids them in evaluating the product quality; provides a quality assurance anchor which is used as well as use satisfaction. The benefits to the firm are that brand equity: provides marketing efficiencies; is a link for brand loyalty; is used to leverage trade

relationships; and, is a competitive advantage and source for extensions and profit margin enhancement.

Figure 5. Aaker's Model of Brand Equity



Source: Aaker (1991)

4.2.2 Keller

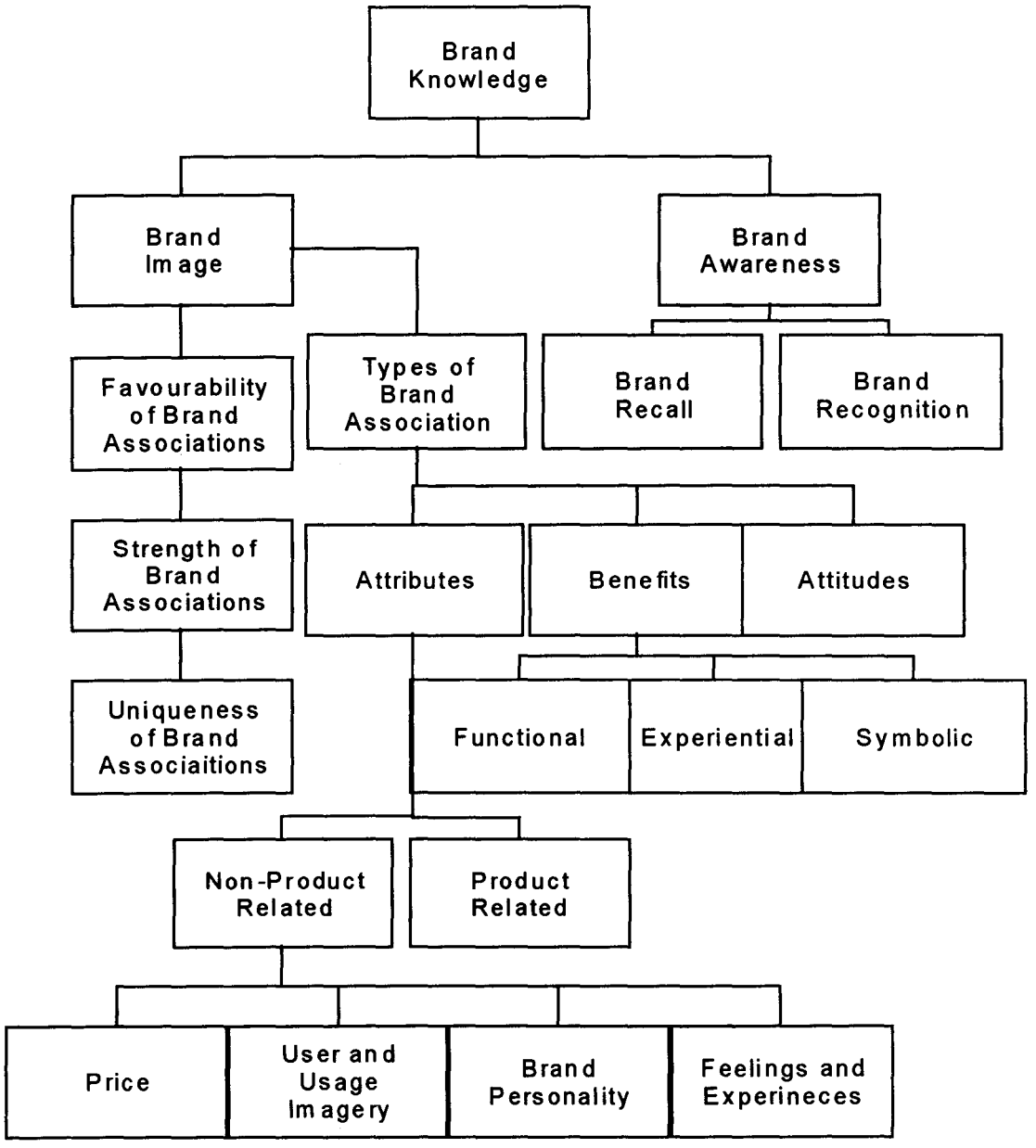
Keller (1993 and 1998) draws heavily on Aaker's conceptualisation, especially the customer and firm levels of brand equity which are the outcomes from his approach. His thesis is that in order for a brand to have value that can be ascertained by some valuation methodology, the brand must first be invested with that value by consumers who are:

> *"familiar with the brand and hold some favourable, strong and unique brand associations in memory." (1993:2)*

Keller derives customer based brand equity from the theory that consumers respond positively or negatively to the differentiated effect of brand knowledge held in consumer memory. Consumers acquire brand knowledge, over time, in a number of ways. Parasuraman, Zeithaml and Berry (1985) found from their research into service quality that the main sources were word of mouth, personal experience and needs, and external communications or, what Blackwell, Miniard and Engel (2001) call, marketer dominated stimuli. The knowledge is stored in memory and retrieved when prompted by a particular need.

In the Keller model (Figure 6) brand knowledge is based on awareness of the brand and image held in memory or, in the language of associative network memory, in interconnected memory nodes.

Figure 6. Keller's Model of Brand Equity



Source: Keller (1998)

4.2.2.1 Awareness

Awareness is a node. Knowledge acquired about the brand is stored in different nodes. When the consumer thinks about the brand category or is faced with a choice under brand selection conditions, the network is activated and the brand knowledge structure is formed by nodes containing semantic or image concepts associating themselves with the awareness node.

Whether a consumer uses brand recognition or brand recall depends on the situational circumstances of the decision and on the level of involvement. Under conditions of recognition the consumer is presented with a brand cue and is able to confirm awareness of the brand name. Recall is when the consumer's cognitive processes are stimulated to retrieve the brand name. In other words given the brand category the consumer will generate the name of the brand as an automatic response. Under high involvement conditions recall is essential in order for a brand to be in the consumer's consideration or evoked set of brands. Under low involvement conditions, it is important for the brand name or its elements to be recognised.

This places awareness at the core of brand knowledge. The network referred to above forms itself around the awareness node: hence the term association. The importance of awareness in brand development was examined by Hoyer and Brown (1990) who concluded that at the routine purchase, low involvement level awareness plays a major role in the decision making process. At the very least it acts as a recognition cue while, at the other end of the brand knowledge spectrum, it can be central to:

> *" ... a highly developed cognitive structure based on detailed information." (p. 141)*

Blackwell, Miniard and Engel (2001) describe awareness of brand names as one of the most fundamental aspects of consumer knowledge., noting that:

> *"Before a product can enter the consideration set, it must gain entrance into the awareness set, which comprises those products known to the consumer." (p. 260)*

Brand image is used by Keller to capture the complexities of association. It comprises types of association and different levels of association.

4.2.2.2 Types of association

When consumers think about brands they do not separate the thoughts into categories. In the consumer behaviour and marketing literature these thoughts have been distinguished by levels of abstraction which Keller places into three major categories of increasing scope. They are: attributes, benefits and attitudes.

Attributes are the features that consumers think characterise a brand. In other words what they think the product or service is and how it will perform. The physical characteristics or content of the product that allows it to perform in the ways claimed for it, are product related attributes. External aspects that are closely associated with the product or service such as price, packaging and imagery related to who uses the product and under what circumstances, are described as non-product-related attributes.

Benefits are what the consumer thinks the product will do for them. The three categories listed in the model are well known in the literature and refer to the functional qualities of the product or how effectively and safely the product will remove or solve the problem. Experiential benefits describe the product or service's ability to satisfy experiential needs such as sensory

pleasure, variety or cognitive stimulation. Symbolic benefits cover areas such as the product or service conferring social approval or personal expression of self-image.

Attitudes are dealt with separately below because of the crucial role they play in connecting the brand knowledge structure to consumer behaviour. In short, attitudes, in this context, are the consumer's overall evaluation of the brand.

4.2.2.3 Levels of association

Three possible levels of association mediate whether or not these associations are used in the consumer's evaluative and decision-making processes: the extent to which they are favourable, strong and unique. Favourable is concerned with consumers evaluating the association in terms of its importance to them and how good or bad the alternative products are perceived to be in delivering the underlying quality. Strength of association is a function of information elaboration. The more people think about information the slower the knowledge will decay over time. The corollary of this is that the stronger the information in memory as a result of the way in which it was stored, the more accessible it is when presented with a retrieval cue.

If an association that is both strongly and favourably held in memory also has qualities that are perceived to be unique to the product, it may provide the consumer with a compelling reason for selecting the brand.

Thus brand knowledge structure depends on the creation of high levels of awareness to which are attached strong, favourable and unique associations.

4.3 Consumer Problem Solving

From the most basic Hierarchy of Effect models such as AIDA (Strong 1925) to the more elaborate and complex models of consumer problem solving (Blackwell, Miniard and Engel 2001), the belief that consumers draw information about brands from both internal and external sources is well documented. It is the information that they accumulate coupled with their personal experience of the brand (Smith and Swinyard 1982), that underpins the concept of consumer loyalty which Pritchard, Havitz and Howard (1999) claim:

> *"remains one of the crucial management issues of our day. (p. 333)*

The extent to which consumers elaborate or think about the knowledge they acquire to make brand-buying decisions is largely dependent on how important the product or purchase is to them. Thus the concept of involvement (Krugman 1965. See also Sinclair 1997) has become a central construct in the study of consumer behaviour generally and brand loyalty in particular.

4.3.1 Involvement

Krugman's initial idea was that users of media (i.e. readers of print media, watchers of movies, listeners to radio and viewers of televisions) utilise the different brain hemispheres in processing media sources. Watching television is a passive activity that requires little logical thought. It therefore is a low involvement medium. On the other hand reading a newspaper calls for cognitive processes in making sense of the written word. Readers of print media are therefore highly involved with the medium.

The concept of involvement has evolved since Krugman's original conception. In its contemporary sense it is defined as:

> *"Involvement is the level of perceived personal importance and /or interest evoked by a stimulus (or stimuli) within a specific situation." (Engel et al 1995:161).*

In the The Handbook of Marketing Scales (Bearden, Netemeyer and Mobley 1993) the authors describe a number of different scales developed specifically for the measurement of involvement. The following analysis (Table 3) of the constructs proposed by ten of these scale designers shows that there is general agreement with the Engel, Blackwell and Minniard (EBM) (Engel et al 1995) definition above.

Table 3. Constructs used to Define involvement for Research purposes

Name of Scale	Author	Central construct
Involvement with a product class	Bloch; Sherrill and Ridgeway (1986)	A long-term interest in a product which is based on the centrality of the product to important values, needs or the self concept – primarily a function of individual differences.
Involvement general to several products	Lastovicka and Gardner (1979)	Comprised of two major components, normative importance refers to how connected or engaged a product class is to an individual's values; commitment refers to the pledging or binding of an individual to his/her brand choice.

A general scale to measure involvement with products	Traylor and Joseph(1984)	Involvement reflects a consumer's sense of self or identity and is activated by external stimuli. It is a consumer's response to a product, message, medium or situation.
Consumer involvement profiles.	Laurent and Kapferer (1985)	Involvement is a multi faceted construct measured along five dimensions: • perceived importance/risk, • subjective probability of making a mispurchase • symbolic or sign value attached to purchase (this differentiates the functional from the psycho-social risk element) • hedonic value – emotional appeal • interest or enduring relationship with the product class. These five can combine to form a single involvement profile.
Personal involvement inventory	Zaichkowsky (1981)	Involvement is a person's perceived relevance of the object based on inherent needs, values and interests.
Enduring Involvement scale	Higie and Feick (1988)	Enduring involvement is related to the person's self-image or the pleasure received from thoughts about or use of

		the product or engaging in the activity.
Foote, Cone and Belding Involvement sub-scale	Ratchford (1987)	Involvement implies personal importance (i.e. relevance) and consequent attention to a product.
New involvement profile	Jain and Srinivasan (1990)	A multi faceted approach that incorporates five dimensions (similar to Laurent and Kapferer): • relevance • pleasure • sign • risk importance • risk probability
Purchasing involvement	Slama and Tashchian (1985)	The self-relevance of purchasing activities to the individual.
Purchase decision involvement	Mital (1989)	The extent of interest that a consumer brings to bear on a purchase decision.

From this analysis it is clear that involvement is concerned with a person's relevance to a product or brand, the importance they place on the product and the level of risk that they perceive to exist in buying it.

In Chapter Two the concepts of salience and image were discussed. It was concluded that they are not opposing theories, but are the anchors of a

continuum with image at the one and salience at the other end (Figure 3). Brands high in salience are those that are characterised by awareness and market penetration. As the term implies the other end of the spectrum is represented by brands that are chosen and used more for their image than presence.

Notwithstanding the views of the Salience School of Marketing (see Chapter Two), the most prevalent view in the literature is that consumers think about brands and make their decisions on which to purchase according to some mental process of consideration. Chaudhuri et al (2001) draw *inter alia* on the works of Jacoby and Chestnut (1978) and Reichheld (1996) to conclude:

> *"Specifically, brand-loyal consumers may be willing to pay more for a brand because they perceive some unique value in the brand that no alternative can provide." (p.81)*

This implies a thinking process and the use of information stored in memory. For each product purchased consumers are confronted with alternatives and have to decide on which best matches their needs. The extent to which consumers think about a single purchase has been categorised as extensive, limited and routine problem solving (Blackwell et al 2001; Howard 1994; Schiffman and Kanuk 1991).

Not all consumers react in the same way when confronted with a purchase for a similar product. This depends on four factors: the type of product under consideration; the characteristics of the communications about the product received by the consumer; the consumer's situational characteristics; and the consumer's personality (Mowen and Minor 2001). Thus buying an inexpensive gift for someone who is important in the consumer's life, even if it is not expensive, can be more involving than making a more expensive purchase of, say, a motor car. The level of involvement is not solely

dependent on, for example, price but on other factors as a well. Mowen and Minor (2001) suggest that involvement has either a short-term application (situational), such as having to call a plumber to fix a burst pipe or longer term involvement (enduring) when the consumer spends a great deal of time thinking about the product such as buying a house, investing in insurance or planning an expensive holiday. These will result in a long-term involvement in the product class. The implications of high and low involvement are that consumers will think far more about a product purchase with which they are highly involved, and very little about a product that has little relevance or salience for them.

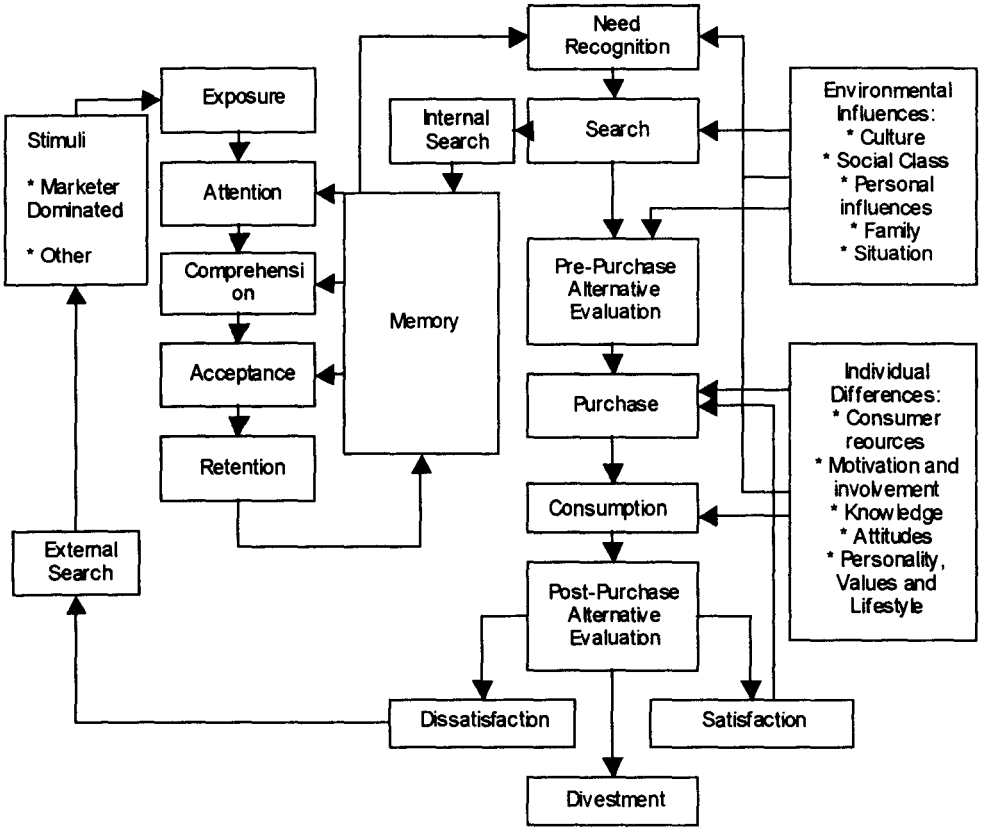
4.3.1.1 Extensive or high involvement problem solving

Howard and Sheth (1969) were among the first of a small number of consumer behaviourists to model the decision making process. Their model has a core sequence of events that consumers pass through when a product decision has to be made. It starts with a gathering of facts or information. Brands are then recognised that conform to what has been learned. From the brands that are recognised those in which the consumer feels some confidence and for which they hold a positive attitude fit into the evoked set (Howard 1994). The intended final target brand is chosen from this set and a purchase is made. Howard and Sheth believe that the same process is at the heart of all purchases with greater search being applied to the selection of an innovative product than one which has become a routine or habitual purchase.

Engel, Kollat and Blackwell, now Blackwell, Miniard and Engel (2001) developed arguably the most respected model of the consumer decision process (Figure 7). First introduced in 1968, it has undergone several changes, but essentially states that consumers pass through a process in making a purchase decision that involves acquiring information from internal

and external sources, evaluating the available alternative choices, making the purchase and evaluating the consequences. The decision making process is influenced by both environmental influences and the differences inherent in individuals. Finally the model traces the process whereby information from external sources such as editorial, word of mouth, personal experience and marketer-dominated sources, such as advertising, enters the memory.

Figure 7. The Blackwell, Miniard and Engel [iv] Model of Consumer Behaviour



Source: Engel et al. 1995

Blackwell et al (2001) view internal search as:

> *"scanning and retrieving decision-relevant knowledge stored in memory." (p. 106)*

It probably is a good deal more than this as the more recent research from neurological science demonstrates (see 4.4 below) and Blackwell et al (2001)briefly acknowledge. The mental process that takes place in a matter of seconds and which is depicted in the Blackwell *et al* model above, is in fact the connection of a vast complexity of node-stored information stimulated by the particular need.

Nonetheless, the Blackwell *et al* model demonstrates that consumers do proceed through a process of consideration as they decide which brand to select. The extent of this process is mediated by involvement: high involvement requiring complex, extended problem solving; midrange problems requiring a lower level of complexity, limited problem solving and habitual decision making for low involvement products requiring little or no mental processing.

The Blackwell et al model provides a comprehensive and acknowledged framework to examine aspects of consumer buying and decision making behaviour. It also aids marketers in refining their strategies which should focus on modifying attitudes and persuasion tactics.

4.3.1.2 Routine or low involvement problem solving

There is a distinction between the amount of information processing a consumer will apply to the selection of a brand for the first time and for repeat purchases of the same product group. For example when selecting a camera for the first time, there is a high perception of risk. Consumers will conduct a

detailed search for information from both memory and external sources. The purpose will be to reduce the perception of financial, performance, or other forms of risk. Once the decision has been made and the camera purchased it is quite likely that the consumer will select that brand again in the future and not embark on problem solving to the same degree. However, the extent to which a consumer will retain the brand at a high level of salience will depend to a large extent on the marketer of the brand and the consumer's exposure to it under different conditions.

Alba and Chattopadhyay (1986) suggest that by retaining the brand in a high state of salience other brand names may be inhibited in consumer memory. This occurs through the consumer being exposed to advertising (particularly advertising that is creatively appealing), seeing the brand in-store, from purchase and usage of the brand. Even a complex purchase such as a motor car might incur higher search activity for the initial selection than for subsequent, repeat purchases.

Consumer problem solving, which Blackwell et al (2001) characterise as a continuum anchored by extended at the one end and limited at the other with midrange in between, is related to the complexity of the purchase. Thus products that are low in perceived risk (low involvement) become largely routine or habitual buys. A consumer will buy toothpaste out of habit rather than from any deep sense of brand loyalty. It is the brand they know, with the flavour they have become used to and which is always available. There is evidence to show that even this level of habitual, low involvement buying can be disturbed by competing brands that are on special offer.

According to Ailawadi, Neslin and Gedenk (2001) this has a great deal to do with the benefits sought by the consumer from shopping and the demographic and psychographic characteristics of the consumer. For

example savings brought about by discounts will appeal to those who are price conscious or have financial constraints.

There are consumers who enjoy shopping and who are entertained by the challenge of choice. Others use the shopping experience to explore because they like innovation and variety and are impulsive; yet others use brands either to distinguish themselves or as a symbol of self expression.
Some consumers are brand loyal, others are loyal to a store. For the former there are switching costs associated with changing brands and others will prefer to shop at the same store even if the same brands are not always available. Consumers who use sales promotion devices such as the price advertisements in the newspapers, or who collect and exchange coupons, will think more about what they buy, than those who make their decisions in-store.

Petty *et al* (1983) studied this phenomenon and proposed the peripheral route to persuasion under low involvement conditions. Rather than presenting the consumer with complex message arguments in marketing communications, as would be the case with high involvement persuasion, marketers should instead, use powerful cues repeatedly as a semiological mechanism.

4.4 Neural Networks

In recent years the idea that semantic memory (as opposed to episodic memory [v]) comprises an associated network of interconnected nodes has become popular among social and cognitive psychologists and has been borrowed by marketing theorists (Collins and Loftus 1975; Hino, Lupker and Sears, 1997; Keller 1993; Du Plessis and Foster 2000). Once information has been processed through short-term memory it is stored in a node. Nodes and links are activated by some form of prompt, cue or prime and then connect with other nodes to establish a structure of knowledge that makes

sense of whatever the stimulus was. The information stored in each node is generally referred to as a concept and might comprise a single word, an image or a descriptive idea or sentence (Collins and Loftus 1982; Anderson and Milson 1989).

For example a node will contain concepts such as the word "car", the phrase "BMW's are expensive"; an image of a grey haired, old man driving an aging Mercedes Benz and so on. Each node could be part of a schema such as "BMW, speed, design, expensive repairs, German and a self image reflection." Within the network of knowledge will be other connections such as Mercedes Benz connected with the concept of a German car. The full package of associated concepts are referred to as schemas. Given a stimulus the schema will be activated. In other words if someone mentions buying a new Porche or booking a holiday in the Maldives this knowledge will stimulate recall of a schema of previously learned and stored information that allows the receiver of the stimulus to make sense of what has been said. Either: "well done that is a lovely car or a wonderful destination", or "that will be a very expensive purchase," or "good diving, but the food is terrible!." (Mowen and Minor, 2001, provided a basis for this discussion).

Quillian (quoted in Collins and Loftus 1975) describe this process as "spreading activation". Rather like a computer conducting a search for information, humans react to an external stimulus by delving into their memories, looking for keywords or connections associated with the stimulus. McNamara and Altarriba (1988) describe the process in these words:

> *"Although specific details vary from theory to theory (of spreading activation) four principles are common to most of these theories: a) retrieving a memory amounts to activating the relevant trace in the memory representation; b) activation of a memory trace spreads to all traces to which it is connected; c) the amount of activation arriving at a*

memory trace is inversely related to its "distance" from the source of activation; and d) the time required to retrieve a memory trace is inversely related to its activation level; that is more active traces are retrieved faster than less active traces." (p. 545)

Arising from this framework is the concept that priming (preparation) aids retrieval. In other words, if a concept is to be recalled or recognised, retrieval will occur faster if it is preceded by a related concept. "Chair" will be more easily recalled if the prime " table" has preceded it. "Coca Cola" will come more readily to mind if the prime is "thirst" rather than "heat" (Hino et al 1997).

Spreading activation is an indefinite process. Collins and Loftus (1975) liken it to asking a person everything they know about a machine. They will start by providing obvious connections such as machines are man made and have moving parts. But soon connections become harder to find and the connections become increasingly obscure, removed and less and less relevant. The links will eventually be distant concepts such as analogies with the human machine, machine lubrication, repairs and maintenance. The connections appear to be limitless. This leads to the conclusion that:

"... people must have a very large number of concepts, and concepts must have very complicated structures." (p. 408)

Each concept is housed in a node and when a network of nodes and links is activated by some relevant stimulus, the activation spreads from node to node. It starts with the nodes closest to the incoming stimulus and then spreads first to all the nodes linked to the first and then on to the nodes linked to each node in the expanding network.

There is evidence that spreading activation will be more extensive if new information is moderately incongruent with that which is already in the system

(Peracchio and Tybout 1996). Called the Schema-congruity effect, it is based on a theory that suggests that it is not arousing when a stimulus is encountered that conforms to expectations. This evokes a mild response because the recipient is familiar with the stimulus. Conversely, when the stimulus causes a disruption of expectations, elaboration takes place in order to make sense of the incongruity (see also Hunt, Kernan and Bonfield 1992).

The effect of incongruent stimulus varies according to the elaborateness or otherwise of the schema. It would appear that if the schema, or network of knowledge, is simple the recipient's judgement on how to accommodate it is based on congruity with established information such as "high calories are fattening". In other words the new information is judged in the context of existing information. The example given is that of a dessert that has a "high calorie" attribute. In a simple, non-elaborate knowledge network this might be interpreted as undesirable. In a more elaborate schema based network, the high calorie attribute will be judged in the context of prior knowledge. For example, since all cakes are high in calories this statement is related more to taste or richness than something negative.

The trigger that activates a network is the prime. In the semantic sense this might be either a category such as dessert which is a prime for brand names; or it might be the brand name itself which is the prime for the associative network or schema associated with each known brand in the category (Morrin 1999).

The extent to which elaboration takes place is related to the relevance or salience of the product category, to the target's motivation and ability to process the information, and also to the level of perceived risk associated with the decision process. These are findings reported by Petty, Cacioppo and Schuman (1983) in the research that supports their Elaboration

Likelihood Model (ELM). The level of involvement (whether high or low) implies two distinct routes to persuasion: the direct and peripheral routes.

When involvement is high consumers will process a great deal of information in order to reach a decision. Internally this implies deep mining of domain specific knowledge structures (Hunt et al 1992), or nodes and connected schemas. Externally, the ELM model has been used to aid marketing communication planning in that it identifies the quality of information that needs to be communicated in order to provide potential users with new (incongruent) information and to strengthen associations already accommodated within a cognitive frame or related schema.

Under conditions of high involvement consumers search for message arguments and marketers should use the direct route to persuasion by providing this in their communications. This information is processed by the target recipient and stored in long-term memory within schemas, connected to the brand awareness node. Because high involvement equates to a low threshold of activation for brands in the consideration set (Morrin 1999; Blackwell et al 2001), this information is easily retrieved when suitably primed.

Schemas that are formed or modified through this process of extensive thinking and elaboration tend to be robust and enduring (Petty et al 1983). They result in strong attitudes that are not easily changed. Morrin (1999) builds on this for her proposition that:

> *" ... because established brand names are stored in networks that consist of relatively strong brand – category associations, they will be relatively immune to the inhibitory [vi] effects of network expansion." (p. 518)*

The extent of this network system of knowledge is discussed in Heath (2000:287-298). In proposing a theory of low involvement information processing with particular reference to advertising, he explains the concept of engrams. This term refers to the brain's record of encoded experiences. The process is called "elaborate encoding" and is the creation of:

> *"... a mass of electrical pathways connecting everything we learned about (a) brand." (p. 292)*

According to Heath engrams are modified, recalled and they can be forgotten. As new knowledge enters the long-term memory, it finds its way to the appropriate engram and reinforces the information already stored there. Confronted with a stimulus, such as the brand category, the process of activation will take the pathway best defined in order to recall the knowledge accommodated in the engram. Using a breakfast analogy Heath explains how knowledge can be lost through interference or "traffic". One can usually remember what one ate for breakfast today, but cannot recall what was eaten this day one year ago. Too much traffic has intervened. New pathways that intersect an engram with new information about, say, new brands or new technology, might blur the originally clearly defined engram.

Conversely, according to ELM, under low involvement conditions which might exist because of the low level of perceived risk attached to the purchase, or because the target is not in a condition of need recognition, a different approach is proposed. Petty et al (1983) argue that under these conditions, where there is neither motivation nor ability to process information, the route to persuasion is the peripheral route, or the use of peripheral cues. The lack of ability, opportunity or motivation to think about the target object means that message arguments will be wasted. The alternative is to use an indirect approach using classical conditioning through advertising or other forms of promotional communication.

One approach is suggested in the Attitude Towards the Advertisement model (in Miniard, Bhatla and Rose 1990). Advertising which attracts attention and which is liked (Du Plessis and Foster 2000), can influence feelings about the advertisement. These in turn contribute to attitudes towards the advertisement and beliefs about the brand. Combined, these two influences – newly acquired beliefs about the brand, and an Attitude Towards the Advertisement (A_{AD}) as a result of a positive affective response to it – can result in an enhanced Attitude Towards the Brand (A_B).

Heath (2000) provides some graphic examples of this. Andrex and Kleenex toilet tissues have competed for many years in the UK market. While Kleenex has an association of comfort built on the attribute of "quilted for extra strength". Andrex claims the attributes of "soft, strong and very long". It uses a Labrador puppy to reinforce these claims. As a result Kleenex has established a quilted cue to represent the soft quality. Andrex also generates a soft benefit, but is strongly associated as well with the puppy, which is a prime for emotional constructs such as "family" and "loving".

In South Africa examples are Nandos and Vodacom both of which are associated with highly liked, entertaining and slightly off-the-wall advertising.

4.5 Recall and recognition

Psychologists use the terms recall and recognition to describe the two ways in which information is retrieved from the long-term memory store. Recall is the more difficult of the two because it requires an internal search process of the memory store and an identification of the relevant items encountered in the store (Lloyd *et al* 1984). An explicit cue such as toothpaste might elicit a list of toothpaste brands from memory. This is known as free recall. Explicit hints might be given such as three stripes or mint flavour. This is prompted

recall because the memory has been aided. Recognition on the other hand requires only retrieval of items stored in memory when confronted with an external prompt such as a list or a display of brands on a supermarket shelf or in a brochure. This requires only one level of processing – identification (Lloyd *et al* 1984; Blackwell *et al* 2001).

There can never be less recognition (R_G) than recall (R_C) (Lloyd *et al* 1984). What is recognised might not be recalled, but what is recalled should always be capable of recognition.

$(R_G \geq R_C)$

Equally for recall to be prompted it must already be in memory. Therefore Aided Recall (Rc_A) will be not be less than Free Recall (Rc_F)

$(Rc_A \geq Rc_F)$

Both recall and recognition are affected by when the information was learned. This is the primacy and recency effect. Tests have shown that when information is processed the first information to be learned and last are the most likely to be recalled. As much as half of the information in the middle of the serial position curve of learned information can be forgotten in recall tests. Psychologists believe that people rehearse more thoroughly the information first heard (primacy) and recall the last learned because it was the most recently processed (recency) (Weiten 1997).

The ability to recall or recognise a brand is at the heart of brand knowledge (Keller 1998). Depending on the circumstances consumers need either to recall or recognise a brand in order to access the associated schema which gives each brand its meaning. Deciding which brand to select from a direct

mail list, or when confronted with brands in the retail environment is recognition. The consumer needs to identify prompts such as the brand name, logotype, packaging or slogan. These elements cue information retrieval from the memory store.

Conversely, if someone asks a friend what movies to see, the friend will generate a list of movies from memory. Those that come to mind will be those most enjoyed (rehearsed) or the ones most recently seen (recency). Of course it is possible that one or more in the list will not be recommended because they were considered to be bad. This process is free recall. If the friend then mentions that the list should contain movies featuring a particular actor or actress or says that they should be drama or action, that they should not be science fiction, the recall has been aided. The friend might not be able to recall any movies and have to refer to a movie guide. Thus recognition has been invoked.

Blackwell *et al* (2001) make the point that:

> *"Until consumers learn about a product's existence, it is impossible to convert them into customers." (p. 260)*

Thus, using measures of recall and recognition brand marketers must constantly test their target markets to ensure existing and potential customers are aware of the brand name. As indicated earlier there is a hierarchy of awareness (Keller 1993). The level that will yield the highest retrieval from memory is recognition.

Questions in market research to elicit recognition will be: "Which of these brands (presenting show card of all available brands in category, sometimes with logotypes) do you know of, or have ever heard of?" (Commercial market research questionnaire)

This is followed by aided recall, then free recall and in marketing the ideal level of free recall is that a given brand is consistently named first in the list of those freely recalled. To this the title of Top of Mind Awareness has been given. The question typically used to elicit levels of awareness is: "list all the brands of (ice cream) you can remember" (Malhotra11993). The interviewer is often instructed to list the brands in the order in which they are mentioned. Top-of-Mind refers to the number of respondents who mentioned the given brand first.

Commercial market researchers do not make a clear distinction between questions for recognition and aided recall. They will frequently ask a question such as the above and list the answers under aided recall.

The distinction is clearer in media research. Here unaided recall is when the interviewer asks the respondents whether they have read any newspapers or magazines in the past month. If the answer is yes the respondents are then asked to name the newspapers and magazines recalled.

Aided recall is measured by the interviewer naming several publications and asking if the respondent has read any of them lately.

Finally recognition is measured by showing the respondent the logo or masthead of the publication and asking if any of the publications shown have recently been read or paged through (Wimmer and Dominick 1987).

Awareness is a necessary condition for the establishment of brand knowledge. It is the node or trace in memory to which associations are attached. Whether it is better to develop the brand at the recall or recognition level depends on the nature of the brand and the level of consumer involvement. Since recall can never be less than recognition,

marketers have to decide whether brand development requires the additional expense and effort to build awareness beyond the recognition platform.

4.6 Attitudes

Brand associations are stored in associative network memory and are accessed when a stimulus activates a connected series of nodes and links. The brand name and the attributes associated with it are stored in these networks and are retrieved when the brand name is recalled. It is believed that the feelings consumers develop towards the brand as stored in this network, whether favourable or negative, are also stored in networks (Keller 1998).

Attitudes are the feelings people have towards objects or behaviours related to those objects. Blackwell *et al* (2001) explain these two types of attitudes:

> *"Attitudes represent what we like and dislike. Usually we do things that we like to do while avoiding things that are disliked." (p. 289)*

This suggests that attitudes predict behaviour, which has been shown not necessarily to be the case. The conventional understanding of attitudes is that they are comprised of three components: cognitive (beliefs and ideas); affective (emotions and feelings); connation (predispositions to act) (Weiten 1997). It was believed that attitudes were formed in this sequence. One learned about an object, developed feelings towards it, and had behavioural intentions regarding it. Over time this sequence has proved to be unstable. It has been shown, for example, that it is possible to act first (such as making a spontaneous purchase in a store); then develop a feeling towards the object of the purchase once it has been consumed (such as a bar of chocolate). Finally one learns what ingredients were used in making it and in what

country the bar was made. This sequence would be conation, affect and cognition.

Attitudes are of crucial importance because they determine whether a brand will be bought or not. They will also determine if the brand will be bought in the future or not. In other words they are the determinant of brand loyalty, brand switching or brand rejection.

Blackwell *et al* (2001) have formulated in their model the influences that impinge on the decision making process and from where the information is sourced. The discussion above explains how information once received is stored in the long-term memory. Brand owners will wish to use this information to ensure that the attitude towards the brand (A_o) is positive. In addition they will wish to ensure that attitudes towards the behaviour (A_b) related to the brand are also positive. A_o is the consumer's evaluation of the object, in this case the brand. A_b represents an evaluation of how the consumer might behave regarding the object or brand (Blackwell et al 2001:289). In other words that consumers will buy it and become regular users of it. This points to attitudes and the ability to change them positively in the direction of the brand as a vital aspect of brand management.

The tri-component explanation of attitudes (cognition, affect and conation) is useful in understanding how attitudes are formed. The theory fails however to predict behaviour or capture the differences between one brand and another.

A step towards this ideal was the development in the 1960s and 1970s of Multiattribute models of consumer attitudes. The belief – evaluation approach described below takes account of the attributes (schemas) that people use to judge products and brands. Attributes in the approach are viewed as beliefs which when related to the brand category have differing

levels of goodness or badness (Fishbein and Ajzen 1975). Brands are then evaluated against these good or bad attributes to determine the extent to which the attributes are present in each of the alternatives on offer. The sum of the evaluations weighted by the beliefs is a measure of attitude strength. The formula for this calculation is:

$$A_o = \sum_{i=1}^{n} b_i e_i$$

Where:

A_o = attitude towards the object
b_i = the strength of the belief that the object has attribute i
e_i = the evaluation of attribute i
n = the number of salient or important attributes

Brand attributes in this approach are the associations stored in memory in the associative network schema. The attributes most strongly, favourably and uniquely (Keller 1998) associated with the brand name in the awareness node, are the ones that will be most influential in guiding a brand selection or brand rejection decision.

The attributes are obtained through a combination of qualitative research to generate the list of attributes and quantitative research to ascertain the extent to which each one is valued. The belief-evaluation approach above requires that each attribute be given a value on a seven point scale where – 3 is the negative belief and + 3 is the positive belief (b_i) that the brand possesses the attribute. Each attribute is measured again on the same scale but this time to evaluate (e_i) whether it is good or bad that the object should possess this attribute. Each brand is evaluated in the same way against each of the most important attributes or beliefs. The products of b_i and e_i are summed to produce the strength of the attitude towards each of the brands. The scores indicate the relative strengths of each brand and also

provide information about the consumer perceived strengths and weaknesses of each attribute. Since it will be recorded that some attributes are bad or undesirable, the brand's performance against these is important information for brand management.

The theory of belief-evaluation as originally conceived by Fishbein and Ajzen was limited because of its attitudinal constraint (see Schiffman and Kanuck 2000). Calculating that consumers hold a positive attitude about the brand does not provide a firm behavioural prediction. At best it implies a behavioural intent (See Blackwell *et al* 2001 for a discussion on intentions). Intentions do not necessarily lead to behaviour although Schiffman and Kanuck report on research that implies greater purchase predictability from intention measures than from other, less positive, scales. In other words a consumer who answers in the affirmative to a question such as : "I will buy it" is more likely to confirm this intention with a purchase, than those who just have a positive attitude to the brands, but whose purchase intention has not been sought.

Marketers wish to convert this intention not just to a single purchase of the brand or use of the service, but to a condition of repeat usage and purchase, or loyalty (Reichheld and Sasser 1990). Achieving this state is consistent with the above discussion on associative network memory because according to Pritchard, Havitz and Howard (1999), consumers use a "complex causal structure" to evaluate the brand they buy. Their resistance to change (from the brand of their choice) is maximised by the extent to which they:

a identify with important values and self-images associated with the preference;

b are motivated to seek informational complexity in the cognitive schema behind their preference; and,

c are able to freely initiate choices that are meaningful.

This might encompass a feeling of trust in the reliability of the brand which Chaudhuri and Holbrook (2001) show is an antecedent to attitudinal and purchase loyalty which in turn have an effect on both market share and price relative to the competition. Thus there would appear to be a direct connection between the attitudes people hold towards brands and the performance of the brand as a company owned asset. Viz. A strongly held attitude towards a brand leads to brand loyalty. This is turn translates into a willingness to pay more for the brand, buy the brand with greater frequency and use more of it.

The link between the affective state and brand trust coupled with purchase and attitudinal loyalty is directly associated with the behavioural metrics of market share and relative price (Chaudhuri and Holbrook 2001). While the authors of this research hasten to add that their results are not fully explanatory of the determinants and outcomes of brand loyalty, they have shown that consumers are willing to limit their buying of branded goods to those with which they feel they have the best trust relationship.

Researchers, at the time of the belief-evaluation approach described above, were unable to find connections such as those reported by Chaudhiri and Holbrook, hence the criticism of the model. While subsequent research has vindicated the belief – evaluation model, its creators Fishbein and Ajzen (1975), developed an expanded version to shift attitudes closer to behaviour.

This approach has been given the name: The Theory of Reasoned Action (TORA). [vii] It retains the tri components of the basic attitude model but applies them not just to the object, but also to the evaluated outcomes of

using the object and to evaluations of how reference groups would respond to this use.

In addition to proposing that intentions are a strong predictor of behaviour, the model introduces two important constructs: subjective norms and attitude towards the behaviour.

Subjective norms are an evaluation of how relevant others think about the intended or completed behaviour. Thus it is suggested that consumers are concerned about how others think they should behave or how they should comply with social norms (see Cialdini 1984).

The second new construct is a measure of how the consumer evaluates the outcome of the behaviour. This is essentially different from an attitude towards the object approach because the consumer is thinking ahead to the consequences of the purchase. This evaluation is said to be more powerful in directing a purchase decision than the attributes and benefits of the object itself (Mowen and Minor 2001).

4.7 Attitudes are Linked to Brand's Economic Life

It is an irony that so much work has been conducted and reported in the marketing literature to help management understand how to build their brands through attitude development, consolidation and modification, and yet these vital measures of brand health and potential are subjugated in favour of the familiar such as profit, sales, gross margin and market share (Ambler and Riley 2000). In the list of top fifteen ranked marketing metrics reported in Ambler and Riley's report (Table 4), awareness is at number four, but the only metric that is close to an attitudinal measure, perceived quality, is at number thirteen.

Of all the metrics measured only profit/profitability, sales, and gross margins reach the top board to any significant extent. Boards are however interested in how much is spent on marketing, but intuitively this is more to do with cash control than optimal investment. At the very least one would have thought that measures such as customer satisfaction would achieve greater importance.

In Chapter Two market orientation was discussed. While this has been a focal topic of marketing interest, these findings would seem to indicate that management has not recognised the role of marketing in the development of demand for its products or services, and has failed to appreciate the value of examining consumer perceptions as a critical measurement of the quality of relationship between the firm and the customers who provide its income.

Table 4. Ranking of Marketing Metrics – UK

Metric	% of Firms Reporting Using Metric	% of Firms Rating as Very Important	% of firms that say Metric Reaches Top Board
1. Profit/profitability	92	80	71
2. Sales, value and/or volume	91	71	65
3. Gross Margin	81	66	58
4. Awareness	78	28	29
5. Market Share (volume or value	78	37	34
6. Number of new products	73	18	19
7. Relative Price (SOM value/volume)	70	36	33

8. Number of consumer complaints (level of dissatisfaction)	69	45	31
9. Consumer Satisfaction	68	48	37
10. Distribution/Availability	66	18	11
11. Total Number of Customers	66	24	23
12. Marketing Spend	65	39	46
13. Perceived Quality/Esteem	64	37	32
14. Loyalty/Retention	64	47	34
15. Relative Perceived Quality	63	39	30

Source: Ambler and Riley 2000

The metrics listed above are primarily measures that reflect behaviour. But they are not direct measures of behaviour; they are mainly derived. For example sales are the cumulative quantification of the behaviour of many people over time. Market share is even further removed since it is the volume or value of sales expressed as a percentage of all volume or value sales in the category. Similarly relative price is share of market by volume divided by share of market by value.

In a replication of the above study carried out in South Africa, similar rankings were found (the SA study was based on a research report carried out in the UK by KPMG in partnership with the Institute of Practitioners in Advertisers. See IPA 1996)

Table 5. Metrics used by Respondents as Marketing Objectives

Metric	% of respondent companies using
1. Changes in Sales Volumes	72
2. Changes in Market Share	65
3. Profit	62
4. Customer satisfaction	59
5. Brand Image	45
6. Brand value	11

Source: Hudson and Sayers 1999

The source of all these sales and derived measures is the attitudes that people hold toward the brand and the behaviour this stimulates. The attitudes that people hold towards brands are thought to direct their behaviour related to the brand (Baldinger and Rubinson 1996; Fournier and Yao 1997). More specifically, if people trust a brand and have a strong feeling towards it (affect), they will be driven to both attitudinal and purchase loyalty, two concepts that are antecedents for market share and relative price (Chaudhuri and Holbrook 2001). The interpolation of trust, affect and measures of loyalty between brand profits and market share is relatively new and would have been, in some circles, unacceptably contentious one decade ago (In fact Table 4 above indicates that in many UK companies this is still the case).

An early interpretation of the PIMS database (originally created by General Electric (GE) and subsequently taken over by the Strategic Planning Institute (Buzzell and Gale 1987)) and was that it indicated a strong correlation

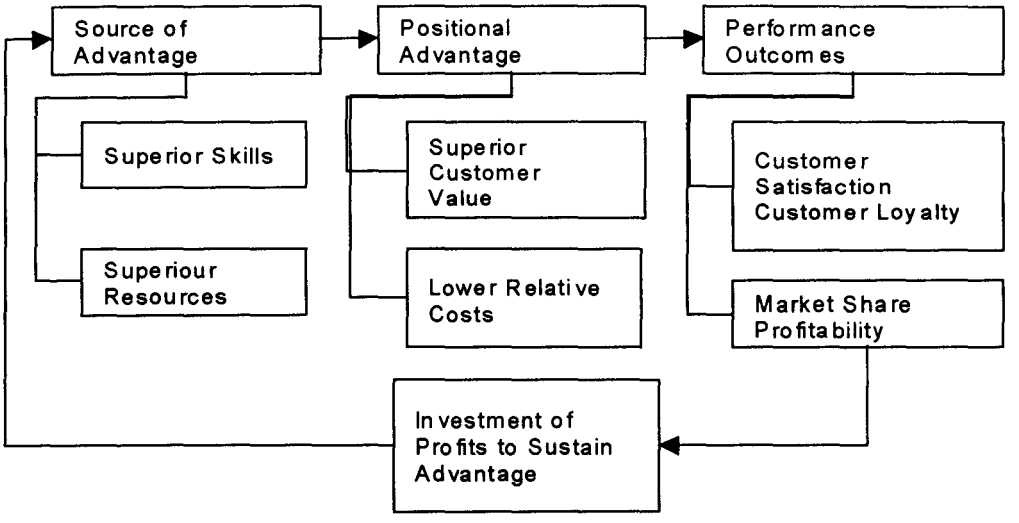
between profit and market share. The explanation was that firms with large market share were able to bring about economies of scale and therefore increased profitability. This was a price, market share, profit equation that implied that profit was entirely within the control of the business. If the firm were able to achieve a premium price for its goods and maintain cost control it would make superior profits. The role of the customer was not a factor.

Conversely, observing the so-called "high volume/low cost "strategy (Webster 1994), the firm could cut the price to achieve higher volumes, achieve scale economies because of the larger throughput, and thereby make more money.

Subsequent analysis of the PIMS database, yielded different results. Based on a finding that higher product quality was associated with willingness by consumers to pay a higher price, attention was focused on the role of perceived product quality on market share. Thus market share was not the independent variable that explained profit. It in turn was a dependent variable highly correlated with customer perceived product quality (Webster 1994. See also DuWors and Haines 1990).

This revised view of the PIMS data and of the relationship between customer perceptions of the product related to profit is captured in the model devised by Day and Wesley (1988).

Figure 8. Day and Wesley's Value Based Model of Business Strategy



Source: Webster (1994:60)

Thus consumer attitudes towards a brand have displaced the dispassionate measures derived from their behaviour. As Webster (1994) states:

> *"using market share as a strategic objective has been an expensive mistake for many firms," (p.58)*

Two studies (Johnson 1984 and Dekimpe et al 1996) have demonstrated that brand loyalty remains a powerful objective for brand owners to aim for and that it is showing no signs of declining. Thus there is strong support that consumer attitudes remain central to the continuing success of brands (see also Petty, Cacioppo and Schuman 1983; Keller 1993; Morrin 1999; Pritchard, Havitz and Howard 1999; Morgan 2000).

Furthermore, a number of studies have demonstrated that building strong attitudinal and relational links between the brand and its users sets up high

switching costs and greater brand loyalty (Jacoby and Kyner 1973; Mellens; Dekimpe and Steenkamp 1996; Fournier and Yao 1997).

Jacoby (and various co-authors for example Olsen and Haddock 1971; Kyner 1973 and Chestnut 1978) have influenced the work of many contemporary researchers into the loyalty phenomenon (DuWors and Haines 1990; Mellens, Dekimpe and Steenkamp 1996; Fournier and Yao 1997; Dekimpe, Steenkamp, Mellens and Abeele 1997; Chadhuri and Holbrook 2001). Some key ideas flowing from their work are summarised below.

4.7.1 Brand loyalty [viii] and routine buying behaviour

When a firm is able to build a loyal core of buyers for its brands it is setting up barriers to competition who have to break down that loyalty in order to convince buyers to switch brands. According to some researchers, it is five to six times harder to acquire new clients than to retain existing ones (Rosenberg and Czepiel 1983; Peppers and Rogers 1993). There is a distinct difference however between those who are attitudinally and behaviourally loyal to a brand (have strong cognitive and affective links and will behave in accordance with their intentions) and those whose behaviour is the only expression of continued purchase. The definition developed by Jacoby (and his various co-authors. See Jacoby and Kyner 1973), makes this distinction abundantly clear. In six parts, it reads:

> *"Band loyalty is (1) the biased (non random), (2) behavioural response (i.e. purchase), (3) expressed over time, (4) by some decision-making unit (5) with respect to one or more alternative brands out of a set of such brands, and (6) is a function of psychological (decision-making, evaluative) processes."*

It is the brand loyal buyer who is most valuable to a marketer. Loyalty is caused by a range of overlapping factors, which might be relational, or emotional (Fournier 1998) creating a bond between the user and the brand. Alternatively, the brand might form part of a multibrand set of preferred brands from which one is more generally selected than the others. The reason for this could be functional (it is perceived to perform better or have better ingredients); experiential (it has been successfully used in the past), or symbolic (it is reflective of self image).

Thus loyalty is a function of attitude and behaviour. The behaviour only response is called routine and is a salience driven repeat purchase habit (see Chapter Two for a discussion on salience).

Loyalty results in: less costly sales (it is cheaper to sell repeatedly to existing customers than to acquire new ones); customers who buy regularly and can be convinced to increase the frequency of usage; and who are usually willing to pay for their preferred brand at a price higher than the brand category average. In addition loyal customers are known to talk to others about their preferred brand, and loyalty is a competitive advantage in that it is an obstacle for competitors to breach, and gives the firm time to respond to competitive moves (Aaker 1991; Mellens et al 1996).

4.7.2 The acceptance and rejection set

Reichheld (1996 and with Sasser 1990) has explored the nature of the relationships companies have with their customers for at least two decades. He strikes a sombre note in the first line of a Harvard Business Review article (1996) when he states:

> *"On average, the CEOs of U.S. corporations lose half their customers every five years." (p. 56)*

What is perhaps even more salutary is his finding that companies are not often alarmed by customer defections (the cause of this statistic) because:

> *"... they do not understand the intimate causal relationship between customer loyalty on the one hand and cash flow and profit on the other." (p. 56)*

The reasons for this are complex but can be partially understood by the work carried out into the attitude/behaviour link (Baldinger and Rubison 1996); customer satisfaction (Jones and Sasser 1995) and measures of brand loyalty (DuWors and Haines 1990).

Baldinger and Rubinson have identified a hierarchy of loyalty. At the lowest and least loyal level are the Low Loyals/non-buyers. This group is characterised by a 9% probability of selecting the brand. The Moderate Loyals have between 10 and 49% probability of selecting the brand; and the High Loyals have a 50% probability of selecting the brand. The researchers found a strong relationship between the attitudes of their sample respondents at the start of the survey and the behaviour subsequently recorded. Thus they concluded that attitude is a strong predictor of purchase behaviour. What they also discovered was that the percentage of consumers falling into the category they defined as High Loyal was smaller than they had anticipated.

They found that, on average, only 12% of users in the category were high loyals and 14% were moderate loyals. 74% either never used the brand or only bought it as a low loyal. What was disturbing however was the extent to which brand loyals move from category to category. While market share might remain consistent over time, there is a high level of switching that takes place with as many as half the high loyals changing brands between periods

and being replaced by others. This is consistent with the findings of DuWors and Haines (1990) that:

> *"The numerical values in the results indicate that brand loyalty is transitory and time dependent." (p. 491)*

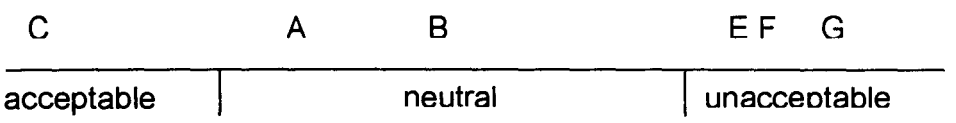
What most of these researchers have concluded is that firms wishing to keep loyal customers must investigate and thoroughly understand the attitudinal causes for the loyalty. This involves searching for levels of awareness and the attributes that are associated with it and by concentrating their communication and one-on-one relationship campaigns on strengthening bonds at these cognitive and affective levels. Since there is evidence that these bonds are only raised from low order to high order by direct experience they must as well move beyond trial of the product or service to commitment (Smith and Swinyard 1982).

Jacoby and Kyner call this the acceptance – rejection function of brand loyalty (1973). They acknowledge that many consumers are loyal to more than one brand: that they select their choice from a portfolio of brands (the consideration or evoked set) that they find to be acceptable to them and for others for whom they are buying (the family).[ix] They speculate that the greater the number of alternatives that are equally attractive within the consideration set the more cognitive dissonance will be invoked (Festinger 1958).

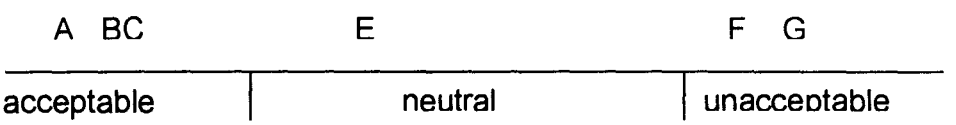
> *"Having once experienced the discomfort of dissonance, it seems plausible that the consumer, in his attempt to avoid its recurrence, will adopt brand loyalty as a purchase strategy."*

Figure 10. Acceptance /Rejection Scales for Two Individuals

Individual 1



Individual 2



According to this conception (Figure 9), individual number 1 would be expected to be more loyal because there is only one brand in the acceptance set. Individual 2 is less loyal because he will consider any one of three brands when making a selection, but will display a preference for brand A. This construct of loyalty has received considerable implicit support over the years (Mellens et. al. 1996; Baldinger and Rubinson 1996; Kotler 1997; Schiffman and Kanuk 2000; Blackwell *et al* 2001). The brand that is first recalled when the category is mentioned tends to be the dominant brand (Morrin 1999).

As an aside, Alba and Chattopadhyay (1986) conducted laboratory tests on the effect of salience in brand recall. In this sense salience means the level to which a brand is activated in memory. They found that brands that are high in salience have the effect of impairing recall of competing brands. It is therefore sound strategy to build high levels of brand recall as a blocking mechanism in addition to the more conventional role of awareness.

Interestingly, this conception of brand loyalty has found its way into trademark law in the United States of America. The Federal Trademark Dilution Act refers to famous trademarks that might be either blurred or tarnished by competitive actions. It is suggested that courts will have to turn to survey data to establish the extent to which a famous brand is famous and the extent to which its fame has been diluted.

Peterson, Smith and Zerillo (1999) propose that the concepts of typicality and domination will become preferred measures of dilutions in court. Typicality is the:

> *"ability of a trademark to elicit recall of its own product category." (p. 159)*

In other words the brand is typical of the category. Coca Cola would be the most typical brand in the carbonated beverages category because when its name is mentioned most people would immediately associate it with its category.

Domination is:

> *"the trademark's ability to be recalled when the product category is mentioned." (p. 159)*

Or, if the carbonated beverage category is the prompt, Coca Cola would probably be the first name that is recalled. Brands with the highest levels of typicality and dominance would be the equivalent of the brands in the evoked set or acceptable end of the above spectrum of brands.

4.8 Concluding Discussion

It is churlish to consider the notion of brands existing in consumer memory as "wishy-washy" (Sampson 1998). It is understandable that financial people wishing to treat brands as assets for investment, tax and other reasons should prefer hard auditable numbers to measures of how people think. However, when Coca Cola was damaged by reports of contaminated bottles in Belgium, or when Firestone and Ford had to defend their brands against accidents caused by faulty products, they called in the public relations experts to help re-build customer perceptions.

A century of research into psychology and half a century spent adapting it for marketing use and developing a broad and varied stream of research to explain how consumers respond to marketing communications and why they favour one brand over another, has brought a new dimension to the measurement of intangible assets.

As long ago as the 1920s Hopkins (1966), acknowledged as one of advertising's greatest copywriters, wrote:

> *"If people can be made sick or well by mental impressions, they can be made to favour a certain brand in that way. And that, on some lines, is the only way to win them." (p. 247)*

Ogilvy (1983) perfected the idea of brand image. As successful in his time as Hopkins was two decades earlier, he challenged the advertisers who champion the use of rational facts to persuade consumers, in these words:

> *"Next time an apostle of hard-sell questions the importance of brand image, ask him how Marlboro climbed from obscurity to become the biggest selling cigarette in the world." (pp. 15 – 16)*

Today politicians, actors, leading businesspeople and sports stars, are conscious of their image: how other people perceive them. Politicians gain votes and support (or lose them in the case of Lord Archer and Tony Yengeni) because of the way they are perceived by voters; the actions or moves of high profile business people can affect company share prices; sports stars can command large transfer fees (or lose their jobs as Hansie Cronje discovered) due to their public image; and popular actors can convert mediocre movies into box office successes because of the esteem in which the movie going public holds them.

The definition of a brand is the value the brand adds to a product. That value can be no more than what is in the minds of the consuming public. Other measures are connected to their behaviour: a function of how they think.

For a brand valuation to truly capture the value that a brand contributes to shareholder wealth, consumer attitudes towards it must feature as key determinants of its monetary value.

End notes

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[i] The main research outputs for brand measurement, that flowed from this initiative, are summarised in the MSI Conference Review (Maltz 1991). In addition major contributions were made by Simon and Sullivan (1992) ; Aaker (1991); Kapferer (1997); Keller (1993 and 1998).

[ii] King first published this book in 1973 and this description appeared in the preface to the first edition.

[iii] The idea of brands adding value (now known as brand equity) is not a new concept. Mayer (1958) spoke of it over forty years ago.

[iv] This text book has been published since 1968. Over the years the authors have changed, hence the different references from edition to edition.

[v] Episodic memory refers to memory for specific events. Semantic memory is memory for general knowledge (See Lloyd, Mayes, Manstead, Meudell and Wagner, 1984, for a discussion)

[vi] Morrin's (1999) work is concerned with the effect brand extension might have on the parent brand name. Her suggestion is that spreading activation primed by exposure to the brand name might be inhibited if an unfamiliar extension category is introduced into the well-known network. The example she uses is Crest toothpaste. When Crest is seen in an advertisement it would activate the toothpaste schema. The spread of this might be inhibited by the introduction of an unfamiliar extension such as mouthwash.

[vii] Most consumer behaviour textbooks contain an explanation of this model (see for example Schiffman and Kanuck 2000:206; Mowen and Minor 2001:131). Interestingly, with no explanation it has been dropped from Blackwell, Miniard and Engel 2001, having been featured in all previous editions.

[viii] For a more thorough discussion on brand loyalty, see Chapter Two.

[ix] This has been a cornerstone of the salience argument presented over many years by Ehrenberg (see chapter two). It was Ehrenberg with Goodhardt (1968) who were among the first to propose the concept of the brand portfolio.

Chapter Five – Brand Valuation

5.1 Introduction

Since the Barwise Report (1989a) and the Marketing Science Institute (MSI) conferences between 1988 and 1995, there has been a great deal of attention paid to the valuation of brands. Whereas the accounting profession decided to differentiate between brands that are acquired and those that are internally generated or home grown, thus implying that brands that companies develop over time, have no value as assets, marketers and financial markets have recognised that brands add shareholder value.

During the early half of the 1990s there was a great deal of attention paid by academics to brands and how they should be valued. This has dissipated somewhat but it has been replaced by a growing interest in brands as intangible assets by the companies that own them and by investors.

In this chapter some key issues regarding valuation are discussed, the early research is reviewed, as are the more contemporary approaches by the leaders in the field.

5.2 Aversion to Discounted Cash Flow (DCF)

In this thesis the definition of brand equity is the one proposed by Simon and Sullivan (1993):

> "... *the incremental cash flows that accrue to branded products over and above the cash flows that would result from the sales from unbranded products". (p. 29)*

Srivastava and Shocker (1991) conclude that Wall Street and academics embrace this definition, and versions of it .

The definition implies future cash flows for both a branded product and one that is not branded. Brand equity is the incremental cash flow that the former is able to earn because of the benefits it derives from the customer franchise it has built up over time. The value of a brand is therefore the difference between what a brand with equity could earn over a certain period of time, less what a product that lacks equity would be able to earn over the same period of time.

The branded version is able to earn these incremental profits because of all or some of the following benefits that accrue to products with high brand equity: the brand has attracted a loyal user group who buy the brand regularly. In order to reduce risk they are prepared to pay a premium price for the brand of their choice; and who will pass on to others the benefits of the brand thus generating referral purchases. The resulting volumes produce economies of scale; and, marketing costs are reduced due to the lower costs inherent in maintaining existing users as opposed to acquiring new buyers.

The value of the brand should be the capitalised, discounted present value of these incremental cash flows. However, early researchers into brand equity rejected DCF because it was thought to be inherently unreliable.

Simon and Sullivan (1992) draw attention to the unstable nature of measurement methods that are based on future projections. They describe their system as using "objective market-based measures." These are derived from published data which, among other things, "incorporates the effect of ... future profitability."

They base this on the ability of analysts in financial markets to take account of available information which they use to discount future sales

trends (see Fama 1965). By default they limit themselves to brands that are owned by publicly quoted companies. This implicitly excludes brands that are owned by privately owned firms. It also poses a problem for firms that are listed under their corporate title and which own multiple brands.

If it were possible to eliminate the imponderables that make future cash flow predictions unreliable discounted cash flow would be a sound base for the calculation of value for such a firm. This was the prevailing view in the late 1980s and early 1990s among the early researchers in the brand equity field (see Birkin 1990; Farquhar et al 1991).

However, the accounting profession has accepted that forecasts and estimates are an inevitable consequence of placing value on certain assets (see for example Brockington 1995; Faul et al 1999; Everingham and Watson 1999. See also clause .31 of A.C 129). Mullen (1993) makes this quite clear:

> *"The value of an intangible asset, like the value of any asset, lies in the future ... bears little or no relationship to the historic cost incurred in developing it." (p. 92)*

Support for a forward-looking approach will also be found in the portfolio theory literature (Markowitz 1952; Reekie and Crook 1995), pioneering brands (for example: Green et al 1995; Bharadwaj et al 1993; Szymanski et al 1995); and Double Jeopardy (Ehrenberg et al 1990).

The source of this antipathy to DCF and forecasting among marketing academics can be found in the early explanations of the Interbrand approach to valuation (Penrose 1989; Birkin 1990). The methodology was explicitly based on "economic use" which was designed to exclude any "hope value".

When discussing DFC Birkin (1990) states quite firmly that:

" DCF is a most difficult tool to use in the brand valuation area." (p. 100)

Consequently, Interbrand based its calculations on a system which applied a derived multiple to a three year weighted average of the brand's historic earnings.

Haigh, who had been director of brand valuation at Interbrand until he left to set up in competition in 1996, described the Interbrand approach in an Institute of Practitioners in Advertising publication (IPA) (Haigh 1996). His description differs only in small detail from those set out in various publications five to seven years earlier by Penrose and Moorehouse and Birkin. In the same publication he outlines an alternative approach to valuation, not dissimilar to the Interbrand method, but which replaces historic cost with future earnings. He argues strenuously in favour of the reliability of forecasting.

Significantly, Interbrand changed its approach in the latter half of the decade introducing DCF as its core calculation (see Trevillion and Perrier 1999).

It will be seen in this chapter that all leading brand valuation methodologies are now using some form of present value of future brand earnings stream.

5.3 Discounting Period

Both Interbrand and Brand Finance use five to ten years as the duration for forecasting brand earnings for the DCF calculation (Trevillion and Perrier 1999; Haigh 1998). This is consistent with accounting practice in which a five to ten year period is used as the maximum period of time that a company could be expected to earn super profits (Faul et al 1999) or

because it is the maximum period for which cash flows can reasonably be predicted (Brockington 1996).

The need for certainty in accounting principles would call to question the wisdom of using a set five to ten year period for the estimate of a brand's future cash flow. A.C. 000 clause .85 introduces the concept of probability in this regard which it links to reasonableness. It is clear that should an item fail to meet the criteria laid down for balance sheet recognition, it might be included in the notes to the accounts if it is felt that due to future events it might ultimately achieve recognition. This refers to items such as assets and liabilities which can be measured and which will be of interest to the users of the financial statements. When the item achieves recognition (such as in the case of a brand which is acquired in a business combination) it must be immediately transferred from the notes to the balance sheet.

Under these circumstances even if a brand is being valued for inclusion as a note to the financial statements, the valuation should be treated as though it had been recognised as an asset.

A.C. 129 requires valuers to :

> *"assess the probability of future economic benefits using reasonable and supportable assumptions that represent managements best estimate of the set of economic conditions that will exist over the useful life of the asset." (clause .21)*

Thus against the test of probability and reasonableness an unquestioned time period (i.e five or ten years) seems potentially imprudent. Since management tends to be over optimistic in its forecasting (see for example Brockington 1995), even five years seems long. The approach described by Morley (1992) provides guidance as to what might be reasonable and provides greater confidence in forecasts and budgets. An analysis of

historic sales or profit for at least as long as it is proposed to forecast is examined. The actual figures are compared with what management of the time forecast would be the performance of the company. Assuming the same management or consistency of management style, a similar degree of accuracy or variation could then be anticipated. The actual number of years for which forecasts could reasonably be made would then be a function of the above assessment coupled with a critical view of the economic and political environment over that period. This could be as great as ten and as little as one year.

Alternatively, a variation on the approach proposed by the accounting profession for impairment reviews and ceiling tests is appropriate. Valuers would take the base year and the years ahead for which management budgets are considered reliable. This might be as little as one year ahead or, if tests as described above provide justification, two or more. Thereafter, a growth rate of, say, 2,5% per annum, could be applied, based on:

> *"Some presumption about prospective growth in the economy as a whole." (Brockington 1996:188)*

5.4 Size as a Factor

The duration of the forecast will depend on the valuation model. It should however encompass the notion that many brands are long lived and that this conservative presumption of incremental profits could continue, in some cases, for a very long time.

Consider that a Johannesburg based law firm has been practicing under its trade name for more than twenty years. During this time it has been one of the top ten Gauteng law firms in terms of size. Contributing to the success of the firm is the fact that it comprises a portfolio of legal services (Portfolio Theory). This, to a large extent, provides stability over time

because departments within the portfolio balance each other out in times of recession and growth. In other words like an investment manager spreading the risk by investing in a portfolio of stocks, the law firm spreads its risk of not maintaining steady growth by establishing a portfolio of services.

The firm - as do others in the top ten category - benefits from the time it has been in existence. Because lawyers are at the intangible end of the tangible – intangible dominant continuum that is characterised by credence evaluation qualities (Lovelock and Wright 1999), the longer it has been successfully established the greater the credence felt by clients in the selection of its lawyers to handle their matters. This is consistent with well supported academic research to the effect that firms established decades ago tend to retain their status as market leaders (see for example Szymanski et al 1995).

Another advantage that flows from longevity and portfolio is known in marketing circles as Double Jeopardy. This refers to Ehrenberg's (1990) contention that large brands have more buyers who buy more frequently and small brands have fewer buyers who buy less frequently: hence the term Double Jeopardy. This would apply to a large and established law firm. It would have built up a client base over many years that would use it frequently and be prepared to pay premium fee rates for the consulting time of senior partners and their professional team. Conversely, a small firm would have a small client list who use its services regularly and many one time clients who need occasional family law, marriage or bond registration.

Finally the large firm, through its portfolio of services, its ability to employ more experienced staff, and because the market is aware of its name and associates the name with positive attributes, is able to charge higher fees than most smaller firms, thus enhancing its earning capacity.

The above is analogous of established brands. By definition they have existed for some time and, although their future is not assured[i], it may be assumed that brands that have been in a leadership role for ten years or more will continue at least for the following ten years and likely many more (Aaker 1991)[ii].

It would therefore seem justifiable to project these brands for as long as their historical performance and future events indicate as possible. Certainly in some cases this could be for the length of time that DCF will continue to produce a present value for the most distant year (See Table 10 in Chapter Six).

5.5 How brands have been valued

> *"The wheat crop depends on the land which yields it. But the value of the crop does not depend on the value of the land. On the contrary, the value of the land depends on the expected value of its crops." (Fisher, quoted in Faul et al 1996:606)*

Valuations have long been required in financial accounting. Their purpose has been to estimate the future benefits of capital goods discounted to their present value. Faul et al (1996) list three requirements for estimating such a valuation:

a. the amount of the cash flows;

b. the time when they will be received;

c. an appropriate discount rate to be applied.

5.5.1 Models of intangible asset valuation

To deal with the relatively new need of valuing intangibles, these three requirements have been adapted and modified. Six models are generally mentioned in this regard (see Aaker 1991:21-30; Farquhar; Han and Ijirii 1991; Simon and Sullivan 1993; Mullen 1993; Haigh 1996). In their pure states as described below each has problems that negatively affect their suitability for the reliable and consistent valuation of brands.

- premium profits;
- residual value or brand earnings;
- relief from royalty;
- multiple of earnings;
- replacement cost or cost based;
- market based.

5.5.1.1 Premium profits

Loyal users of a brand are frequently willing to pay a premium for the brand of their choice. This method projects the premium over the average price of the category in which the brand sells, or over the price that a generic equivalent product could achieve in the same market. The net present value of the stream of premium profits are capitalised to determine the valuation. The technique is said to reflect the demand elasticity of the brand.

In the form stated above the method is problematic in that not all brand leaders sell at a premium price and yet they are profit contributors due to

volume and lower production and distribution costs. The second approach suffers through the lack of generic products in many markets.

Mullin (1993) makes the point that this procedure is only valid if the estimate shows that the firm earns these premium profit because it owns the brand and not because of some other reason such as its strong distribution network.

5.5.1.2 Residual value of brand earnings

The brand is valued using estimates of future earnings. It is then re-valued as if the brand was not an influence and that "normal" profits would be earned. The present value of the second estimate is then deducted from the present value of the first to arrive at the residual.

The problems with this approach are similar to the price premium approach in that it would be difficult to know what influence the brand actually had on the profit stream. It would be equally problematic to know what the "normal" profits would be.

5.5.1.3 Relief from Royalty

This method became very popular in South Africa in the mid 1990s when companies exploited the provisions in the Tax Act section 11 (gA) which made it possible for the purchaser of a trademark to write off the purchase price over a twenty-five year period. The act required that the sale is made to an unconnected party and that a fair value is placed on the trademark. Typically, once the purchaser had deducted from the price paid the net assets and made an allowance for goodwill of, say, 15% of the price, the balance could be applied to the intangible value of the asset purchased, if it could be reliably valued.

Royalty relief assumes that the owner of the trademark is saving royalties or licence fees that would be paid to a third party owner if the intangible was rented or franchised. The notional royalties are applied to a projected stream of turnover, usually for a ten-year period, and then discounted back to present value using a discount rate and capitalised.

Problems associated with this approach start with the lack in most markets of any database of comparable royalty rates. Consequently those involved in the process use subjective judgement in selecting what they consider to be an appropriate rate. Using turnover as the measure of the asset's performance is misleading because turnover incorporates many reasons for the performance, such as good or poor management; a strong or weak sales force; efficient or inefficient procurement of raw materials; and the strength of distribution, that have little to do with the brand and more to do with the rest of the business.

Other problems are that an arbitrary duration of ten years is invariably used and there is little consistency among valuers as to the components of the discount rate (risk free and risk premium).

As in other jurisdictions the South African Revenue Services (SARS) withdrew section 11 (gA) in November 1999 because in their view it was being abused by inflated values. In line with the United Kingdom Revenue Service, whose regime SARS follows, a modified version of section 11 (gA) will be introduced in due course.

5.5.1.4 Multiple of earnings

Interbrand pioneered this approach to brand valuation. It developed the approach in response to the unprecedented merger and acquisition activity of the mid 1980s. Birkin (1991) explains that management of the firm that initiated the need, Rank Hovis McDougal (RHM), made it clear that the methodology had to reflect what became known as "economic

use". That is the value of the brand in its current application regardless of future, as yet unrealised, plans for extension or expansion. In this context success arising from such actions could not be anticipated but would only be brought into the valuation once they have occurred and been recorded. Secondly, because there is no market for most brands, the notion of a brand premium was rejected. The value was to be the value in the hands of the existing owner and not one that might (or might not) be paid by some third party acquirer.

The method weights the past three years of after tax, before interest, profit earned by the brand. The weighting uses the formula or three times the current year, twice the second and one times the furthest year divided by six. This is to smooth any abnormal highs or lows. A charge for capital is applied to separate the brand from a non-branded version.

Interbrand devised a list of seven factors which, in combination, are supposed to account for the strength of the brand. These convert to a factor (or discount rate) which, when applied to an "S" curve correlates with a price : earnings ratio. This is the multiple. When applied to the result of the profit formula described above, the brand value is produced.

Several criticisms have been levelled at this approach. First there is no evidence that the seven factors and the values attributed to each were tested for external validity. Second, the list has been criticised for being incomplete and subjectively scored. Third the "S" curve has not been calibrated in any way that has undergone the rigours of scholarly research. Fourth, the p : e axis which is scaled to a maximum of twenty appears to be arbitrarily related to stock exchange ratios for the general industry in which the brand falls. Finally the seven factors themselves have been criticised in that, for example, it is assumed that all brands aspire to global sales. Thus a beer brand such as Windhoek Lager would be severely disadvantaged because it is peculiarly Southern African (Barwise et al 1989; Aaker 1996; Kapferer 1997).

5.5.1.5 Replacement cost or cost based

Aaker (1991) describes the estimates that Kidder Peabody made regarding the launch of a new consumer product. Their estimate was between $75 and $100 million. Taking the higher of the two and factoring in a 25% probability of success (it would need four product launches to produce one that succeeded) a firm should be willing to pay $400 million for an established brand. Since Coca Cola has been valued at over $68 billion [iii], its owners might feel this offer to be somewhat low.

It might be possible to aggregate the costs of development of a brand (i.e. all its advertising, sales, research and development) for a relatively new brand, but older brands would not have historic information available and might have been quite cheap to establish. Birkin (1991) makes the particularly telling point that if this approach was to be adopted brands that fail could have as much value as those that succeed.

Most important however is the reality that it is not how much a firm invests in a brand that counts, it is the extent to which its contemporary market perceives it to be unique for them. This tends to be a function of more than just the historic marketing and promotion and incorporates dynamics such as word of mouth, personal experience, and the present competitive environment.

5.5.1.6 Market based

This approach assumes the existence of a market in brands or that some proxy for a market can be derived from other transactions. The value of the brand would be related to what could be obtained in a sales and purchase of a comparable brand.

Simon and Sullivan(1993) developed a methodology along these lines. As has already been mentioned earlier this approach is based on the difference between the current market value of the branded product's firm and the replacement value of its tangible assets. Tobin's *q* (1978) is used as the device to conduct this calculation. The method makes assumptions which are not tested. For example in decomposing the intangible gap derived from the *q* calculation, they make the assumption that there are only three components: brand equity; the value of other firm-specific factors not associated with brand equity; and, market specific factors that lead to imperfect competition. Further they assert that brand equity will comprise the largest component of the gap.

They then utilise current and past advertising support given to the brand; the age of the brand; its order of entry into the market; and its current and past advertising share.

The immediate problem with this approach is the availability of data stretching back as far as would be needed for many long-lived brands. It also assumes a role for advertising that might not always be justified. Ehrenberg and Goodhardt(1980) stimulated a decade long debate on the power of advertising. They coined the phrase "The Weak Theory" and, although this belief that advertising possesses limited powers to change buyer behaviour was restricted to European interest, the idea was captured in the North American stimulated concept of Integrated Marketing Communications (IMC).[iv] Both ideas make it clear that brands need more than just advertising to build brand equity. At the communication level a full mix of communication tools need to be used in an integrated manner to achieve a message link with the consumer; and this mix has, itself, to be integrated with marketing and the business as a whole to achieve and maintain leadership.

The greatest weakness in the Simon and Sullivan approach is that it cannot deal with firms that trade with more than one brand. This failing

apples to all approaches that use the market based approach: they lack the ability to measure any more than the single brand involved in a transaction, or quoted on the stock exchange as the corporate product brand.

5.6 Marketing Science Institute (MSI) Sponsored Approaches

The "Capital Topic" status awarded to Brand Equity at the MSI sponsored first conference on the subject (Leuthesser 1988) was intended to stimulate a stream of research into the topic. The types of research that were thought to be helpful in further understanding the concept were categorised in three ways:

a. Assessing the amount of actual and potential equity in a brand

b. Creating and maintaining brand equity

c. Expanding brand equity via brand extensions.

By the time of the second conference in 1990 several academics had responded to these topics; their finished work (in the form of working papers) followed as the dates below show. The second dates, where applicable, indicate the appearance of the work in refereed journals. Those dealing with the measurement of brand value fall under (a) above and are reviewed below (N.B. Simon and Sullivan's 1991 contribution is reviewed in 5.1.6 above):

5.6.1 Farquhar, Han and Ijiri (1991;1993)

Farquhar et al (1991) propose Momentum Accounting as an approach to brand valuation. By implication they are critical of other methods available at the time which they consider to be "untrustworthy". Momentum Accounting is defined as:

> *"the time derivative of income variables (stated as sales per month, profits per year, material costs per week, etc.) (p. 16)*

Graphically they explain the difference between conventional and momentum accounting and how this would benefit brand valuation. Whereas conventional accounting counts the assets at the start of a period and states them again at the end of the same period adjusted by profit or loss, their approach uses a "momentum statement" which traces the cause and effect between income and expenses fluctuations that bring about these changes.

They see a parallel between conventional and momentum accounting in the income statement which illustrates the changes to the balance sheet and the "Impetus Statement" which accounts for the changes to the Momentum Statement. The method assumes a causal link between sets of impulses and the momentum they bring about. This turns out to be subjective however. In an example they state that sales momentum from a firm with a single brand product was caused by a combination of advertising and promotions. The ability to know this, they claim, would be the task of an:

> *"expert assessor who might make such estimates just as a professional appraiser might value the noncash assets of a starting firm." (p. 19)*

Two main problems are apparent from the description given of the method: first it does not result in a brand valuation but rather is a management tool purported to assist management in understanding what causes rises and falls in their brand's sales; and, second, it is based on the ability to establish a direct and detailed link between sales trends and elements of the marketing mix. This is a problem that has puzzled marketing experts for decades and for which there is still no definitive answer.

5.6.2 Kamakura and Russell (1991; 1993)

Kamakura and Russell base their approach on a model of consumer choice which proposes that consumer perceptions are shaped by just two stimuli: psychosocial cues and the physical features of the product. Perceptions lead to preferences that in turn lead to choice. They use this framework to model the value of the brand to the consumer as opposed to the value of the brand to the firm. Value is measured at the preference stage by assessing the overall perceived quality of the product. This construct can be broken down into tangible and intangible components. Alternatively, the brand value can be assessed at the choice stage by observing the way brand selection is influenced by changes to price. These three separate measures (overall perception of quality; perceived tangible and intangible components of the brand; and, the brand's response to price changes) capture three different aspects of brand equity.

The researchers drew on scanner data to measure the purchase behaviour of 302 households over a fifty-one week period. The product sector was laundry detergent.

The data from the scanners were combined with data regarding advertising expenditure over this time, and the laboratory tested performance rated attributes of each competing brand. In addition information regarding order of entry, price per ounce and advertising exposure was combined in the calculation.

From the analyses that follow the researchers drew conclusions such as brands with high perceived value can achieve high market share and high prices, whereas, notwithstanding their low price, brands that have low perceived value tend to have low market share.

They further reach the conclusion that brands with high intangible value scores are those that were early entrants to the market.

Apart from the fact that this type of analysis is limited to brands that have scanner data available together with the other inputs such as advertising levels and exposure rates, and laboratory measures of brand attributes, the approach suffers from at least three other defects:

a The approach is based on past and current data and makes no attempt to forecast future profits or earnings (Simon and Sullivan 1991).

b No account is taken of other inputs to consumer preference such as personal experience (Parasuraman et al 1985; Smith and Swinyard 1982); Brand salience (Eherberg 1990) or the possibility of these consumers buying the leader through habit rather than loyalty (Engel et al 1995).

c The approach states the obvious: that brand leaders attract repeat purchases and higher prices.

5.6.3 Srivastava and Shocker (1991)

Srivastava and Shocker develop an integrative framework that links the various facets and dimensions of Brand Equity. Their purpose is to help in providing a deeper understanding of the concept. The framework then forms a basis for a discussion on band strength and brand valuation.

The key linkage in the framework is between brand value and brand strength. They propose that brand strength is largely dependent on the brand's current strength and its prospect. They frame this position in the context of the number and aggressiveness of the competition, the relative strength of competing brands and the rate of technological innovation and its affect on the brands future prospects and vulnerability. The implications for brand valuation arising from this framework are discussed more fully in Chapter Six.

Srivastava and Shocker evaluate the multiple of earnings approach as used by Interbrand. They conclude that the methodology is:

> *"... subject to some of the problems that plagued growth-share matrix approaches to product portfolio planning." (p. 19)*

The problems to which they refer are the subjectivity inherent in some of the seven factors; the "S" curve and the determination of the risk free rate which is the P/E average for the industry concerned.

They list a number of problems associated with the alternative approach – DCF – but state that these problems are not endemic to DCF but are inherent in any procedure for valuing brands and marketing strategies. They warn valuers simply to be aware of these shortcomings and to consider carefully the relevant inputs.

The problems they enumerate are paraphrased as follows:

a Forecasts tend to be optimistic showing rising sales and profit. They do not usually – nor are they able – to take account of declining sales.

b The forecasts assume that the scope of the brand project will remain consistent over time. A strategic investment by the firm or in the firm could influence the brand either negatively or positively. As examples they cite cannibalisation of the brand through extension or positively by corporate synergies.

c Because of the problems inherent in long-term forecasts time periods are often short (for example five years). This however is inadequate to account for most valuable brands that have long-lived durations.

e Arbitrary risk premiums tend to be used that may not fully reflect the riskiness of brand strategy (a broad interpretation of a point not clearly made in the document).

f The expected cash flows are based on the situation as it is at the time and do not take account of how management might react to new market data.

5.6.4 Mahajan, Rao and Srivastava (1993; 1994)

It is assumed that brand equity plays a role in the consideration of company management when considering the purchase of a competing firm. This is the hypothesis that Mahajan, Rao and Srivastava set out to test. They use the balance model developed by Farquhar and Rao. [v] The thesis is that members of an executive committee looking for and conducting an acquisition or merger would look for certain factors which they would each evaluate as being similar or dissimilar to those present in their own organisation. They would look at a balance between those that were similar and those that were not but which would add value.

The test they conduct is among a limited sample and as a result provides inadequate data. The claim they make for their approach is that it would

assist management in determining where each member of the committee involved in seeking out and negotiating a purchase of another firm or brand, stands regarding the choices.

Specifically they believe that the balance model is useful for:

a evaluating potential candidates for acquisition;

b identifying attributes, including brand equity attributes, that may be perceived as important by decision-makers in determining the suitability of candidates;

c assessing the role of brand equity variables in determining the acquisition choices.

5.7 Two Popular Methodologies

Responding to the demand of industry in the mid-1980s, Interbrand Plc. devised a valuation methodology in 1987. [vi] The company claims that it is the world's leading brand consultancy and over thirteen years has valued over 2 500 brands. The methodology has been outlined above. It was based on historic cost principles and used a multiple to scale up the brand related profits to brand value. In supporting papers and articles Interbrand executives specifically rejected forward looking tools such as DCF and the use of survey based measures of consumer perceptions of the brand since these were considered to be "soft" (Birkin 1996).

Haigh left Interbrand in 1996 to launch his own brand consultancy called Brand Finance Limited (IPA 1998). His methodology for valuing brands is an Interbrand hybrid, but with several modifications. In a publication dated 1996 Haigh describes the Interbrand approach in the same terms as it had been described since Penrose (1989) first described it publicly. In

the same publication (IPA 1996) Haigh describes a forward-looking alternative.

The Interbrand approach described by Batchelor (1998) is clearly a change from the original. This is confirmed by Trevillion and Perrier (1999). Between 1996 and about 1997, Interbrand had rejected its original precepts and adopted a forward looking, marketing linked approach.

Batchelor (1998), a senior employee of Interbrand, goes so far as to criticise the original model focusing specifically on the inadequacy of multiples and in using past performance as a basis for establishing the brand generated profit for the base year. It is possible that the new approach was devised at the same time as the multiple of historic earnings methodology, but not used due to pressure from clients to be auditable and objective. Writing in 1991,Birkin (1991:188) states:

> *"Notwithstanding this (the reasons for not using DFC), the Interbrand approach .... has been adapted to value brands on a DFC basis." (p.. 188)*

These two valuation methodologies (Interbrand and Brand Finance) are commercial approaches marketed in a competitive market. Since they appear to dominate the market, they are described here. It must be emphasised that they are described using information commercially available. Neither is the subject of contemporary academic papers and little scholarly literature exists from which to draw empirical support. Such underlying theory that may exist (corporate finance, accounting, legal and marketing) is referred to by writers about the approaches casually without reference.

5.7.1 Interbrand

The DCF version of the Interbrand method is grounded on three considerations: the financial performance; the brand's marketing strength; and the brand's legal position (Batchelor 1998).

5.7.1.1 Financial performance

Brand earnings and profit before interest and taxation are examined along with management forecasts for the next five years. The reasonableness of these forecasts is judged against the historical analysis. If no management forecasts are available, it is implied that this is prepared by Interbrand. The previous use of three years weighted average profit has been discarded.

Based on the concept of Economic Value Added, a charge is made against the capital employed to isolate the value the brand is adding to the business. The result is the Earnings from Intangibles.

A tool called the Role of Branding Index (not used in the previous model) has been introduced to identify what would be lost if the brand was no longer available to the business. The result is applied to the Earnings from Intangibles to produce the before tax earnings from the brand. Taxation at the corporate rate of tax in the country in which the brand is being valued is then deducted. This approach is similar to the dilution tool used in the Wits University (BrandMetrics') methodology (see Chapter Six). The difference being that Interbrand derives the drivers from interviews while the Wits approach derives its by way of a Delphi type iterative survey of experts.

5.7.1.2 Marketing strength of the brand

Table 6 Interbrand's List of Brand Attributes

Brand Attribute	**Explanation**	**Maximum score**
Market	Analysis of the market in which the brand is sold. Stable with high barriers to entry or vice verse	10
Stability	The extent to which the brand is established in its market	15
Leadership	If the brand dominates the market or not	25
Trend	Analysis of the long term future of the brand	10
Support	The extent of support the brand has been given	10
Geography	Those brands that have global franchises or potential are viewed as more valuable than those with limited geographical penetration	25
Protection	A measure of the brand's legal protection	5
TOTAL		**100**

Source: Trevillion and Perrier 1999:36

Whereas the brand strength scores based on the seven attributes of a brand (Table 6) were, in the original model, used to determine the multiple, this device is now used to evaluate the brand risk.

Based on a risk free rate such as government bonds, the risk premium is a function of scores derived from the above analysis. A brand scoring 100 out of 100 would attract "a slightly higher discount rate" (than the risk free rate). At the 50/100 level the premium would take the discount rate to: "a level that is broadly in line with the average performance of branded goods companies." (We suppose this to mean that the rate would be

based on the average of the brand's industry sector). A brand scoring the weakest score of 0/100 would be: "discounted to infinity".

From available literature it is not clear if the period for which brand earnings are projected is five years or if some other device is used to project the future economic benefits. If it is five years no distinction is then made between short and long-lived brands.

Commentary.

The Interbrand approach has been used, in its original conception, to value over 2 500 brands. Presumably its clients have accepted the change from the original to the, for them, new approach. Possible areas of weakness are in the Role of Branding, the duration of the projected earnings and the selection of the discount rate.

a. There is little explanation about the source of the factors used in this device. They are apparently obtained from interviews, market research or market observation. In view of the company's experience in this field it should be able to produce a normative list of factors. The importance of this aspect of the valuation calls for a high degree of reliability on this element that is not made clear in the supporting evidence. Aaker (1996) sums up the general concern with this approach in the following terms:

   "The subjectivity of both the criteria and the assessment of the brands, however, makes the dimensions difficult to defend and affects the reliability of the resulting measures." (p. 314)

b. According to Trevillion and Perrier (1999:34) a five-year forecast is used. No comment is made about how this might be scaled up further to reflect the strength of the brand. The Brand Strength

derived from its evaluation of seven attributes does not fulfil this role:

" ... (it) reflects the relative security or "riskiness" of the brand's future earnings and which thus determines the discount rate to be applied." (p. 37)

c The ability of a brand to achieve long-term profits for its owner is more a function of consumer brand equity than a risk adjusted discount rate. The latter is a device developed to take account of economic risk in financial markets and for the evaluation of capital projects. It is the correct use of the risk adjusted cost of capital to adjust the brand after tax earnings to reflect the incremental profits over a non-branded version, but using it in the scaling up phase ignores the competitive environment.

5.7.2 Brand Finance

Not surprisingly (due to the relationship between the owner of Brand Finance and his major competitor, recently his employee, Interbrand), there are striking similarities between the current Interbrand approach and that marketed by Brand Finance. Both claim "economic use" as the basis for their calculations. This is described as a valuation of the brand as it stands in the current owner's hands. It considers the return the current owner actually achieves from owning the brand as opposed to its value to a third party or including any "hope" value.

If this is meant to imply the contribution the brand makes to the asset value of the business, this is a reasonable claim. Both methodologies are based on the current profits earned by the brand, scaled up to future earnings by way of management forecasts of five to ten year forecasted earnings. Each discount these earnings back to present value using a risk

adjusted discount rate. They differ in the method used to estimate the risk premium. The capitalised present value is the brand value.

Using a property analogy, this is the present worth of the asset. The return would then be the rentals that the firm could earn from the asset. The return for the brand would be the net earnings that the brand generates expressed as a percentage of the current value of the asset. These two variables (earnings and brand value) are highly correlated in that forecasted earnings are the basis of the DFC calculation. Any change in earnings would immediately affect the brand value. It is questionable therefore that this methodology could be used to calculate return on the brand asset.

The methodology is in four parts: financial analysis, branded analysis, brand risk analysis and legal analysis.

5.7.2.1 Financial analysis

The initial calculations are similar to those described by Interbrand. Brand revenues are obtained for each segment of the branded business. This is the lowest level for which there is brand accounting. Gross revenues are reduced by any non-brand sales such as those resulting from own label production.

Costs associated with the production and sale of the brand are identified and deducted, including allocations of central overheads. Forecasts based on management budgets for the following five to ten years are then extrapolated. These are tested for reasonableness. The method used for this test is not described.

A fair charge is made for the value of the tangible assets employed in the business. This is equivalent to the corporate finance theory of super

profits over and above the cost of capital. However in this case a nominal rate of interest is selected.

Taxation is deducted at the corporate rate of tax applicable in the jurisdiction concerned.

5.7.2.2 Brand Value Added

Brand Finance uses what it called a "judgemental approach" to estimating the portion of the remaining profits for which the brand is responsible. The well known statistical approach of conjoint analysis is, typically, used(there is no indication of how this is used). When "large sample" trade off analysis is used to identify the dimensions the system is said to produce reliable conclusions. No tests for external validity to support this claim are exhibited. The implication is that the statistical approach is not always conducted and nothing is said about the approach then used to produce what Brand Finance calls: Brand Value Added (BVA) ™. It is assumed that this analysis, whichever way it is conducted, results in a percentage by which the brand profits are reduced.

5.7.2.3 Brand Beta

Brand Finance uses the risk premium element of the DCF discount rate to account for the likelihood of a brand being able to produce the earnings attributed to it in the cash flow forecasts. Haigh (1996, 1998) is consistent in his criticism of the approach used by Interbrand for evaluating the risk. He states:

> *"As a consequence of these criticisms (of the Interbrand approach) Brand Finance developed an alternative approach to discount rate determination grounded in acceptable investment theory." (Haigh 1998:23)*

The approach entails the following:

a. A risk free rate is selected. This is usually the ten-year government bond yield in the market concerned.

b. By reference to the local stock market investment data providers an average risk premium is identified for each industry category to be measured.

c. A device called BrandBeta™ analysis is used for this purpose. A list of factors influencing brand performance is evaluated. Each factor is marked out of ten from data made available through company records or research. When summed out of 100 a score is produced which Brand Finance compares with a credit rating. 100/100 is a brand with no risk attached; 50/100 is average for the category; and 0/100 is risk associated with an unbranded product.

d. The vertical scale of a cross-tabulated table is calibrated 0 to 2. The average risk premium mentioned in (b) above is given the mean score of 1. The ideal brand is half this score and the unbranded double. Added to the risk free rate, the discount rate is used to discount the projected five to ten year brand earnings to present value.

e. Because brands are, generally speaking, long-lived, an annuity is applied to the final year's earnings.

Commentary.

The Brand Finance methodology differs from Interbrand in two substantive ways: the manner in which the risk premium is estimated and the use of an annuity to represent the long lived potential of the brand. Other areas of difference are matters of degree. For example the mechanism used to

reduce brand after tax profits to represent the brand only earnings is based on trade off analysis and conjoint analysis. This approach requires large sample market research to obtain the factors and dimensions and have them rated by a knowledgeable sample of respondents.

a Risk premium: The BrandBeta analysis is a quasi investment tool using the rating approach of credit rating agencies. Low risk brands achieving scores from 91 – 100 on the scoring template are rated AAA. Brands scoring 0 – 10 are rated D. While the device used to calculate these scores uses verifiable information, the allocation of the resulting risk premium appears to have been arbitrarily chosen. The average is selected according to the procedure described in 5.3.2.3 (b) above. This is assigned a score of 1 on the BrandBeta axis. The extremes are then anchored at double this and half this score. No explanation as to why these multipliers are chosen is provided.

b Annuity: In an example of how the Brand Finance approach works in practice the five year discounted cash flow gives a value of 152.4. This has been produced by projecting the brand profit for five years, discounting it to present value using a 15% discount rate, and capitalising the present value. An annuity is then applied to the earnings in the final, or fifth, year. This produces an increment of 135.3 and a total value of 287.7 (152.4 + 135.3). In the example the two are incorrectly summed to 303.6. (The approach is in fact a perpetuity since no term is stated and 20.3/0.15 = 135.3, as suggested by Srivastava and Shocker (1991:18).

The use of perpetuity beyond the five-year horizon assumes that the brand will continue to generate earnings at a constant rate into the future. This is not a conservative approach and ignores the rule of forecasting that long term forecasts tend to be more

inaccurate than short term forecasts (Shim and Siegel 1988:245). If projections are to be made to distant horizons, they should at the least take account of the growing uncertainty of the data. The fact that the annuity is 89% of the carefully constructed discounted value to five years should signal a warning to the valuer of the danger implicit in this technique.

5.8 Brand Evaluation

Keller (1998) draws a distinction between the sources of brand equity and its outcomes. This stems from his conceptualisation of brand equity which places it firmly in the mind of the consumer. While the outcome is the value of the brand, measured by one of the approaches described in this chapter and the next, the sources that bring about the value are measured by systems that evaluate the strength of the brand in consumer memory.

It has been argued that the division between the source and the outcome is the stumbling block in using brand equity as a means of managing and measuring brand equity. The outcome is said to be of use in financial transactions and for financial statements, the same value is of limited use as a marketing metric because the extant valuation methodologies are based on profit, ownership and cost structures. They do not incorporate measures that are at their core: buyer attitudes and behaviour.[vii]

That implies the need for a comprehensive model that merges both the needs of the financial and marketing functions: a requirement fulfilled by the Wits valuation methodology described in Chapter Six.

Many commercial organisations have devised models designed to measure sources of brand equity. These make performance claims with suspect motives. Most of these have been developed by enterprises with a vested interest in what their models produce. The Young and Rubicam

Brand Asset Valuator (Keller 1998) was developed after an extensive global survey of brands and their equity. The study was designed to explain the brand equity of some 500 global and 8 000 local brands in 27 countries. Arising from this research is the brand building sequence that the authors claim brands must progress through. The four development pillars are Differentiation; Relevance; Esteem and Knowledge and, brands are claimed to move, sequentially though these as they progress through their life cycle.. New brands will start with equally low levels of each. As they grow each pillar will grow in sequence until all four pillars reach their optimal levels. As brands decline they start to lose their differentiation and relevance maintaining esteem and knowledge.

The Power Grid is a device designed to position a brand according to these four pillars and track the brand's position. The agency uses this research to advise clients where the brand is positioned. Marketing strategy is then developed to maximise or defend the brand's position within the Power Grid. Communication is a key component in that strategy with advertising being called on to build and maintain the brand.

Other commercial approaches include Total Research's Equitrend (Aaker 1996). Taylor Nelson Sofres' Conversion Model; Milward Brown's Brand Pulse (see Haigh 1996 for a brief summary of these two) and Aaker's Brand Equity Ten (Aaker 1996). [viii]

5.9 Concluding discussion

PriceWaterhouseCoopers (Eccles et al 2001) have argued the case for value reporting. They take the view that corporate reporting is in need of radical review and that the traditional approaches to the provision of information to investors by the stewards of that information in management and their accounting advisers, is inadequate. They state:

"Rather than simply reporting financial performance and assuming that it completely captures the value the company creates, managers should also provide information on the quality of the assets in its (sic) Value Platform and how it manages them to create shareholder value." (p. 214)

The Value Platform is a device they introduce to define a company's assets that includes its people and innovations and its customers, brands, suppliers and reputation. Brand equity is one of the areas that they list as being missing from current reporting and which creates a "large" gap in the information supplied by managers to investors. It should be noted that this book was finished after the collapse of equity markets was well under way . In fact the authors trace the start of the so-called melt down to a single day in April 2000 when NASDAQ registered its most dramatic and volatile performance. Thus the proposals made in the book were not penned when value was at its peak with high market to book ratios.

There appears to be a very real need for methods of reporting assets which drive shareholder value and which are not currently included in formal accounting methods. In this chapter the approach to valuing brands has been examined and found to be wanting. The methods devised at the start of the 1990s were too technical and academic and most failed to survive beyond the scholarly environment which stimulated their creation. The most popular methodology and its major derivative was criticised in the MSI brand equity literature and subsequent books (Aaker 1991) for being too subjective and lacking external validity, and yet it remains the major tool used today to measure brands.

End notes

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[i] For example Chrysler and C-to-C cigarettes were both once leading SA brands that are no longer available. More recently John Orr, Levison and Deans announced their closure.

[ii] Aaker publishes a list which compares the leading brands in 1925 and 1985. In the twenty-two categories listed, in only three cases are the leaders of 1925 no longer

leaders sixty-one years later. Those three have slipped either to number two position, or in one case to number five. None have fallen off the list. The list was originally produced by The Boston Consulting Group and published in *Perspectives* in 1987.

[iii] In the *BusinessWeek* survey (6 August 2001) of The 100 Top Brands, Coca Cola is given a value of $68,95 billion.

[iv] The IMC concept was sponsored by Don Schultz who describes it in the book authored with Stanley Tannenbaum and Robert Lauterborn, *Integrated Marketing Communications* published in 1993 by the NTC Publishing Group. Shimp (1997) gives a thorough review of the approach. In short it recognises that advertising alone cannot achieve the goals typically set for it, it works only when integrated with the other elements of the communications mix.

[v] The reference cited is Management Science pp 528-539 – January 1976. However the authors provide ample information about the Balance Model and how it is applied.

[vi] In a press release issued in 2000 in which the criteria and methodology used to conduct the values for the World's Most Valuable Brands survey were described, the writer states that the Interbrand methodology was pioneered thirteen years ago.

[vii] See Haigh (1996) for a summary of arguments advanced by Paul Feldwick, Planning Director in London of BMP DDB Needham.

[viii] With the exception of the Y & R model, these approaches have not been described because they are concerned with the source rather than the outcome of brand equity.

Chapter Six – An Alternative Valuation Approach

6.1 Introduction

In the previous chapter various approaches to the valuation of brand equity were described. It was concluded that the tendency was to devise commercial models with proprietary instruments designed to differentiate the model for competitive purposes. In the case of the original Interbrand model it was developed to avoid non-financial components. Skirting potentially troublesome issues rendered the Interbrand approach problematic in that it failed to account, for example, for consumer brand franchise, even though this concept is perfectly acceptable in corporate finance (Leibowitz 1997a). The approach also avoided the use of Discounted Cash Flow (DCF) on the grounds that it was forward looking and therefore subject to serious error in wrongly anticipating, for example, inflation (Birkin 1990). In Interbrand's revised version (Trevillion and Perrier 1999), both of these omissions were, to some extent, included.

The apparent weaknesses in the Interbrand approach (and subsequently, as well, in the Brand Finance derivative), claimed by its promoters as the world's most popular, stimulated development of the model described below . Because it was developed within an academic environment it was subjected to the rigours of scholarly examination, and used only best practice drawn from the brand equity, corporate finance, economics and accounting disciplines as its sources.

The approach brings together the discipline of finance and marketing to reflect the source of brand strength and the use to which brand valuation is put.

6.2 Definitions

Brand valuation is being used for a wide variety of uses. They range from accounting, licensing of brands, mergers and acquisition and marketing. To be acceptable in all these applications brand valuation should be grounded in firm accounting and marketing foundations.

Two definitions have guided development of our model: the accountants' definition of an asset and a generic definition of brand equity drawn from the combined work of the MSI researchers; especially Simon and Sullivan 1992; Srivastava and Shocker 1991 and the MSI definition itself (Leuthesser 1988)

6.2.1 The accounting definition

According to A.C.000 an asset is:

> *"a resource, controlled by the enterprise as a result of past events and from which future economic benefits are expected to flow to the enterprise." (Para. .49 (a))*

A resource is defined by The Oxford English Dictionary (OED 1999) as:

> *"A stock or supply of materials or assets."*

In the accounting sense a resource with an economic nature (Everingham and Watson 1999) possesses the following features:

a It may take physical form such as machinery or property but could equally be in the form of patents, copyrights which have no physical form but from which future economic benefits are expected to flow to the enterprise.

b Legal ownership is an indicator that a resource is an asset, although this is not implicit in the definition. The omission is to allow for items that may be leased, or hired, but which generate economic benefits to the enterprise.

c It has been acquired at cost although donated resources could also qualify.

d It can be separated from the rest of the business and is therefore exchangeable. Everingham and Watson qualify this by stating that goodwill is usually considered to be an asset, but in accounting terms it is itself not exchangeable.

It is clear that brands conform to this definition and are therefore assets. They are resources in terms of the above OED definition; they are controlled by the enterprise in that they were either internally generated or acquired in a business combination; and they generate economic benefits.

What is also clear from the definition is that any attempt to value an asset in terms of this definition must ascertain the present contribution the asset makes to the enterprise and must incorporate in the calculation estimates of the future economic benefits that will flow to the enterprise that controls it.

6.2.2 The marketing definition

The conclusion at the closing of the first MSI conference on brand equity was that the concept should be defined as follows:

> *"a set of associations and behaviours on the part of a brand's customers, channel members, and parent corporation that permits the brand to earn greater volume or greater margins than it could without the brand name; brand equity gives the brand a strong,*

sustainable, and differentiated advantage over competitors." (Leuthesser 1988:31)

Subsequent researchers have simplified this to a more straightforward:

"the added value endowed by the brand to the product." (Farquhar 1990: p. 7)

Or

"the incremental cash flows which accrue to branded products over and above the cash flows which would result from the sale of unbranded products." (Simon and Sullivan 1993:29)

These definitions require a valuation methodology to be able to deduct the cash flows or earnings of a non-branded product from its branded counterpart. The accounting definition makes it clear that this applies not just to the current branded earnings but the future, projected earnings as well.

In terms of these definitions a valuation methodology must incorporate the following:

a The brand's earnings from present time to a future distant horizon.

b A form of proxy or market value for the non-branded version.

c Earnings of the brand separated from the rest of the business

d The cause of the branded product earning incremental profits over a non-branded version.

6.3 Base brand earnings

According to Farquhar et al (1991) most brand valuations employ a stage that separates the cash flows attributed to the brand from other sources; and a second stage that modifies this base estimate to reflect the brand's future profitability. In this section the first stage is described.

6.3.1 Earnings or Cash Flow?

The Barwise report (1989a) clarified the various approaches to brand valuation, suggesting two stages that should normally be employed. The first stage requires the valuer to separate from other sources the current earnings or cash flows attributable specifically to the brand. In the second stage these profits are scaled up or modified to reflect the future profitability of the brand (Farquhar 1991).

Valuers have to date tended to use earnings rather than cash flow as the basis for the valuation since brand profits will in most instances equal brand cash flows (Mullen 1993). There is no recorded reason for this in the literature and while it is instinctively correct, because a brand is intangible, its value should be separate from the need for capital investments and other cash inflows and outflows that would distinguish cash flows. However, the choice needs to be tested.

Earnings are the after tax, accounting profit generated by a brand. This is the excess of money earned over money expended during a finite period of time. The time period is usually one calendar year and the after tax surplus earned during that period are credited to shareholder funds or reserves. This is the money the firm has earned and which is available to the shareholders who can decide to leave it in the business, or take it out as dividends (Brockington 1995; Gordon and Shillinglaw 1974; Brealey and Myers 1988).

Earnings do not necessarily depict the liquidity of the firm nor its viability and adaptability (Brockington 1995). A firm may be profitable according to its accounting records, but because the cash it has earned during the year is tied up in illiquid assets, it may be unable to pay its bills (Gordon and Shillinglaw 1974).

Cash flow statements differ from profit statements because they show what cash is available to management to pay creditors, invest in growth and pay dividends to the shareholders.

Forecasts of future cash flows have become a vital element in the management of modern companies. These statements provide management with information that allows it to make strategic decisions regarding the future of the company.

Cash flows are categorised under five headings: operating activities; investment activities; interest and dividends; and taxation (Everingham and Watson 1999 quoting from A.C 118).

6.3.1.1 Cash Flow from operating activities.

> A brand is an intangible asset in that it is controlled by the organisation and will generate future economic benefits. The economic benefits that are derived from sales are the cash inflows. The variable costs of achieving these sales plus the fixed costs associated with brand revenues are deducted from the inflow to arrive at brand profit. Profit subsumes the amounts owed to creditors and owed by debtors, regardless of the terms under which the amounts will be paid. Also included in profit will be the depreciation of assets. This is a book entry and does not affect the cash position of the firm. This is the distinction between profit and cash flow. Profit includes non-cash amounts that must be allowed for in the accounts but which do not impinge on the

availability of cash (see Brockington 1995 and Everingham and Watson 1999).

Brands tend to be unaffected by this distinction. Forecasts of operating inflows and outflows cannot take into account the timing of cash availability. Terms to pay for supplies and to be paid for goods supplied by retailers will be corporate negotiations and could change because, for example, of the relationship the key account manager has with a channel member. Brand valuation is based on the net profits the brand itself will generate, separated from other aspects of the business, and apart from the tangible assets needed to produce it. Consequently its does not have to carry the amortised costs of its assets.

6.3.1.2 Cash flow from investing activity

This item refers to investments in resources that will further enhance the generation of future income (Everingham and Watson 1999). The type of investment envisaged is listed in the cited work and includes, *inter alia*, the purchase of property, plant and equipment, intangible assets such as development costs. A brand owner, in the interests of innovation and brand extension, might incur the latter. However, it is unreasonable to anticipate this type of expenditure unless a previous pattern has been established. Brand valuers should carefully examine historical records to test this possibility.

Other items under this heading are the receipt of payments from the sale of resources; advances and loans; payments and receipts for forward contracts.

With the exception of the intangible item referred to in the first paragraph, investment is not relevant to the calculation of brand value and should not be considered.

6.3.1.3 Cash flow from financing activity

A company is routinely involved in the raising of capital to finance its future activities. Financing in this context refers to cash proceeds from the issuing of shares and other equity instruments; the redemption of the enterprise's shares; proceeds from debentures, loans and other short-term borings; cash repayments of moneys borrowed; and, the flow of cash in regard to leased equipment.

6.3.1.4 Cash flow from interest and dividends

Companies distribute a portion of net profit after tax to shareholders in the form of dividends and pay interest on amounts borrowed. These are expenses and incomes that occur at the corporate level. Amounts paid and earned are subject to corporate decisions and should not be included in the costs associated with a single brand. Birkin (1990) argues that should interest be included the valuation could be materially affected by a change in corporate financing arrangements.

6.3.1.5 Cash flow from taxation

Taxation in this context refers to tax commitments arising from financing and investment activities. Since brands are not involved in this taxation is not applicable. It is however relevant to the operating profits. Birkin (1990) states that valuations are based on after tax profits which makes it important to ensure that all revenues

are collected on the same basis so that a single tax rate can be applied to each year's calculation.

Because the choice is regularly indicated in the brand valuation literature (see for example Farquhar et al 1991; Mullin 1993; Birkin 1990), it is important to understand the distinction between earnings and cash flow. However, it is not necessary to use cash flow for brand valuations because the valuation is not concerned with the availability of cash in each projected year. In the valuation calculations there is no call, for example, to take account of inventory minimisation, or to bring in outstanding debtors; neither is there a call to incorporate the benefits of obtaining longer credit lines from suppliers (Lee 1992). Additionally, there are no receipts or payments involved in the trading accounts of a brand that would not be captured in the net profit calculations or projections. It is reasonable to assume therefore that in the case of most brand valuations earnings equals cash flow.

The use of Discounted Cash Flow (DCF) as a device to calculate the present value of brand profits is therefore a misnomer since it is discounting a future stream of earnings and not cash flows. But in this context, it is no less valid.

6.4 Profit from Brand Premium.

To arrive at brand earnings the valuer starts by identifying brand revenues and deducting the cost of sales, the costs associated with selling (marketing and sales) the brand, other variable and fixed costs and the charges debited to the brand to cover its share of general and administrative expenses (see for example McDonald and May 1995).

Brand revenues exclude those credited to the brand but not earned under the brand name. Two examples of this would be a Fast Moving Consumer Good (FMCG) brand that packs its product for retailer own brands. These

revenues are incremental brand revenues but are sometimes included in the brand's income stream. This form of product is not sold under the brand name and should be accounted for separately. In some instances this may require judgement as to what portion of these revenues is brand related and which is not.

The second example is a TV station that sells its outdoor broadcast unit spare capacity. The station uses the outdoor units in the production of its product offering. When not in use other TV stations may use them for their own purposes. The brand valuer would have to use judgement in assessing what proportion of this revenue stream, less the relevant costs, should be allocated to brand revenues and which should be eliminated so as not to overstate the brand related revenues.

To arrive at the brand gross profit, all costs must be deducted. This includes the cost of sales, variable costs such as packaging and fixed costs that the brand must carry such as marketing and contribution to central overheads and administration. In the case of financial services, these costs would include commissions to brokers and agents and administration costs. As Birkin (1990) explains this will be before interest and finance charges. Interest rates are negotiated at corporate level and are not relevant to the valuation of a brand because the basis of funding has nothing to do with the brand's performance. Further, changes in interest rates will have a significant affect on brand value even though they are unrelated to the brand. They are therefore normally excluded from the calculations.

Once these costs have been deducted the average tax rate is applied to the result.

6.5 Separating the Brand from the Product

The approaches to brand valuation covered in the previous chapter fail to find a way of identifying the non-branded version. Either, as is the case with Simon and Sullivan, the idea is introduced in the definition and then not pursued, or it is felt to be too hard to define. The usual argument is that no market exists for most brands or no generic equivalent is available for comparison. (see for example Kapferer 1997; Keller 1998)

We have drawn on the corporate finance literature to find a solution and in particular the concept known as the "franchise margin" which Leibowitz (1997a) defines as:

> *"the incremental margin on a given product beyond what could be realised by a new "commodity competitor" who would be content to just earn back the cost of capital." (p. x)*

Franchise margin is more commonly known as "economic rents" or the excess of profits over and above the opportunity cost of capital (Brealey and Myers 1988). It is usually assumed that economic rents would be short lived because if they were sustained for any length of time, the firms in the industry would expand, and firms outside the industry would be attracted to enter it.

Brealey and Myers argue that these extra profits are unstable because if a marketer is first-to-market with a new, improved product for which consumers were willing to pay a premium price, it would not be long before competitors entered the market and squeezed down prices. A patent that cannot be matched for several years might be sustainable, as might an exclusive supply of raw materials, or a proprietary technology. Apart from these exceptions, these writers are firm on the point that most companies earn no more and no less than the opportunity cost of capital.

Conversely, Leibowitz (1997a) believes that:

> *" in markets where cost of production efficiencies do not create any persistent benefits, the majority of the franchise margin will be derived from the company's ability to extract a better price per unit of sales ... In this sense , the franchise margin truly represents the special value of the brand." (p. 2)*

Adam Smith (quoted in Ehrbar 1998) made this point over two centuries ago when he proposed that:

> *" .. . a business has to produce a minimum, competitive return on all the capital invested in it." (p.2)*

Stern and Stewart (see Ehrbar 1998) has captured this concept with their Economic Value Added (EVA) equation:

> EVA = NOPAT – C%(TC)

Where NOPAT is the Net Operating Profits After Tax; C% is the percentage cost of capital, and TC is total capital. The latter comprises both debt and equity (Ehrbar 1998)

Stern and Stewart has built an entire business around measuring the extent to which firms are able to add value above the cost of capital (Ehrbar 198)

The device commonly used to calculate the Weighted Average Cost of Capital (WACC) is the Capital Asset Pricing Model (CAPM). Based on the premise that there are two sources of finance for capital: debt and equity, the model weights each of these within a company according to the proportion of each used; the after tax interest paid on the debt portion and

the risk adjusted interest rate associated with the equity portion taking into account a risk free rate, risk premium and market beta.

The equation for this calculation is as follows:

$$K = W_D K_D + W_E K_E$$

where:

K = cost of capital

W_D = weight of the debt structure in the firm

W_E = weight of equity structure in the firm

K_D = after tax cost of debt

K_E = cost of equity

The cost of equity is adjusted to reflect the risk associated with the investment. In security markets the β - coefficient [i] is the relationship a share has with its market portfolio. A β of 1 means that the returns generated by the share are perfectly aligned with returns of the market portfolio. In other words the risk associated with an investment in the share is in line with the risk associated with the portfolio overall. A β of less than 1 indicates that the share is less risky than the portfolio of shares, while a β greater than 1 implies that the share has a tendency to either over or under perform the portfolio, and therefore has unique characteristics which makes it a risky investment from which a higher than average return should be expected.

Given the β -coefficient for the firm, or for a firm with a similar exposure to risk (betas, based on data from the JSE Securities Exchange, can be obtained from various sources including the Bureau for Financial Analysis (BFA)), the cost of equity can be estimated using the following formula;

$$K_E = r_f + \beta(r_m - r_f)$$

where:

r_f = risk free interest rate

r_m = expected return of the market

β = the systematic risk

Thus the discount rate that CAPM produces is a sensitive measure of the item being analysed relevant to its own environment and that of the market sector in which it operates.

The power of this model relative to the brand valuation task can be summed up as follows:

a It is a proxy for the non branded version, or what Leibowitz (1997a) calls a commodity competitor. This is because the commodity competitor is happy to earn no more than the cost of capital. By definition a brand must add economic value and earn economic rents for its owner.

b Because the brand is an asset (intangible) the weighted average cost of capital is an appropriate discount rate for discounting the future cash flows.

c The presence in the equation of market betas and risk premiums penalises high-risk brands and rewards those that are well managed and profitable.

In claiming that brands, patents, unique images, protected distribution systems, or other forms of intellectual property that enable the firm to extract excess profits have special pricing power, Leibowitz is not going

against the generally accepted principle of economic rents being short-lived, except in conditions of monopoly. He states:

> *"In today's competitive environment few products can count on long "franchise runs" with fully sustained profitability. At some point the tariff barrier erodes, the patent expiries, the distribution channel is penetrated, the competition is mobilised, or the fashion simply shifts." (1997a. p.2)*

What this points to is the need for firms to constantly review their brands and markets to find ways to sustain the pricing power needed to achieve positive franchise margins, and to look tirelessly for new market opportunities to maintain this pricing benefit. This has been the strength of market leaders such as Coca-Cola, McDonalds, Microsoft and General Electric.

The extent to which a brand owner is capable of this level of brand marketing is captured, partially, in the CAPM equation with its risk adjusting components.

6.6 Brand Influence on Incremental Profit

The "Super" profits that a firm earns over and above the cost of capital results from intangible resources the firm has developed. These include, among others strong leadership, management of costs, special knowledge and processes; patented computer programs and famous trademarks or brands. These are intangibles that in this process have been named the resource-set.

6.6.1 Intangible resources

In accounting terms an asset must be capable of being identified separately so that if it is sold it may be disposed of without affecting the rest of the business. Brand valuation must therefore deal with the portion of the brand's premium profits (those that it earns over and above the cost of capital, or the approximated non-branded version) that would be earned by the brand regardless of its ownership. In other words all sources of profit not directly attributable to the brand's equity must be expunged.

A brand is intangible and exists only in the minds of the public who know the name and recognise the brand symbols. Its influence could apply to the selection and repeat purchase of the brand by consumers (loyalty); the willingness of suppliers to sell their raw materials to the brand owner at a keener price because of the consistency of demand and retail distribution channels that will stock the brand because it is well known. Media brands will attract advertising because advertisers know that the newspaper, radio station or television channel has a sound following. Financial markets will respond more positively if a major bank invests its funds in a particular way and thus achieves a more favourable return on investment than a smaller lesser know financial institution.

Reekie and Crook (1995) describe this phenomenon as signalling [ii] which they define as:

> *"where a buyer invests in an attribute which signals that he or she is a low risk partner." (p. 67)*

The concept is introduced in the context of labour markets (see as well Mankiw 1997), but in non-labour markets it is a well-known phenomenon as well. Reekie and Crook (1995) list, among other attributes that signal information about the firm, financial soundness, guarantees and brand-

name advertising. It is the latter signal that may be picked up by many partners in the brand marketing process that invests the brand with its value. Reekie and Crook liken branding and the investment marketers apply to it to:

> *"posting a bond" which will be forfeited if post-contractually the product is found not to be up to expectations." (p. 68)*

The qualities embedded in the brand name are signalled to more than just the end consumer. They refer, as well, to the labour market where well-qualified individuals might wish to join a company that markets well-known and strong brands. But it is not the brand alone that drives incremental profits.

The Durban based bank, NBS, attracts deposits from clients and pays out on demand. A large portion of its profit is derived from management of the margin between deposits and withdrawals. The bank's ability to achieve this margin is mainly to do with the skill of the money market specialists the bank employs and the quantum of money they have available to invest. But the brand plays a role too. The brand signals to the money market that the NBS is a consistent source of funds that require investment. That signal would make the bank a desirable, identified customer.

The *Sunday Times* sells close to 450 000 copies each week. This is mainly due to consumer demand for the brand. But it is also made possible by the distribution network made available to the publishers by its distribution set-up that ensures that copies are delivered to street sales points, stores and private addresses.

These two (demand by readers and the cost of distribution) and the NBS margin management attribute mentioned earlier are just a few of the generators of incremental profit, additional to the brand. They are unique

to the brand and since they are resources (Hunt and Morgan 1995) that the company controls and which generate economic benefits, are assets.

6.6.2 Market -based assets

A firm's market value is usually estimated by calculating the discounted present value of its expected cash flows. Traditionally these were estimated on the basis of the tangible assets listed in the firm's annual financial statements. Over the past twenty years, investors have valued public companies, increasingly, on the basis of their intangible assets in additional to the tangible values. On many stock exchanges this ratio of intangible to tangible is as high as 4:1 in favour of intangibles (Sveiby 1998). Even though several attempts have been made to decompose the market to book ratio so as to better understand what the intangibles are that drive it (Simon and Sullivan 1993; Lev 1997; Srivastava, Shervani and Fahey 1998), no general agreement has yet been reached as to what they are and their relative importance. There are indications, as reported in Kerin and Sethuraman (1998:270) whose research showed that brands explain as much as 40% of the market to book ratio of the Finance World listing of "The World's Most Valuable Brands." [iii]

Srivastava, et al (1998) provide a conceptual framework that links marketing to finance and in particular establishes a link between market based assets and shareholder value.

It is probable that the examples given above (NBS and Sunday Times) are market-based assets which are defined as assets that add shareholder value. The conditions under which these assets achieve this are when they conform to the following:

a The resource is convertible in that it can be utilised in a variety of ways to exploit an opportunity or combat a competitive threat.

b It is rare in that it is not available to competitors or is only available in lesser quantities.

c The asset is imperfectly imitable in that rivals will find it hard or impossible to replicate.

d It does not have perfect substitutes in that strategically equivalent convertible assets are not available, and it is difficult to develop them.

The accounting definition of an asset (A.C.000) includes the requirement that future economic benefits must flow from them to the enterprise. This could occur if the asset is exchanged for other assets such as cash or if it is used to settle a liability (Faul et al 1999). However the true value of an asset to an organisation is its value in use, or as Faul et al put it, if the asset is:

> *"used singly or in combination with other asses in the production of goods and services sold by the organisation." (p.35)*

Typically these tangible assets are property, plant and equipment, raw materials, supplies, inventory and finished products. Companies can utilise these assets to their economic benefit by deploying them in at least five ways as illustrated in Table 7.

Table 7. How Assets Work for a Firm

Benefit	Tangible asset	Intangible asset
Lower costs	Enhance productivity	Lower sales and serving costs arising through superior relationships with and knowledge of channels

		and customers
Attain price premiums	Revenues are enhanced through sourcing higher quality raw materials, between equipment that results in superior product functionality, features and durability	High perceived value arising from building both customer and channel equity
Generate competitive barriers	Force others to make similar investments	Create high switching costs thus reducing both customer and channel propensity to buy alternatives
Provide a competitive edge	Superiority can lead to improved working conditions, more loyal and productive staff: other assets (e.g. employees) therefore gain in value.	Heighten marketing effectiveness through greater customer satisfaction
Provide managerial options	Share plant or equipment across products	Greater equity leads to increased customer trial and opportunities for brand extension

Source: adapted from Srivastava et al 1998

This analysis attempts to show that intangible resources are as likely to generate future economic benefits as the tangible assets that have traditionally featured on company balance sheets. Whereas it is the physical properties of the tangible asset that create this capacity, intangible resources, having by definition no form or shape, are judged by other means. Srivastava et al identify knowledge and relationships as the basic signals. They justify this by demonstrating that these two are more likely to meet the requirements of the resource-based test listed above (a to d) than most tangibles. They will create value by exploiting the firm's tangible assets because the stronger the relationship a firm has with its channel and customers the wider the range the tangible assets will be called upon to produce and the better the firm will be able to utilise its tangible assets to respond to new features and different functions. In addition they form a sound base for firms to maximise the use of its tangible assets to take advantage of the network of partners and associates which comprise the firm's market environment.

This contention is supported by a rich stream of research into the related concepts of relationships and knowledge (ibid. p5). [iv] In the brand equity, customer satisfaction and strategic relationship literature, the need for superior relationships with and knowledge about the customer and his/her buying behaviour is constantly underlined as a precursor to sustainable competitive advantage.[v]

6.6.3 Identifying intangible resources

The distinction between intangible resources that are recognised as assets and those which serve other purposes is not clear. For example there are those that accountants recognise as intangible assets; those that the financial community use as signals to justify a positive gap between market and book value (Tobin's q), and there are the set of resources that generate the superior profits that successful firms earn over and above the cost of capital. Accounting standard A.C.129 categorises intangible

resources as scientific or technical knowledge, design and implementation of new processes or systems, licences, intellectual property, market knowledge and trademarks (including publishing titles and brand names. These are described as resources, because in terms of the accounting standards not all will be recognised as intangible assets (see Chapter Three).

Whether or not they are recognised by the accountants as assets they could be part of the set of resources that account for the premium over book value created by investors and analysts, and they could form part of the resource set that is responsible for firms earning profits in excess of their cost of capital.

a These resources become accounting intangible assets if it is probable the future economic benefits that are attributable to the asset will flow to the enterprise, and that the cost of the asset can be reliably measured (A.C.129).

b They contribute to the market to book ratio if they produce, according to the investment community, positive net present value of future cash flows (Brealey and Myers 1988). [vi]

c They form part of the resource set that drives the superior profits of firms that earn in excess of their cost of capital (Srinivasan et al 1998) - if they conform to the criteria as set out above (6.6.2.a - d).

The three sets have been classified according to their source and named the accounting set, the capital market set and the resource set. Table 8 lists the resource items ascribed to each by the sources cited.

Table 8. Identified Intangible Resources

Accounting set (6.6.3.1)	Capital market set (6.6.3.2)	Resource set ** (6.6.3.3)
Computer software	Brand name *	Brand awareness
Patents	Patented technology *	Brand image
Copyrights	Proprietary database *	Customer relationships
Motion picture films	Software copyright *	Speed to market of new products
Customer lists	Publishing title *	Fast market penetration of new products
Mortgage servicing rights	Current and past advertising #	Strategic/ network partnerships
Fishing licences	Age of a brand #	Strong installed customer base
Import quotas	Order of entry #	Brand extensions: leveraging brand equity
Franchises	Research and Development ‡	Price premiums
Customer or supplier relationships	Unique product features ‡	High customer switching costs
Customer loyalty	Consistent product quality ‡	Management of costs
Market share	Favourable distribution arrangements ‡ #	Management of working capital
Marketing rights	Sales and Marketing efficiencies #	Management of fixed investments
	Management efficiencies #	Supply chain management
		Customer satisfaction
		Customer retention

Long term value of loyal customers. Exploitation of relationships
Technological innovation

Sources [vii]: * Mullen 1993; # Simon and Sullivan 1993; ǂ Srivastava and Shocker 1991; # Weston Anson 1997; ** Srivastava et al 1998

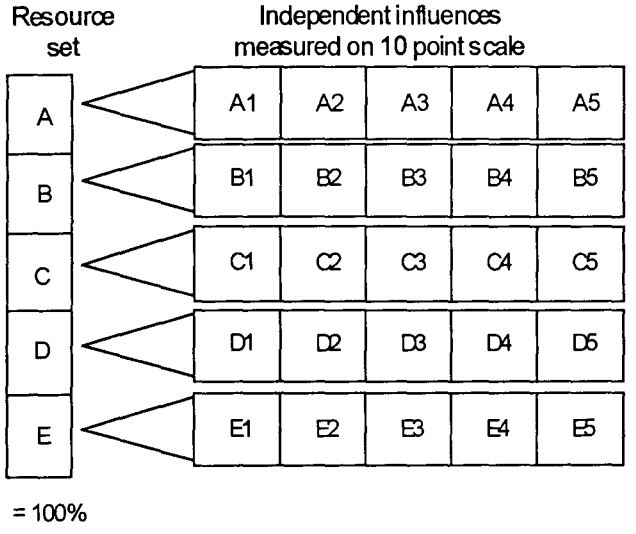
These lists are not exhaustive. They never could be because it is impossible to know all the drivers of incremental profit. These added value cash flows arise mainly from exogenous perceptions: that is views, opinions and attitudes held by suppliers, capital providers, risk bearers, customers and suppliers. (Reekie and Crook 1995).

In Figure 10 this discussion is summarised in graphic form. Using the device described in the next section (6.6.3.1), the resources most likely to be responsible for the generation of "super" profits are identified and are indicated in the figure by A ... E. Each of these resources in turn is considered to be dependent on a discrete combination of variables – hence the title of the model. By definition brand valuation is only concerned with the influence of the brand equity variable and, in this methodology, the non brand variables are neither identified nor measured.

It is assumed that brand equity has a differential influence on each of the variables in turn. Measured on a ten point scale anchored by 0 and 10, this influence may be 0, or the brand may play no role in that variable generating profits. This might be the case, for example, when a monopoly exists and there is no competition, or in the case of quality of raw materials. On the other hand it may be as high as 10 in the case of brand name. It is important to note that brand equity is different from brand, which might be a resource. Brand is the brand name, or trademark in its

symbolic form. Brand Equity is the influence exerted by consumers of the category who have built up Brand Knowledge.

Figure 10. The Resource Dependence Approach



An approach is therefore needed to identify the resource set (A ... E) and then quantify the influence of brand equity on the set. Expressed as a percentage this quantification is the portion of "super" profits generated by the brand alone.

6.6.3.1 The Delphi Approach

Brand valuation measures brand equity, or the brand asset. To do this it must strip out the brand related portions of the incremental profit after the cost of capital has been charged. The above discussion has indicated that any number of resources could bring about this superior profit performance. In addition the brand name and its reputation might exert a greater or lesser influence in any or all of those resources performing their role. Since they are qualitative by nature and cannot be calculated quantitatively [viii] and since they will vary from company to company, a case specific, qualitative method is required to identity them.

In the forecasting literature approaches are categorised into methods that are judgemental, extrapolative and causal (Fildes in Makridakis and Wheelwright 1987). The task of identifying and quantifying the resources that drive incremental profits is closely allied to forecasting in that it is an abstract process that places a value on the unknown.

Extrapolative approaches require quantitative variables and tend to build on historic trends drawn from existing data sets. The historic trend is then projected and is measured at time *t*.

Causal models also identify a variable to be forecast but link this to the factors that have historically caused it. The established relationship between the variable and factors are used for the forecast.

Judgmental forecasting is conducted either by individuals making judgements about the future; draws from the collective knowledge of a committee (known as well as the Jury of Executive Opinion) working together; or by the Delphi Approach, which is conducted in a series of rounds with each member working independently of the other (Aaker and Day 1990).

Both the Committee system and Delphi are appropriate for conducting the brand asset dilution process required at this stage of the methodology. They are each reviewed below:

6.6.3.2 Committee

According to Aaker and Day (1990) this is the most used method in consumer product and services firms and second to sales force estimates in industrial product firms. Often provided with background information, representatives of different disciplines within the firm such as marketing, sales, operations, manufacturing, purchasing, accounting and finance,

meet to discuss the forecast. In bringing their respective perspectives to bear on probable market or sales potential, they hope to reach consensus.

Benefits are that it can be quickly convened; the inputs to the forecast are up to date in that the basis is the current situation. It draws on the richest source of knowledge in the firm; the collective knowledge of its key executives; and, finally it does not depend on historic data.

The drawbacks are that it is informal and unstructured; it is doubtful that any average opinion is likely to emerge; results are likely to be biased towards either the latest experience of an individual, and by the organisational status of an individual and to relative strength of character (Aaker and Day 1990; Fildes in Makridakis and Wheelwright 1987; Shim and Siegal 1988)

6.6.3.3 Delphi adapted for use

The Delphi Approach overcomes at least some of these shortcomings and has been made easier to administer through modern technology: the Internet in particular.

A panel of experts from the same range of disciplines listed above is invited to participate. They are each sent a list of questions to answer. Their responses are collected and analysed by the monitor who prepares a second round in which the mean scores and average opinions from the first round are combined into a second questionnaire. This continues for up to four iterations at the end of which some degree of agreement about the issues should have been reached.

The benefits are similar to the Committee system in that present circumstances are taken into account by the firm's most knowledgeable staff. In addition, since each member of the panel works independently and anonymously, there is no interpersonal influence.

The disadvantages are that it takes time to encourage all the participants to complete each round and that consensus is not always reached.

Two conflicting reports indicate mixed views as to the efficacy of the approach. Fildes (1987) reports on a study that compared the various forecasting techniques against a number of criteria. While all the extrapolative methods were given scores of 4/4 for reported effectiveness, both Committee and Delphi were given scores of only one. Conversely, Shim and Siegal (1988) report an experimental case in which very accurate results were achieved.[ix] (Aaker and Day 1990; Fildes 1987; Martins et al 1996; Shim and Siegal 1988)

The approach used in our model uses a four round iteration.

First the participants are told what will be expected of them, what the purpose is and when they will be required to respond. An executive senior to the panel members usually endorses the procedure and emphasises its importance.

Table 9. The Prompt list Provided to Panel Members in the First Round

Financial:	Control of costs; beneficial raw material contracts; management of margins (financial services); management of fixed investments and investment returns.
Legal:	Registered legal rights; patents; trademarks; franchises; licences and copyrights.
Branding (or marketing):	Brand awareness and equity; price premium; market share; brand name; speed to market with new products and innovations, extensions; brand portfolio.
Customer:	Installed customer base; customer lists; stable customer relations and customer satisfaction/retention.
Process:	Consistent product quality; innovation; research and development.
Logistics:	Supply chain management; favourable distribution arrangements.
Technology:	Special computer systems; technological innovations and patented technology.
Management:	Strong leadership; stable management team; quality management.

Source: This list has been established from actual Delphi style workshops conducted in South Africa and is revised or modified when new items emerge from valuation Delphi rounds and are given substantial support.

Second, using a form, and prompted by a shortened version of the list in Table 8 above (see Table 9), participants are asked to either tick the resources they think are responsible for superior profits or add additional ones.

Third, the responses are analysed by counting the number of ticks or mentions each item is given. The ten most frequently ticked/mentioned

items are transcribed onto a second list for round two. In this round the participants are asked to rank the ten resource items in order of importance. On return, the results are analysed with the items ranked one assigned a score of ten and the item ranked ten assigned a score of one. The scores are summed and percentaged across the total. Based on a decision rule of 85% the items that explain 85% of the incremental profit are selected. This typically is five or six and occasionally seven.

Fourth, the winning resource items are listed and sent back to the panel members. They are asked to allocate 100 points across the items indicating the relative importance of each in generating incremental profits. Each may be awarded any number, less than 100, but the individual scores must total 100 (Malhotra 1993).

Fifth, the same resource item list is sent back to the panel members, shuffled to reduce repetition. This time the panellists are asked to score each item on a scale of nought to ten according to the extent they think the brand influences each item's profit generating power.

Finally, the brand ratings from the fourth iteration are weighted by the item importance scores, from the third iteration, and summed to produce the brand asset dilution factor. This is applied to net profit after cost of capital has been charged to produce the brand asset value or brand premium profit. (it is possible, and sometimes expeditious to use the Delphi Approach mechanism as outlined in the Committee style workshop.)

In Table 10 the resource items emerging from ten brands valued during the 2000/20001 year are listed. The numbers are the mean rankings achieved by each. The incomplete rankings in some cases were caused by the distribution of scores and the effect of averaging.

Table 10. Top Mentioned Resource Items Extracted from ten Valuations conducted during 2000-2001

Resource item	A	B	C	D	E	F	G	H	I	J
Advertising									1	
Brand awareness			3	4	5					6
Brand image	6	7	4		4	5	4	1	3	
Brand loyalty								1		
Cost management – low production costs	2	1	8				5			
Customer satisfaction								5		
Customer service	10	3					1			
Distribution – availability			7	3	2		3			2
Diversity of product range		2					3			
Financially sound – well managed	1									
Good customer care – retention	8	9				2	2			4
Installed customer base								4		
Investment return		4					2			1
Lack of competition – monopoly	4									
Market share – market dominance	3	5	6	5				6		
Price charged	5	10	7	1					5	
Product quality			2			1		3	6	
Quality of management		5				4				
Raw material quality			5							
Reputation									2	
Sales/marketing efficiency										3
Social awareness	9									
Supply chain efficiency				9		3				

Target marketing									4	
Technological innovativeness	7									5
Brand asset (%)	54	51	82	88	71	70	61	70	86	55

A = parastatal; B = insurance co. C = canned food producer; D= weekly newspaper; E = frozen food producer; F = TV station; G = bank H = paint brand; I = business magazine; J = insurance company.

The resources identified during the Delphi procedure are generally similar to the items on the list in Table 9 which were drawn from the literature. Exceptions are items such as social awareness and product range otherwise the items differ only in degree and words chosen to describe them.

The brand asset scores in the last row are the weighted scores arising from the calculation and indicate the portion of the superior profits that are directly attributable to the brand: hence the brand asset. This percentage is applied to the profits remaining after the cost of capital has been charged resulting in the base profit to be modified to reflect the future profitability of the brand (Farquhar et al 1991).

Expressed algebraically, the last two phases of the brand asset calculation are expressed as follows:

$$\text{Brand asset} = \sum_{i=1}^{n} r_i b_i$$

Where:

r = resource set given relative importance by constant sum calculation
b = brand influence on each measured by rating on a ten point scale

The percentage that this calculation produces is the amount applied to the profits remaining after the cost of capital has been deducted from the NOPAT. It produces the Brand Premium Profit (*BPP*), which is *a* ... *c* in Figure 11 below

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Example of the brand profit dilution process

Nike Dilution analysis

A. Resource set, relative strength

Product innovation	20.77
Global brand	19.08
Product quality	14.00
Marketing communications	14.54
Trademark	10.31
Sponsorship	12.77
Distribution	8.54
	100.00

B. Influence of brand equity on each resource

Product innovation	6.4
Global brand	9.9
Product quality	6.1
Marketing communications	6.9
Trademark	9.1
Sponsorship	5.7
Distribution	3.7

C. Application of formula to derive dilution percent

Product innovation	13.29
Global brand	18.82
Product quality	8.59
Marketing communications	10.08
Trademark	9.35
Sponsorship	7.32
Distribution	3.19
	70.64

The list of resources was generated in a group session attended by eighteen senior staff members representing all aspects of the business and conducted according to the Delphi method. The final set were those resources that achieved the highest number of mentions which, as a percentage of all mentions, summed to 85% or more.

In C above the resources scores (A) have been multiplied by the brand equity scores (B) and the product summed to achieve the dilution percentage. This percentage is applied to brand profits, after the cost of capital has been subtracted from the NOPAT, to result in the Brand Premium Profit (BPP), or the portion of profit directly attributable to the brand.

A forecast is then made using management budgets (growth rate *m*) for no more than five years from the base year (this is usually one year, but up to five years might be used in the case of insurance companies where the cash flows from the embedded value estimate are available), followed by a conservative growth prediction (growth rate *g*) based on the GDP growth for the country's economy. At the time of writing, for South African valuations, growth rates of between 1,5% and 2,0% are being used.

The maximum period for which a franchise run is estimated is twenty years (half the forty year decay period mid-point), which is *c* ... *d* in Figure 12 below.

The franchise run period (*c* ... *d*) is designated BPP_i^U and is calculated according to the following formula:

$$BPP_i^U = BPP_m^U (1+g)^{i-m} \quad \text{for } i = m+1, m+2, \ldots, 20$$

Example of application of growth rates to BPP.

In the case of Liberty where the actuarial calculations, based on in-force premiums, had been supplied a growth rate of 15% per annum for four years following the base year was applied. While the actuarial calculation continued at this rate well into the future a more cautious approach was taken in the brand valuation with a growth rate of 5% applied to the fifth year and beyond.

In the case of consumer brands where management forecasts are notoriously inaccurate, an average of the previous three years growth is calculated and the lower of this or the forecast used for one or two years after the base year. Thereafter the GDP rate is applied as indicated above.

6.7 Category Expected Life

It has been shown that both Interbrand and Brand Finance have chosen between five and ten years as the duration for their DFC calculations (see Chapter Five). Brand Finance recognises the long-lived possibilities of the brand by applying a perpetuity (named an annuity in the company's literature) to the last year's forecast. The apparently random selection of a horizon valuation is commonplace (Brealey and Myers 1988)[x].

This standardised approach to all brands regardless of their longevity is intuitively incorrect. Two fields of research in the marketing literature support this: Adoption and Diffusion (Rogers 1983) and the Product Life Cycle (see Perreault and McCarthy 1996: Chapter Ten).

a Adoption and Diffusion. According to this model new ideas take time to become accepted. Initially they are tested by a small group of Innovators (2,5%); these are followed by the Early Adopters (13,5%) who lead by example. The Early Majority (34%) follow the lead set by the Early Adopters. The Late Majority (34.5%) tend to be the sceptics who have been resistant to the innovation and come to it late. By the time the balance of the potential adopters, the Laggards (16%), involve themselves in the market a new version of the innovation has often been adopted by the innovators. The introduction of the personal computer and the mobile telephone have been a conspicuous example of this process.

b Product Life Cycle. This model describes the stages of a new product from introduction to withdrawal. Reekie and Crook (1995:444) explain the shape of the curve as sales rising slowly at first, then accelerating as markets become familiar with the products and prices are reduced. Sales then level off as the product matures and markets become saturated. Sales decline occurs as new innovations replace the old and demand for existing brands falls off. This is consistent with the Franchise Run concept described under 3.3 above. It is also consistent with the concept of valuation horizon in which the present values of a company's free cash flows are forecast to a valuation horizon and a value is added to represent the forecasted cash flows after the horizon (Brealey and Myers 1988).

These models make it clear that there is a shape to a brand's life. In many instances brands that were launched as long ago as the 1800s have remained in the mature phase for more than one hundred years (see Aaker 1991). To set a standardised five or ten year life on a brand ignores the fact that brands live within categories and that they are subject to the life cycle of the category. The motorcar caused the demise of the

horse and carriage; the airplane changed the shape of both road and rail travel; personal computers have altered the way offices operate; e-mail has virtually replaced the facsimile machine and reduced both telephone and postal usage. Reekie and Crook ascribe this to changes in tastes, costs, technologies and prices, among other factors. While brands such as Coca-Cola, Eveready batteries, Gillette, Colgate and Liptons are still leaders in their categories, others such as Kellogg, Kodak and Singer sewing machines have had to re-invent themselves to cope with changing tastes and technologies that rendered their original product design inappropriate to contemporary demands.

In corporate finance language brands have an expected life that encompasses the franchise run, and a period of decay. This is distinct from the marketing concept of Product Life Cycle (PLC). The latter assumes that a product has four phases starting with the brand's introduction and tracking its growth phase when it is subject to growing sales and low profit due to the investment being made in its growth, its phase of maturity when it is at the peak of its profitability and finally, its decline (see Kotler 1996; Perreault and McCarthy 1996 for full explanations of the PLC concept).

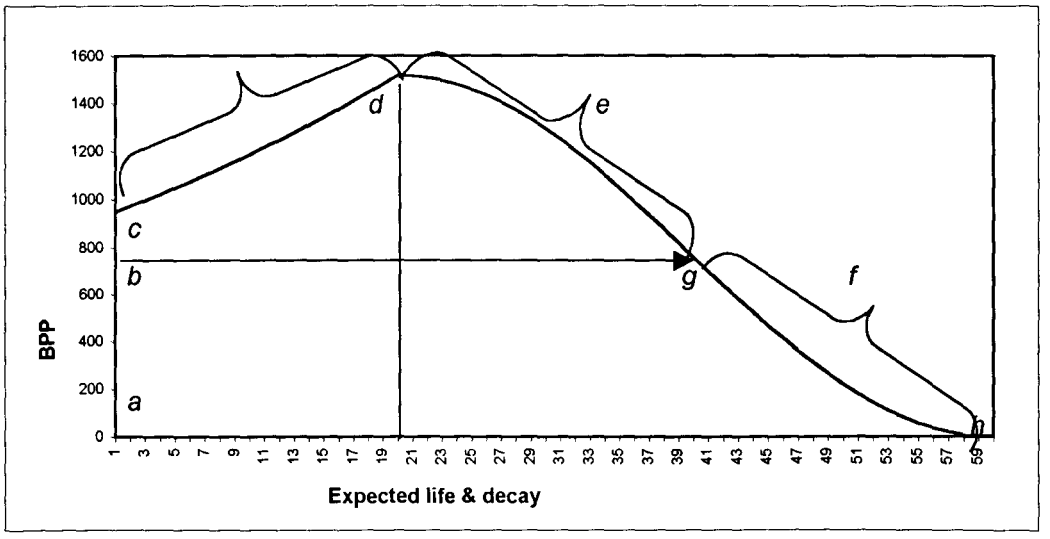
Brand expected life is an estimate of the number of years for which the Brand Premium Profit (BPP) must be projected in order to calculate the present value of the discounted flows. In the Wits model the franchise run is driven by Brand Knowledge Structure (BKS) and it is the number of years in the expected life estimate from which the brand value is derived. Since marketing actions should be designed to affect the BKS positively and, if required, to correct negative market perceptions, expected life is the link between marketing and brand value. The more years to be discounted the greater the value; the fewer years to be discounted the less the value. Expected life does not attempt to predict the brand's PLC because it will be the goal of the brand owner to maintain the expected life of a strong brand indefinitely and increase the expected life of a lesser

brand over time. It must be emphasised that the concept of expected life does not predict the live of the brand; it is a financial expression of a brand's strength taken at a point in time.

The franchise run (*c* ... *d* in Figure 12)is the phase during which the brand continues to earn superior profits due to the strength of the brand asset; the decay period commences in the year following the end of the franchise run. Since decay could occur rapidly or slowly over time, it has been modelled as a down sloping *S* curve falling slowly initially, then more rapidly and then fading at a slower pace to the end of the tail (*d* ... *h* in Figure 11).

In order to avoid a sharp fall after the franchise run ends and the start of the decay, a sinusoidal wave pattern decay slope has been employed in the formula. However it was necessary to correct for the + 1 to – 1 scale that results from the use of this mathematical device; hence the addition of 1 and division by 0,5. This converts the scale to 1 ... 0 (see 6.10.3).

Figure 11 . A Graphic depiction of the Wits Model



The Wits approach encompasses these requirements as follows:

First the category in which the brand sells is defined. A category is a market in which products or services compete in response to customer

preferences (Nielsen 1992). It takes account of the choices consumers have in satisfying their needs. Marketers who have installed category management systems treat the category as a business unit and adjust their product mix in accordance with consumer demand. They are looking for broad categories of products or services that allow for greater penetration of the consumers' pocket. The definition of the category will be a joint decision between the valuer and the client marketing staff and will draw on existing market research and the product management system utilised by the brand owner. In order to retain a level of conservativeness required for brand valuation the category definition is based on the existing user base and not on any projection into potential users.

The central measurement in the model is the expected life of a notional dominant brand in the category (*b ... g)* in Figure 11. The maximum expected life has been set at forty years, based on the American Generally Accepted Accounting Principles (GAAP) which permits acquired goodwill to be amortised over its useful life[xi]. The maximum period permitted is forty years (McCarthy and Schneider 1995). The expected life (*b ... g*) projects the BPP through the franchise run (*c ... d*) to the mid point of the decay period (*d ... h*). This is considered to be the mid point because it is assumed that whereas some brands would reach the end of their franchise run and decay instantly, others would decay slowly over a long period. The mid-point (*g*) is therefore half way between the end of the franchise run(*d*) and a point in time representing the longest reasonable period of decay (*h*).

Table 11: Present Value (PV) of R1 discounted at various discount rates

Discount rate	Years 1 –10 %	11 – 20 %	21 – 30 %	31 – 40 %	41 – 60 %	61 – 80 %
5%	83	54	22	12	9	3
7,5%	73	41	14	6	4	0.1
10,%	65	33	10	3	1	0.26

Note: the figures are the percentage increases in PV between the column periods. For example the PV grows by 83% between one and ten years at the 5% level.

To determine a terminal point for decay, R1 was discounted to infinity using 5%, 7,5% and 10% as discount rates. No growth was included. At 5% the period from 61 to 80 years returns a 3% increase in PV over the twenty year period compared with the 9% for period 41 – 60. At the higher rates, more likely to be encountered in any economy, when using the WACC to calculate the discount rate, the returns of 0,01% and 0,26% are infinitesimal. Since negligible value would be added after sixty years, this has been selected as the terminal decay time horizon. If (*g*) is the midpoint and (*h*) the terminal horizon, twenty years on, the midpoint is twenty years from the end of the franchise run (*d*).

At the other end of the scale we have selected ten years as the horizon for a marginal brand in the category. This selection is subjective but is based on markets where their owners maintain small share brands in the market. According to Double Jeopardy theory (Ehrenberg et al 1990) small brands have few customers who buy the brand infrequently. Thus the brand must sell at low prices and must constantly be promoted thereby eroding any profit potential the brand might have (salience; see Chapter Two). It is unprofitable in most cases to maintain such a brand in a market and ten years would seem a generous time to award a brand that scored well on the five-point scale below.

We suggest, in line with Jacoby and Kyner (1973), that a brand with ultimate acceptance would dominate the category as the single brand within the acceptance set. We position this brand at the distant time marker (*g*). Conversely, the weakest brand in the category would be positioned at the other extreme and would be the marginal brand in that it has minimal acceptance and maximum rejection (See Chapter Four

Figure 9).

Drawing on the work of Srivastava and Shocker (1991); Mahajan et al (1993); Lieberman and Montgomery (1998) we have isolated four variables that are highly influential in the stability or otherwise of a product category. They are longevity; leadership, barriers to entry; and vulnerability to change. We use these four factors to calculate, in years, the expected lives of the dominant and marginal brands.

a Longevity: Aaker (1991) has shown that the longer a market has been in existence the less susceptible it is to change. While many famous brands have existed for generations, we need a more sensitive measure and have selected ten years. In the Wits conception a category is long lived if it has been in existence for ten year or more. This acknowledges, for example, the advent of new categories such as online retail sales, which very quickly have become established.

b Leadership: The same applies to market leadership. In markets where there has been a single leader for seventy years or more, the probability that the status quo will continue is strong. Lieberman and Montgomery (1998) support this view by linking the related concepts of First Mover Advantage and the Resource Based View. The argument revolves around the propensity of early entrants to occupy geographic, technological and customer perceptual space through their pioneering, early mover advantage. However it has already been shown that technological change, among other forces, can shake even the sturdiest of market. Therefore the risks associated with a category and presented by new alternative consumer choices must be factored in to the category expected life equation. Again we use ten years. If there has been single leader for ten years or more, we consider this to be a stable market.

c Barriers to entry: High barriers to entry protect categories from new entrants; low barriers attract all and sundry. Except in monopolistic or oligopolistic markets this is characterised by the ease or difficulty that confront new competitors who wish to enter the market (see Han, Kim and Kim (2001) for a new insight into the extent to which barriers to entry are the deterrents that are claimed of them. Their findings lend validity to the dangers inherent in new entries into established markets. The solidity of first movers is more susceptible to change and attack than was traditionally expected). There have been a number of instances in South Africa where low or relatively low barriers to entry have allowed new companies to enter, grow and compete wit the traditional leaders. Two examples are Discovery Health in Insurance and African Merchant Bank in the banking field. Both of these companies entered the market within the last ten years and each has risen to compete with the long established leaders.

d Vulnerability: A brand's expected life cannot be modelled in isolation. As Reekie and Crook put it: "markets become saturated" (1995. p 444). Perreault and McCarthy (1996) say about the maturity phase of the life cycle:

> *" ...competition gets tough. Many aggressive competitors have entered the race for profits" (p. 312).*

A brand valuation must therefore take both competition and the industry environment into account.

For example, Internet banking has changed the way bank customers access their savings and make their payments. Standard Bank was very successful in introducing an effective online system. First National Bank was less successful and had to invest heavily to replace its original system with one that was competitive with Standard Bank. The stability of a

category and the ability of brands within it to continue to earn incremental profits are vulnerable to competitive activity and category structural change.

In developing a procedure for using these four factors to calculate the expected life of the dominant brand (*b* ... *g*) and of the marginal brand we use a five point scale on which the category is scored according to the four determinants of expected life. The values in Table 11 have been calculated so that they are a function of the forty-year dominant and ten-year marginal brand time makers. A five point scale was chosen because a neutral, or mid-range, answer is possible for each variable. The scale is balanced so as to allocate equal weights to both favourable and unfavourable responses (Malhotra 1993) with the centre point available for a neutral answer.. The product of the scores awarded gives the dominant and marginal time durations. If the values in the right hand cells are multiplied together they achieve a score of 40 and 10 respectively. At the other extremes the product is 1. Thus the greatest distance that could be achieved between a dominant and marginal brand is 40 – 1 = 39.

The survey instrument used to acquire the scores is shown in below in Figure 11 and is completed in a workshop attended by brand specialists and by reference to recorded data. The factors calculated to determine the life of the two categories are as follows:

Table 12. Determinants of Dominant and Marginal brands

Dominant brand

Variable	Weak				Strong
Longevity	1,7486	2,6580	3,0150	3,2455	3,4200
Market dominance	0,8940	2,0657	2,6580	3,0804	3,4200
Vulnerability	0,6392	1,8211	2,4955	3,0007	3,4200
Barriers to entry	1	1	1	1	1

Marginal brand

Variable	Weak				Strong
Longevity	1,4678	1,7100	1,9194	2,0536	2,1544
Market dominance	1	1	1	1	1
Vulnerability	0,6813	1,0772	1,5234	1,8658	2,1544
Barriers to entry	1	1,3572	1,71	1,9574	2,1544

The cell values in the tables above were calculated by Professor J.U de Villiers and included here with his knowledge and permission.

In order to convert these values into a form that can be used in a workshop, the questionnaire in Figure 11 has been developed. The questions have been worded to encourage experts within the company whose brand is being valued, to use hard data where possible. For example market data such as that supplied by A.C. Nielsen can be used for the questions regarding both Longevity and Leadership. The same source (or type of source) is used to answer the question on "bottom end churn" or barriers to entry. The final questions is usually a quantification of work the company has conducted during its strategic planning process. It is particularly helpful if the company has employed devices such as scenario planning.

Figure 12. The Scale based Questionnaire used in Category Expected Life Analysis.

Scale:	1	2	3	4	5
LONGEVITY - For how long has the category existed?	New 0 -2	3 to 4	5 to 7	8 to 9	10 years and more
LEADERSHIP - How would you characterise the last ten years of brand leadership in this category?	No consistent leadership	Regular changes	Several changes	Recent change in leadership	A single, ten year leader
BOTTOM END CHURN - At the bottom of this category, are the entrants well established, or is there constant churn?	Constant chum, low barriers to entry	New entrants are unable to establish themselves	A few entrants have come and gone	A change has occurred over the category life	Established entrants, high barriers to entry
VULNERABILITY - How vulnerable (to change, increased competition etc.) is the category's continuing ability to provide a profitable and viable market?	Major change in process	Undergoing change	Subject to change	Somewhat stable	Completely stable

It must be pointed out that these scales have not been formally tested for external validity. The questionnaire has, however, been used in over twenty valuations and has been refined to overcome misunderstandings and lack of clarity.

The resulting values are the link between the strength of the brand in consumer memory (see Chapter Four and 6.8 below) and the expected life of a notional dominant and marginal brand. The formula developed to combine the two measures is as follows (see 6.10.2).

$$Y_B = Y_M + \frac{(Y_D - Y_M)(BKS_B - BKS_M)}{(BKS_D - BKS_M)}$$

Thus, the expected life of the dominant and marginal brands along the line *b ... g*, are estimated by applying the results of the brand category

research to the values in Table 12 and combining these with the BKS scores described below. (See examples in Chapter 7 for detailed explanations of how these values are used in practice.)

6.8 Brand Knowledge Structure (BKS)

Until relatively recently economists had a divided view of advertising: a key component of marketing. On the one hand it could be informative which was constructive. On the other it could be combative which was repetitive and wasteful (see Harris and Seldon 1959). Modern day economists are more understanding of the marketing process. Mankiw (1997) expresses the contemporary view when he states:

> *" ... brand names provide consumers information about quality when quality cannot be easily judged in advance of purchase. ... brand names give firms an incentive to maintain high quality since firms have a financial stake in maintaining the reputation of their brand names." (p. 375. See also Reekie and Crook 1995:370-371)*

Mankiw further makes the point that consumers have good reason to pay more for brand-name products (as compared with generic substitutes) because they can be more confident in the quality of these products.

They do this by learning about brands and storing knowledge about them in their memories. The brand symbols aid recall and recognition of this stored information and marketing communications, such as advertising, re-enforce memory of the brand symbols and what they signify.

The effect of this is to shore up the barriers against competitive intrusion. Once a brand is established in consumer memory it becomes one of the more robust entry barriers that deter new challengers. As Han, Kim and Kim (2001) explain at the conclusion to their study into entry barriers:

" ... the strong showing by proprietary assets (which includes patents, brand names, trademarks and so forth) in fending off both innovative and noninnovative challengers alike underscores the strategic importance of intangible assets." p.11)

6.8.1 Brand Knowledge and brand profit

Keller (1993 and 1998) has described this process as Brand Knowledge. Drawing on neuroscience he has conceptualised brand knowledge as comprising brand awareness and brand image. A brand name is stored in a single node in memory and is associated with attributes that are learned through communications, word of mouth and personal experience. Engel et al (1995) state that these can be marketer dominated such as advertising, or can flow from other sources.

Brand associations are measured by their strength, favourability and uniqueness and are differentiated from each other by the extent to which they are perceived by their users to satisfy their needs in terms of these associations. It is important to know that this understanding of how consumers think about brands is not new. Keller's work arose from brand equity research. But it draws on a long history of previous study. [xii]

While attention has been focused on brand equity since the term emerged in the late 1980s (Leuthesser 1988), the power of brands to improve company profitability has long been known. King (1973) writes: "What makes companies succeed is not products, but brands." Buzzell and Gale (1987) and Gale (1992) demonstrate this by analyses of their PIMS database. They found strong relationships between successful brands (measured by perceived relative product quality), weight of advertising and company profitability.

Long before this, Procter and Gamble introduced the product management system in 1929 in order that a single executive could:

> *"give his exclusive attention to developing and promoting (the) brand." (Kotler et al 1996:102)*

According to Engel et al (1995) the field of consumer research, from which arose consumer behaviour, started in the 1960s. Its purpose was to provide marketers with a greater understanding of how consumers chose brands and made buying decisions.

The network of knowledge about brands that resides in consumer memory is called Brand Knowledge Structure (Keller 1998) and is a conjunction of the extent to which the user group is aware of the brand, the ease with which the name is recalled or recognised and the strength, favourabilty and uniqueness of the attributes associated with it. The stronger the associations in memory the greater the likelihood that the brand will be in the consumers' evoked set; a precursor for brand loyalty. Since brand loyalty has been shown to lead to benefits such as a willingness to pay a premium price for the brand, greater purchase frequency, lower marketing costs and the advantages that flow from satisfied consumers referring their brand to others, the link between Brand Knowledge Structure and a brand's financial performance are clearly established (Farquhar, Han and Ijiri 1991; Kamakura and Russell 1991; Kerin and Sethuraman 1998; Leibowitz 1997a)

6.8.3 The Brand Knowledge Structure framework

In this model the conceptual approach to Brand Knowledge proposed by Keller has been adapted to provide a framework for estimating a Brand Knowledge Structure (BKS) metric. That is a single number that represents the strength of the brand being measured relative to a notional dominant and notional marginal brand. In section 6.7 above a

mechanism is explained to establish time markers. The distant time marker is a proxy for the strength of the most dominant brand in the market category. The extent of this strength is a function of the category itself evaluated by the category's longevity, stability or otherwise of market leadership, barriers to entry and vulnerability to future events and pressures. The dominant brand will have the highest possible consumer evaluation based on survey data that conforms to the BKS framework.

Similarly the weakest brand in the category is given a metric. The brand being valued is positioned, according to the same measurement regime, between the dominant and marginal points (*b ... g*). It might indeed be the dominant brand. The basis for the calculation of BKS is the Fishbein and Ajzen formulation of attitude measurement (see Chapter Four). It has been chosen because it provides a framework within which attributes (or associations in the Keller sense) are weighted by an importance factor and summed to produce an overall score.

This approach deals well with noncompensatory consumer evaluation strategies (see Blackwell, el al 2001 for a full discussion on consumer search and evaluation strategies) in that consumers are asked to rate attributes in terms of importance and then use a similar scale to evaluate the extent to which these attributes are thought to be present in each brand in the consideration set. Thus if one attribute such as taste or price is of sufficient importance to consumers that they will not sacrifice it for another, this is indicated by the score applied and the extent to which this is thought to be present in the favoured brands.

It also allows for the expression of what Blackwell et al (2001) call cutoffs. These are levels at which the importance of a non compensatory attribute will be compromised. For example consumers may buy Nike shoes because they conform with the most important attributes. However there will be a price cutoff above which a competitor brand might be preferred

even though a key attribute such as comfort may be perceived to be sacrificed.

Fishbein and Azjen (1975) showed how attitudes are formed and how they can be measured. An attitude towards a brand is defined as:

> *" A summed set of beliefs about the object's attributes weighted by the evaluation of these attributes." (Engel et al 1995:369)*

The formula for this calculation is:

$$A_o = \sum_{i=1}^{n} b_i e_i$$

Fishbein and Ajzen used beliefs about attributes and their evaluation for their model Beliefs are measured on a seven-point scale anchored by –3 and +3 which record how good or how bad it is that a brand should posses the attributes most frequency mentioned by consumes in appropriate research. Evaluation is measured on the same scale and is an assessment of the extent to which each brand possesses the attributes.

As has been explained in chapter four, this is the preferred approach for this model, since it results in a robust measure of how the brand is evaluated by its users. The research also allows for the notional dominant and marginal brands to be constructed from the highest and lowest scores recorded in the research for any of the brands and their attributes.

It must be emphasised that the methodology described in this chapter is intended for use in practical business conditions. Valuations are conducted within typical confines of financial limitations and data availability. For this reason the methodology consists of frameworks to which available data can be fitted. In the case of BKS the model requires standardised measures of brand knowledge from a survey source that will

provide consistent data over time. The valuer must assess the data available and adapt it to the framework described above. The example below shows how this has been achieved on one valuation project.

Example: BKS scores for insurance company Liberty

The valuer was advised by Liberty that research had been commissioned from commercial research company Markinor. The valuer was able to influence aspects of the questionnaire to ensure the data needed would be obtained, but this had to be within the budget constraint imposed by Liberty and the research approach used by the research company.

Attribute	Import	Lib.	W/S	Dom	W/S	Marg	W/S
Trust and confidence	0.218	23.3	5.08	68.1	14.85	2.4	0.52
Financially stable	0.144	25.7	3.7	65.4	9.42	0.3	0.04
Care for clients	0.135	20.2	2.73	57.1	7.71	2.4	0.32
Ensure financial prosperity	0.08	18.6	1.49	54.9	4.39	2.5	0.2
Ensure financial future	0.076	21.7	1.65	53.3	4.05	3	0.23
Reliable company	0.075	20.9	1.57	62.0	4.66	2.4	0.18
Associations			*16.21*		*45.06*		*1.5*
Awareness (free)		11		29.8		1	
Awareness (prompted)		85.7		99.4		7.1	
Average Awareness			*48.35*		*64.6*		*4.05*
BKS			**7.84**		**29.11**		**0.06**

Key: Import. = impotence; Lib. = Liberty: Dom. = Dominant brand; Marg. = Marginal brand; W/S = Weighted score.

The list of attributes had been generated by focus groups and previous research. There were 23 attributes grouped under three headings: Corporate Image; Customer Care and Service and Financial standing.

Respondents were asked to rate each attribute according to their relative importance and then state with which insurance companies they associated each attribute. A ranking was used to assess importance. Respondents were asked to select the five most important under each category and rank them with one being the most important and five the least. In order to standardise the results, these have been decimalised. The associations were based on the number of respondents associating the attribute with each company.

The cut-off at "reliable company" was selected because of the gap between the 0.075 awarded to this item and the next ,which scored only 0.04. This is in keeping with the object of the BKS variable in the model which must provide a practical input to marketing planning. Thus only the criteria which are most important to existing and potential users of the service should be used in the analysis.

In accordance with the Fishbein formula, each attribute is weighted by the decimalised importance score and the scores are then summed.
The discussion below explains the relationship associations (attributes) have with awareness. The attribute scores are therefore multiplied by the average of the free and prompted awareness scores to produce the BKS.

Since Liberty did not achieve the highest scores the dominant brand is derived from the highest scores awarded to any insurance company measured. Likewise the marginal brand is derived from lowest scores awarded to any insurance company measured.

It was shown in Chapter Four that associations (the attributes referred to above) are linked in consumer memory to the node in which the brand

name is stored. Stimulated by some external cue, the name is recalled or recognised and this activates the brand schemas in which the associations are stored.

Therefore the strength of a brand in consumer memory is a function of recall and recognition and the evaluated attributes associated with them.

Free or aided survey instruments measure recall and recognition is measured by visual prompts. In most commercial consumer research, free and aided recall are used. Recognition tests are generally reserved for media and copy research.

It was explained in Chapter Four that recognition cannot be less than recall and that prompted recall cannot be less than free recall. This hierarchy has been described as a series of three sets of accessible knowledge in memory: the Universal, Retrieval and Consideration Sets (Alpert and Kamins 1995). The Universal Set is the full set of brand names capable of being recalled. The Retrieval set is the set of brands that is recalled when prompted. The Considerations Set is the short list, portfolio of brands from which the brand to be chosen will be selected. Recognition is the hierarchy base. Anything recalled must be capable of recognition. The second level will be aided recall: Anything freely recalled must be capable of being prompted.

It can be inferred from Alpert and Kamins (1995) that brand selection follows retrieval and consideration:

> *" ... because of brand distinctiveness and uniqueness, the pioneer brand was found to be retrieved, considered and selected with a greater likelihood than the follower." (p. 43)*

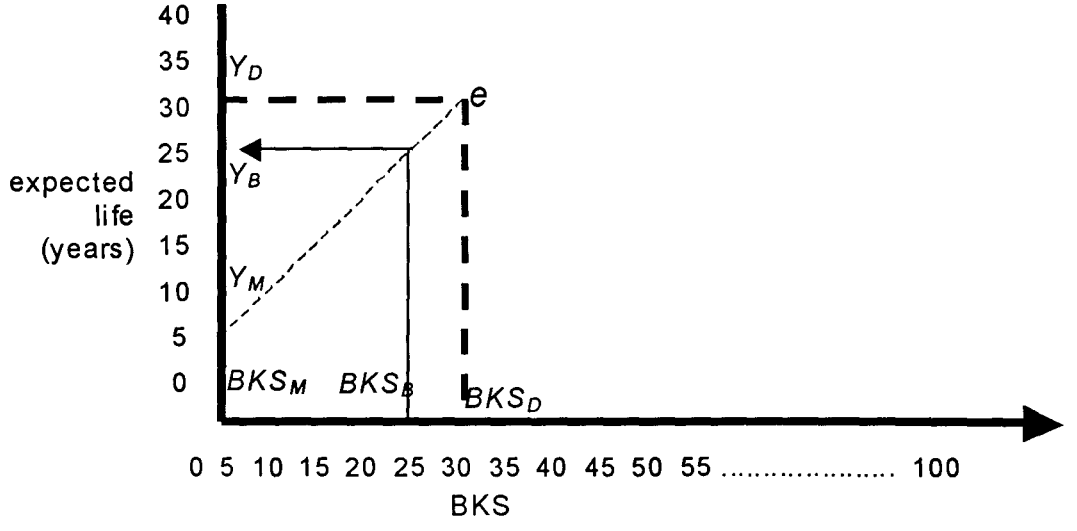
Blackwell et al (2001) explain that either recall or recognition can be the most relevant retrieval process depending on whether the object is relying

solely on internal search to make a decision when free recall is called into play, or if the brand is selected at the point of purchase when recognition (or prompted recall) is the appropriate mechanism.

Therefore while these levels of retrieval have been described, correctly, above as a hierarchy all three need not be invoked in the brand selection process. Because, under different circumstances, any of the three levels could be the correct measure and at least two of the three are usually measured in consumer research (free and aided recall or free recall and recognition), a conservative measure of awareness for this model is the average of the survey-based data.

BKS is therefore derived from the product of the awareness average and the decimalised percentaged mulit-attribute score from the belief – evaluation equation. It combines with expected life, as depicted in Figure 12, to convert the object brand BKS to its expected life and franchise run of uninterrupted profits.

Figure 13. BKS combines with Dominant and Marginal Expected Lives to estimate Brand Expected Life.



The expected life of the marginal brand intersects the vertical axis at Y_M. The dominant brand is at Y_D The score for the marginal brand BKS_M

displaces *0* on the horizontal axis. The angle of the line that joins the Y_M intersect at *e* determines the expected life of the brand being valued. Half of this is the brand franchise run.

6.9 The valuation process

This explanation follows the flow chart (Figure 13) and is cross-referenced to the preparations (coded V_{prep}); processes (coded V_{proc}); decisions (coded V_{dec}); and terminal (coded V_{term}).

6.9.1 Net Operating Profit After Tax (NOPAT) ($V_{prep}1$)

This is a straightforward accounting procedure. The revenues must be those generated by brand sales alone. Any sales resulting from other sources, but included in the brand income statement must be excluded. These might, for example, be sales from sales of the product manufactured for use as a Dealer Own Brand.

The cost of sales is deducted to arrive at gross operating profit. Fixed and variable costs summed and deducted. Attention is paid to the allocation of head office costs since not all of these should be carried by the brand. Judgement is needed to determine which of these should be retained and which not.

While this is not part of this calculation, marketing costs should be separated and listed independently so that they can be used in return on marketing investment calculations. If, in the case of a financial services company, interest from investments attributable, say, to policyholders is removed, the corresponding asset base in the balance sheet must also be removed.

Depreciation is retained since this is a proxy for asset replacement. Interest and finance charges are removed since the brand should not carry

amounts that are subject to corporate negotiations and are accounted for in the WACC estimate.

An average tax rate for the company is applied to arrive at the NOPAT ($V_{dec}1$).

Care must be taken to ensure that the NOPAT truly reflects the earnings of the brand. Sometimes abnormal charges occur in the base year, which have an adverse effect on the valuation. If, by reference to the previous two years this amount is found to be abnormal, the weighted average of the three years should be used to smooth the abnormality.

(See discussion of cash or earning's flow under 6.3.1)

6.9.2 Capital employed ($V_{prep}2$)

This amount must reflect the assets applicable to the brand and which are interest bearing. Accruals for tax payments are usually removed. While the calculation is straightforward for manufacturing companies financial services companies need special understanding and treatment. The assets are the investment assets owed to shareholders plus the retirement obligation and other liabilities.

6.9.3 Weighted Average Cost of Capital (WACC) ($V_{prep}3$)

The cost of capital is usually estimated by use of the Capital Asset Pricing Model (CAPM). The ratio of debt to equity is obtained from the balance sheet, and the cost of each easily obtainable from company management and records. The appropriate risk free rate, risk premium and market Beta must be obtained from a suitable source such as a merchant bank.

6.9.4 Incremental profit ($V_{proc}1$)

The cost of capital ($V_{prep}3$) is applied to the capital employed ($V_{prep}2$) to arrive at the amount to be deducted from NOPAT to represent the non-branded version (see 6.5 above) ($V_{dec}2$). $V_{proc}1$ is the incremental profit over the cost of capital earned by the branded product.

6.9.5 Isolating the brand asset ($V_{prep}4$)

This procedure is described 6.6. An approach such as the Delphi Technique is used to identify the resource set of market-based assets that are responsible for the company earning profits above the cost of capital. By selecting the resource set responsible for most of this profit estimating both the relative importance of each by the application of a constant sum estimate and the influence that the brand name has on each, a percentage is achieved that identifies the proportion of the incremental profits that can be directly attributable to the brand.

The result is the Brand Premium Profit ($V_{proc}2$). (See also 6.5 above)

6.9.6 Forecasting the brand's growth ($V_{proc}3$)

Management usually prepares budgets for brand sales and profit. Forecasting is however extremely hard and while it is now usual for companies to prepare five year forecasts these are often based on simple methods that, according to an editorial in a journal concerned with forecasting (Chase 1997):

> *"are easy to comprehend and mostly ... involve judgement by company employees." (p. 2)*

Chase goes on to comment that when targets are not met, the targets are revised by management or:

> *"(Management) puts a financial plug in place hoping someone will over-deliver." (p. 2)*

Revenue and profit budgets are typically inaccurate and valuations should therefore be based on a conservative view. In the formula below in appendix D we allow for between one and five years. In practice five years are rarely used. The exception is insurance companies which can provide the cash flows on which their embedded value calculations are based. These are "in-force" values and are therefore moderately reliable. With other organisations it is preferable to limit the forecast to a maximum of two years and with fast moving consumer goods in volatile markets, one year only should be used. Thereafter, a growth rate that depicts the country's likely economic growth should be applied. The combined management and GDP growth are projected for a maximum of twenty years being half the forty years used for the brand's likely expected economic life. (see 6.9.7 and 6.10.1).

6.9.7 Dominant and Marginal Brands ($V_{prep}5$)

In section 6.7 above the procedure for setting the time horizons for the dominant and marginal brands is explained. The dominant brand is a function of the theoretical maximum of forty years (see page 248). The scores awarded on the five point scale to the four variables in the questionnaire displayed in Figure 11 are multiplied to produce the dominant brand in years. If a category is awarded 5 points for each variable its expected life will be 40 years. Similarly the expected life of the marginal brand is a function of the theoretical ten year maximum (see page 250) and is calculated in the same way.

Using the form in Figure 11 at a workshop attended by marketing specialists who are knowledgeable about the brand category and the forces that have historically and will continue to shape it, scores are determined which, when applied to the values in Table 11 produce the expected life for the dominant and marginal brands.

6.9.8 Brand Knowledge Structure (BKS) ($V_{prep}6$)

BKS is discussed in detail in Chapter Four and again under 6.8 above. Drawing on survey-based data, the awareness score is the average of the measures used (recall – free; recall – aided; recognition). Association is the summed product of the belief and evaluation scores applied to each attribute. The BKS is the product of awareness and association and is calculated for the brand being valued and for a notional dominant and marginal brand.

The BKS score for the strongest brand in the category is substituted for the marginal brand's expected life. If the category expected life is 32,5 years this becomes the expected life for the brand with the highest BKS score. Similarly the brand with the lowest BKS score substitutes for the marginal brand's expected life.

The expected life of the brand being valued is then calculated by application of the formula in item 2 in the mathematical explanation in section 6.10.

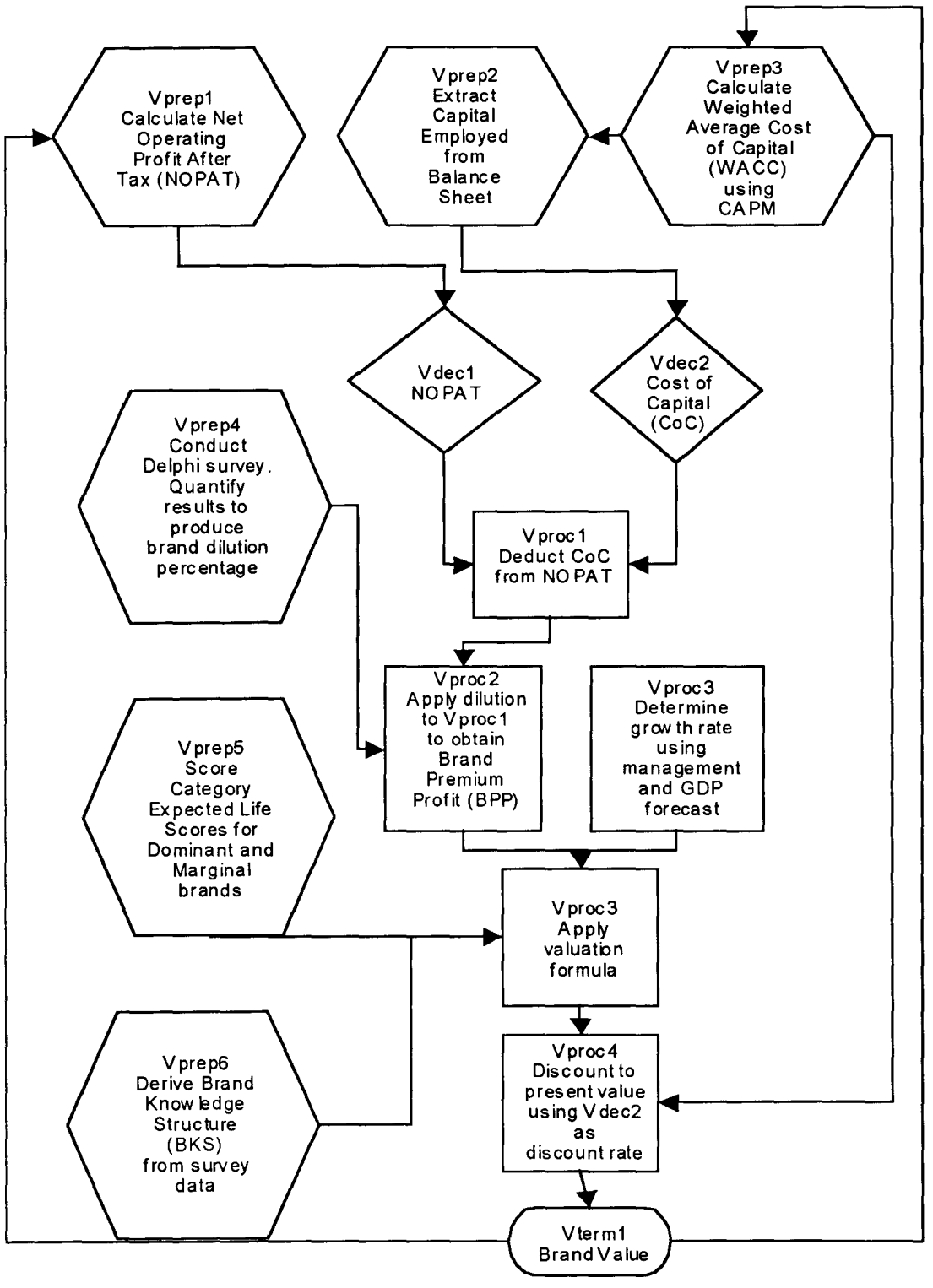
6.9.9 The Expected Life Calculation ($V_{proc}4$)

The expected life of the brand is a function of the years estimated for the marginal and dominant brand and the BKS scores achieved for each (see 6.10.2). The franchise run and expected decay are then estimated according to the formula in 6.10.3.

6.9.10 The Brand Value ($V_{term}1$)

The brand value is the capitalised, discounted present value of the earnings captured by the formula, using the cost of capital as the discount rate ($V_{proc}5$).

Figure 14. An Integrated Brand Valuation Methodology



6.10 Mathematical Explanation of the Expected Life Calculation and Discounted Cash Flow

6.10.1 Twenty year forecast of uninterrupted Brand Premium Profit

Brand Premium Profit is the result of the NOPAT less the cost of capital, further reduced by the dilution factor obtained from the Delphi exercise. We call this BPPi (for Brand Premium Profit), and then distinguish between uninterrupted BPP (lets call this BPP_i^U) and decayed BPP (let us call this BPP_i^D) management forecasts, for between one and five years, depending on our assessment of their reliability. We call the number of years for which management forecasts exist *m*, then we obtain management forecasts of BPP_i^U for i = 1, 2, ..., *m*.

We then estimate a conservative growth rate g , and use this to estimate the uninterrupted brand premium profits for 20 years (Forty years(40) is the mid point of the decay period and is half way between the 60 years terminal horizon and the twenty year franchise run maximum).

$$BPP_i^U = BPP_m^U (1+g)^{i-m} \text{ for } i = m+1, m+2, \ldots, 20$$

From a combination of management forecasts (years 1 to *m*) and extrapolated growth (years *m*+1 to 20) we then have the annual uninterrupted brand premium profits for 20 years.

6.10.2 Calculate brand expected life

We have already obtained (from the preparation shown in the flowchart and described in the text):

Y_D = expected life of the dominant brand

Y_M = expected life of the marginal brand

BKS_D = Brand Knowledge Structure of the dominant brand

BKS_M = Brand Knowledge Structure of the marginal brand

BKS_D = Brand Knowledge Structure of the brand being evaluated

We then calculate the expected life of the brand as:

$$Y_B = Y_M + \frac{(Y_D - Y_M)(BKS_B - BKS_M)}{(BKS_D - BKS_M)}$$

6.10.3 Calculate Brand Premium Profit (with expected decay)

The annual forecast of Brand Premium Profit with expected decay is then produced from the above.

We assume that no decay takes place in the period up to half the expected life of the brand, and call this the period of the uninterrupted franchise run. This period is half the expected life of the brand. We define the last full year in the uninterrupted franchise run to be year *j*, or:

$$j = INT\left(\frac{Y_B}{2}\right)$$

(or, *j* is the integer portion of half the expected life of the brand)

We define the remaining fraction of a year after year *j* up to the end of the uninterrupted franchise run to be *f*, or:

$$f = \frac{Y_B}{2} - j$$

The annual forecast of Brand Premium Profit (with expected decay) is then:

$$BPP_i^D = BPP_i^U \quad \text{for} \quad 1 \le i \le \frac{Y_B}{2}$$

$$BPP_i^D = 0.5\left[BPP_j^D (1+g)^f\right]\left[\cos\left\{\frac{\pi\left(i - Y_B/2\right)}{Y_B}\right\} + 1\right] \quad \text{for} \quad \frac{Y_B}{2} < i \le \frac{3Y_B}{2}$$

$$BPP_i^D = 0 \quad \text{for} \quad \frac{3Y_B}{2} < i < 60$$

(Sixty years is the terminal horizon due to the negligible returns after this time in which DCF would produce a present value).

6.10.4 Calculate the Brand Equity value

The Brand equity is then calculated as the sum of the present value of the Brand Premium Profits with expected decay, or

$$BV = \sum_{i=1}^{60} \frac{BPP_i^D}{(1+k)^i}$$

where BV = Brand Value

k = cost of capital

Disclaimer. The author acknowledges the work of Professor J. U. de Villiers in writing the above algebraic expression of the methodology.

6.11 Closing discussion

The need for a valuation methodology such as the one described in this chapter is highlighted by comment in the editorial preceding the *BusinessWeek* survey of the Best Global Brands (Shepard 2001).

The Editor states:

> *"In developing our ranking, we avoided the vagaries of consumer perception surveys, which can change on a whim." (p. 1)*

He then goes on to say:

> *"As the economy struggles, brand building and keeping the profile high have become more important than ever." (p. 1)*

He then explains that the way brands survived the last turn down (prior to 2001) was by not trimming marketing budgets. Since a major portion of marketing budget allocation is for Integrated Marketing Communications (Shimp 1997), which includes advertising, to "keep the profile high", the editorial writer is acknowledging that it is customer perceptions that drive brand value. And yet surveys that track the results of this seemingly critical task are rejected in favour of " rigorous financial analysis."

It was this shortfall in the existing valuation methodologies that prompted the development of the Wits method (see Chapter Five). The methodology combines soundly based accounting and corporate finance theory and practice, with that of marketing. The accusation that this makes the approach too forward-looking, subjective and based on assumptions is countered in the text by three key arguments:

a The accounting standard dealing with intangible assets explicitly recommends the forward looking Discounted Cash Flow technique as a method for estimating the value of an acquired intangible asset (A.C.129: .31);

b When estimating the useful life of "an item of property, plant and equipment," accounting standard A.C 123 encourages accountants to use their judgement based on appropriate experience.

c The survey-based data used in the methodology is employed in a relative and trend sense. It requires valid sample sizes to minimise statistical error and it sets out the methodological approach that should be used as a framework for the questions. In the model the data are used to set distances between the dominant and marginal brand and to place the object brand in the intervening space.

This is no less subjective than is the seven-item scale that Interbrand uses. In fact it is more soundly based in theory and scientific research procedure than Interbrand's largely unsupported measurement scale. Also, the full expected life modelling of the brand provides a more precise view of the strength of the brand than do the five and ten year projections plus a perpetuity calculated on the final year, used by both interbrand and Brand Finance.

In the concluding remarks to Chapter Three it was reported that the International Accounting Standards Board (IASB) has expressed its intention of re-examining its standard that deals with Goodwill and Intangible Assets when businesses are combined (A.C.131), and it acknowledges that associated units are studying, among fifteen others, the standard dealing with Intangible Assets, including brands. In addition it is also reported that courts in both the United States of America

and in Europe are increasingly calling for survey data in cases concerned with the dilution of trademarks (Kearney and Mitchell 2001; Peterson, Smith and Zerillo 1999). When a judgement is given a valuation will be required for the court to assess the monetary value of any assumed damage.

A final point is to underline the pragmatic nature of this model. While it was developed in an academic environment it is intended for everyday business use. As such it must be sufficiently adaptable to deal with a broad variation in both the quality and quantity of input data; commercial financial constraints; abnormal circumstances; different management requirements and policies; and a variety of research sources and approaches from which Brand Knowledge Structure (BKS) must be extracted. For this reason, as has been explained, the methodology comprises a series of interlinked frameworks to which different types of data may be fitted. The methodology is therefore flexible with the proviso that the source data is both reliable and will be consistently produced in the future.

Coupled with the growingly strident call for marketing to become more accountable at the board level of companies (see Chapter Two), a valuation such as this which combines finance and marketing would appear to be propitious.

End notes to Chapter Six

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[i] See chapter two, 2.17 for a description of the process for estimating β.

[ii] In the marketing literature the concept of signalling is covered under semiotics. Shimp 1997) discusses the phenomenon.

[iii] Finance World went into liquidation and Business Week has taken over the publication of an annual league of leading brands. See the August 6, 2001, edition.

[iv] Shelby Hunt and Robert Morgan (1995) propose a new theory of Comparative Advantage. In a thoughtful article they eschew the commonly accepted theory of perfect competition arguing that firms to do not aim to be average. They refer to the set of resources that would make one firm unique and different from its competitors.

[v] In addition to the academic research that has been conducted, these two concepts are investigated in considerable depth in recent commercial publications. Leading in this are Peppers and Rogers 1993; Edvinsson and Malone 1997 and MeKenna 1991)

[vi] See the discussion in chapter three on The Efficient Market Hypothesis (EFM).

[vii] The references cited here are primary sources for the items on the lists. These items will not, in most cases, be exclusive to the authors cited. The items will be found consistently throughout the marketing, corporate finance and accounting literature.

[viii] The best known attempt at quantifying intangible resources is the financial approach to brand valuation described by Simon and Sullivan (1993). This approach uses historic and current data of advertising, market position and order to market and includes dummy variables as proxies for the unknown resources. The approach is an abstraction based on highly suspect theoretical foundations. The role of advertising, alone, in creating brand equity is at best debateable (see for example Ehrenberg's weak theory of advertising as described in Sinclair (1997)

[ix] The case study was reported by Surenda Singhvi in Financial Forecast: Why and How? Published in Managerial Planning March/April 1984. In this a panel of twenty Americans with college education, widely dispersed throughout the USA, were asked to estimate the population of Bombay, a city none had ever visited. Their consensus after several rounds was 7,8 million which was close to what the population was at the time.

[x] Brealey and Myers state, facetiously,: "sometimes the boss tells everybody to use ten years because that is a round number." Anecdotally it is said that ten years is used in Relief from Royalty estimates because the inventor of the method had only ten columns on his analysis sheet.

[xi] At the time of finalising this thesis (August 2001) it was announced that the American Financial Accounting Standards Board (FASB) has approved two new accounting standards. They are FAS 141, Business Combinations and FAS 142, Goodwill and Other Intangible Assets. The effect of these two standards is to abolish the amortisation of goodwill and to allow acquired goodwill to be retained on the balance sheet subject to annual impairment reviews. These standards came into effect as from 30 June 2001 and 15 December 2001 respectively.

[xii] See Chapter four for a full discussion on the Brand Knowledge Structure and its antecedents.

Chapter Seven - Brand equity in South African Business

Readers of this chapter must note that the case studies below are included with the permission of the companies concerned on the understanding that the data and information about their brands will be treated confidentially for three years from the date of completion of this thesis.

7.1 Introduction

The brand equity valuation methodology described in Chapter Six has, since mid 1999, been applied to a number of South African companies and their brands. The need for this was stimulated by brand management recognition that new ways of accounting for their brand expenditures are needed that relate the brand to the balance sheet (see Chapters Two and Three). Financial management has been forced by the new accounting standards (see Chapter Three) to give consideration to intangible assets. While brands and other intangibles will not yet meet the criteria laid out in the standards for recognition as assets, their inclusion in the standards has raised levels of interest. General management has long searched for a way to assess marketing expenditure that does not rely on esoteric marketing measurements. Brand valuation offers solutions to each of these categories of company management and is the reason for a heightened interest in recent years.

While the formula for valuing brands according to our approach is laid out in detail in Chapter Six, in practice, operational circumstances frequently require improvisation and flexibility. For example, management of the company whose brand is being valued may be reluctant to commission research additional to what it has already acquired. They may demand that the existing research data be used because in their view it covers the valuation

requirements. Within limits it is possible to adapt less than ideal research to the requirements of the model. Similar problems arise from the nature of the business, the way financial data are prepared, abnormal entries in the income statement or in management forecasts. Under these circumstances the valuer has to be flexible but firm in the extent to which modifications, exceptions and variations can be accepted without affecting the reliability and integrity of the model. But he must be willing to make adjustments and the model is well suited for a degree of modification.

In this chapter two valuations, Black Cat Peanut Butter and insurance company Liberty, are fully described. This is followed by select examples of valuations in which obstacles were overcome and variations to the model made.

7.2 Black Cat

Langeberg is a company in the listed Tiger Brands group. It is based in the Western Cape and produces many of the company's brands whose raw materials (fruit and vegetables) are grown in that region. One of these is Black Cat peanut butter which has been a South African favourite for many generations.

The holding company Tiger, previously know as Tiger Foods, has grown through acquisition but was known primarily to be a producer and distributor of food commodities. In keeping with the global trend towards branding, the company took the decision to change the nature of its business. It would change its name to Tiger Brands, focus its attention on improving its marketing capabilities and rationalise its range so that the balance was in favour of branded goods.

A natural extension of this was that it should value the brands it owns and use the resulting values as a new measure of marketing effectiveness; in time, to be used as an additional investor measurement for inclusion in the narrative (until this becomes an accounting requirement and a mandatory inclusion in the financial report - see Chapter Three) section of the annual report.

The Black Cat valuation was commissioned as a test case. At the time of writing the methodology and its usefulness are being evaluated with a view to it being adopted throughout the company.

The Black Cat valuation is featured here in full because it was relatively straight forward and is a good example of how the model works and of the more frequent problems the valuer will face.

7.2.1 NOPAT and Cost of Capital

It is important that the team that works on the valuation is fully representative of the company. In this case it comprised senior executives from Finance, Marketing, Operations and Sales. At the workshop (7.2.2) this senior team was augmented with a further layer of middle management, primarily from marketing and brand management.

The cost of doing business with large retail chains is a series of discounts that are basic to being awarded shelf space. In the case of Tiger Brands the discounts are negotiated at the corporate level by the Key Accounts Executives. Consequently they are not viewed, in this valuation, as brand related and are deducted from the gross revenues as a non-brand related item (see 6.4). Other discounts such as promotional allowances are agreed at the brand level and are therefore included in the "other fixed costs" line item below.

Because some of the production facilities are shared by other Langeberg brands, the capital employed was based on an allocation according to the brand's share of revenues.

Table 13. Black Cat NOPAT

Brand Gross revenue	75 324 000
Less: non brand revenue (discounts)	8 855 000
Less:	
Cost of sales	51 726 000
Marketing and sales	6 612 000
Other fixed costs	10 720 200
Brand gross profit	5 618 000
Less tax at 30%	3 932600

Management forecasts were examined and compared with the previous three years trend. Based on this and taking account of management forecasts, a conservative growth rate of 5% was allowed for the first year after the base year, and thereafter revenue was increased by 2,5% per annum reflecting a likely GDP rate of growth for the country. In the light of events, this was over optimistic and probably overstates the likely growth after the first year by 0,5% p.a. It was however the correct projection for the time and means that a revaluation would show a small decline in brand value reflecting the harder economic times which will impact on consumer demand.

The cost of capital was estimated at 16,89%, based on the Tiger Foods balance sheet and was applied to the capital employed in the production of Black Cat of R5 999 000 (R5 999 000 X 0.1689). The approach to this calculation is described in detail in the Liberty case that follows.

Black Cat incremental profit over the cost of capital, therefore, is:
R2 919 369. (R 3 932 600 – R1 013 231)

7.2.2 Brand Premium Profit

The brand asset value was obtained through the Delphi Technique conducted among a panel of senior Langeberg executives who agree to participate. The exercise was carried out at a workshop held in September 2000. The procedure was as laid out in Chapter Six.

Using the list in Table 9, participants were broken into groups and asked to select five resources from the list. They were encouraged to add to the list if they felt a resource was missing. It was also explained that the categories on the prompt list were there for guidance only. The resources that emerged were written on a flip chart and each participant was asked to choose from the list what he or she felt were the five most important in generating "super profits". The number of mentions for each were counted and the ten with the most amount of mentions noted. Each participant then had to rank the ten awarding ten (10) to the most important resource and one (1) to the least.

The rankings were collected and summed. Each score was expressed as a percentage of the total of the scores and the decision rule of 85% used to select the resource set components. These are the six shown below in table 14.

Using a prepared form, the participants then allocated 100% across the resource set (constant sum) to indicate their perceived relative importance. Finally, they were asked to indicate the influence they thought the brand's

consumer based equity had on each by allocating a score of nought (0), meaning no influence, to ten (10) meaning totally influential.

Table 14. The Black Cat Resource –set and its quantification

Resource	Importance	Brand influence	Weighted score
Product quality	22,3	7,7	17,7
Brand Image	20,7	8,3	17,18
Brand awareness	19	5,2	9,88
Salience – leadership	12	6,6	7,92
Distribution	15	6,2	9,3
Cost effective production	11	8,4	9,24
Brand asset			71,2

The brand asset percentage was calculated according to the formula in 6.7. The resource set and the values assigned to each resource are set out in table 14 resulting in a dilution of the incremental profit of 71%. This percentage reflects the amount of incremental profit attributable directly to the brand.

Accordingly, the Brand Premium Profit is: R2 072 751 (R2 919 369 X 0.71)

7.2.3 Dominant and Marginal brands

Using source material such as Nielsen reports, sales figures and expert knowledge, the questionnaire in Figure 11 was completed to calculate the brand category expected life.

Table 15 Scores for Dominant and Marginal brands in category

Determinant	Average score
Longevity	5
Leadership	5
Vulnerability	3,7
Bottom end churn	3,8

Applied to the cell values in Table 12 in Chapter Six the Dominant brand is positioned at 35,1 years (3,4200 X 3,4200 X 3,0007 X 1) and the Marginal brand at 7,87 years (2,1544 X 1 X 1,8658 X 1,9574).

7.2.4 Brand Knowledge Structure (BKS)

At the time of conducting the valuation it was found that existing research was inadequate and too old - the latest survey had been completed two years previously. Cape Town research company Research Surveys was contracted by Langeberg to conduct fresh research and the questionnaire was modified to ensure the data produced could be used in the valuation.

While the sample covered separately the black, coloured, Indian and white racial groups, it was demonstrated from previous studies that the product category enjoys similar usage in each and fundamentally, with minor variations, for the same reasons. Therefore it was not necessary to apply any weightings as has been the case in other valuations illustrated below.

Table 16. BKS calculated on all respondents

Criteria	Import.	Black Cat	Marginal
Tastes the best	8,19	67,5	1
The brand I trust	8,2	68,5	1
My kids like it the best	7,9	57,5	1
Consistent good quality	7,4	77,5	1
Has a good texture	7,28	77,6	1
Spreads evenly on bread	7,18	70,8	1
Worth a little more	7,2	63,5	1
Awareness (free recall)		64	1
Awareness aided recall		100	2
BKS		30,07	0,01

Black Cat is the clear market leader in a market in which there are few major contestants and many small brands: hence the low scores for the marginal brand. Following the Fishbein formula (Chapter Six, 4.6) and Keller's Brand Knowledge construct (Chapter Six, Figure Six) each association was weighted by its importance score and the sum of the weighted associations multiplied by the average of the two awareness scores to produce the Brand Knowledge Structure (BKS). Since Black Cat is the clear leader in all aspects, it is the dominant brand and no further data had to be extracted.

7.2.5 Brand Value

The expected life of the brand is calculated by applying the formula from Chapter Six, (6.10.2):

$$Y_B = Y_M + \frac{(Y_D - Y_M)(BKS_B - BKS_M)}{(BKS_D - BKS_M)}$$

$$Y_B = 7{,}87 + \frac{(35{,}1\text{-}7{.}87)(30{,}07 - 0{,}01)}{(30{,}07 - 0{,}01)}$$

$$Y_B = 7{,}87 + \frac{27{,}23 \text{ X } 30{,}06}{30{,}06}$$

$$Y_B = 35{,}1$$

The uninterrupted franchise run is half of the expected life, or 17,55 to which the decay formula (6.10.3) is applied which, when discounted to present value using the cost of capital as the discount rate and capitalised, produces a brand value of R18 745 439.

To test the value for reasonableness a short valuation procedure was applied projecting the brand premium profit for ten years; discounting this to present value using the cost of capital as the discount rate, and adding to the present value a perpetuity calculated on the tenth year. This produced a value of R18 897 000.

7.2.6 Lessons learnt

a Even straightforward valuations such as this need careful attention to detail. The allocation of the capital employed is critical since it could over state the cost of capital unless it is fairly allocated. The fact that a diversified company such as Langberg is able to use its plant for

more than one product range, is economically beneficial. This fact could well be a factor should the company wish to sell the brand, since the acquirer might not be able to effect the same benefit.

b Brand valuation is new. When the valuation is tabled there are few yardsticks by which to judge it. This inspired the short form test of reasonableness mentioned at the end of the last section. This was derived from the approaches used by Interbrand and Brand Finance (described in Chapter Five, 5.7.1 and 5.7.2). The diluted Brand Premium Profit is projected for between five and ten years, depending on the strength of the brand. It is then discounted to present value using the cost of capital as the discount rate. A perpetuity using the same discount rate is calculated on the last year of the DCF, and added to the capitalised present value.

The availability of such a test begs the question as to why this more simple approach should not be used instead of the full methodology described in this thesis. The answer is in the model's complexity. Valuations produced according to our formulation show management where the key drivers of brand value are, and they focus attention on where potential lies to improve or defend the brand's value. Various "what if" analyses are made possible by the methodology which guide marketing strategy development, promotional objectives and marketing budget setting.

7.3 Liberty

The team that worked on this valuation was primarily from the brand management group, but involved as well the financial director, commercial director and actuaries. The workshop was included in a full day's strategy

seminar and was attended by more than thirty delegates from all aspects of the business.

Liberty set about reconstructing its brand strategy in the year 2000 and employed a director of Brand Management to oversee this task. She called for proposals from Interbrand and BrandMetrics (the firm that conducts valuations using the Wits approach). The work was awarded to BrandMetrics which, having completed the valuation, is now working with Liberty management on brand strategy.

This valuation demonstrates the difficulties posed by insurance companies in the way their financial results are calculated and presented. It also points to the problems that arise from using inadequate research. Wherever possible, the BKS research should be conducted for the project. It is an economic reality however that this will frequently not be possible and the valuer must then take great care in interpreting and applying the data.

7.3.1 NOPAT and Cost of Capital

Insurance companies pose several problems for brad valuation some of which are articulated in this case. The basic problem is that the nature of their businesses based, as they are, on the investment of their customers' savings, and certain legislative requirements regarding the protection of these funds, makes extracting the information needed for brand valuation hard to access. There are no cost of sales to speak of and operational costs are bundled into a heading called management expenses and are relatively low. Income and expenditure is net premium income and claims and policy holder benefits. There are usually several investment funds with varying beneficiaries. In addition, due to actuarial approaches such as embedded

and appraisal values actuaries sometimes believe the valuation methodology replicates their own work.

The approach, with variations to suit different circumstances, described in this section, has now been applied to several insurance companies and appears to satisfy both the accountants and actuaries.

Headline earnings is the net amount after all income and expense flows, including taxation, have been accounted for. To this we add interest earned from investments to arrive at the NOPAT. There also is a capital fund invested in the stock market which in Liberty's case produced a surplus in 1999 and a deficit of similar proportions in 2000. This is a function of the stock market's performance and nothing to do with the brand. As a result it was decided to leave the investment return out of the equation, but this meant removing the investment asset from the balance sheet as well.

The result of the Liberty estimate is set out in Table 17 below.

Table 17. Liberty NOPAT

Headline earnings	1 543 000 000
Interest paid	146 100 000
NOPAT	1 689 100 000

The cost of capital was estimated at 17,35% calculated as follows (see Chapter Six, 6.5):

a The prime rate of interest at the time was 14,5% which, after tax, results in a cost of debt of 10,15%.

b The risk free rate used in the estimate of the cost of equity is the government bond, RSA 150 which at the time of the calculation was returning 12,27%.

c The beta used was calculated by the Bureau of Financial Analysis (BFA) which used 104 weeks of historical data. The Liberty return was regressed against the Johannesburg Security Exchange's overall JSE index which was used as a proxy for the market. The resulting beta was 1,1349.

d Based on a twenty year analysis of South African share returns, the BFA recommended a risk premium of 6%.

e The formula for calculating the cost of debt is:
cost of equity = risk free rate of interest + beta(market risk premium)
12,27 + 1,1349 (6) = 19,08.

f According to the balance sheet (2000), the Liberty debt to equity ratio is 19 : 81. The Weighted Average Cost of Capital is therefore:
(19,08 X 0,81) + (10,15 X 0,19) = 17,35%

Table 18. Liberty capital employed

Assets	
Total assets	75 943 100 000
Less liabilities:	64 702 000 000
Owed to shareholders	*62 137 600 000*
Retirement obligations	*114 400 000*
Current liabilities	*245 000 000*

Asset base:	11 241 100 000
Less: investment assets	2 446 800 000
Assets	8 794 300 000
Cost of Capital @ 17,35%	1 525 811 000

The Liberty incremental profit over the cost of capital, therefore is: R163 289 000. (R1 689 100 000 – R1 525 811 000)

Insurance companies use embedded value to estimate the present value of "in-force" life policies and add to this an estimate of anticipated new business which they call appraisal value. Since the embedded value is the present value of business already written and appraisal value is a projection of the level of growth anticipated, it is realistic to use these values for the growth forecast. Based on the embedded values provided by Liberty we applied four years of growth at 15% per annum and 5% per annum thereafter. This was a conservative rate of growth compared with those used in their own forecasts.

7.3.2 Brand Premium Profit

The brand asset value was obtained through the Delphi Technique conducted at a seminar/ workshop attended by over thirty participants from all aspects of the business.

The resource set and the values assigned to each resource are set out in the table below resulting in a dilution of the incremental profit of 55%.

Table 19. The Liberty Resource-set and its quantification

Resource	Importance	Brand influence	Weighted score
Brand name	11,6	9	10,4
Unique computed system	11,3	3,1	3,5
Client relationships	16,9	6	10,1
Management o investments	23	5,6	12,9
Sales and marketing efficiencies	17,1	5,6	9,5
Intermediaries and brokers	20,1	4,4	8,8
Brand asset			55,2

The Brand Premium Profit therefore, is: R90 135 528
R163 289 000 X 0.552)

7.3.3 Brand expected life

The Brand Expected Life exercise was carried out at the same workshop of senior managers and resulted in the following scores:

Table 20. Scores for Dominant and Marginal brands in category

Determinant	Average score
Longevity	5
Leadership	5
Vulnerability	3,7
Bottom end churn	3,8

Applied to the cell values in Table 12 in Chapter Six the Dominant brand is positioned at 35,1 years and the Marginal brand at 7,87 years.

7.3.4 Brand Knowledge Structure (BKS)

The data for the BKS calculations was extracted from surveys commissioned by Liberty and conducted by Research Surveys among samples that were segmented by race and other demographics. The results were reported as well by users of Liberty and of all users of insurance companies. Two findings are important in this regard:

a While no records are kept to indicate the extent to which Liberty has acquired black policy holders it is thought to be low. This is because the firm has always aimed at the high net worth individual who in the South African context tend to be white. According to AMPS the proportion of the black population taking out whole life policies is 33% of the total. Endowment and savings are 30% and retirement annuities are 32%. It was agreed to set the ratio for Liberty at 90% white coloured and Indian and black 10%. This weighting was agreed to by Liberty.

b The large disparity between the scores given to Liberty in the survey by its own policy holders in the sample was so great that it was decided to provide a range of values: one using the Liberty policy holders and the other applying the entire sample. The scores for each are in the tables below:

Table 21. BKS calculated on all respondents

Criteria	Import.	Liberty	Old Mutual	Sanlam
Efficient customer service	7,8	14,8	27,9	32,7
Financial well-being	7,8	13,2	27,1	30,8
Accessible - easy to do business with	7,7	14,1	18,9	32,6
Meet my changing financial needs	7,6	14,7	29,6	33,1
Products /services to help me realise my dreams	7,6	14,6	28,6	32,1
Expert financial advice from representatives.	7,6	12	30,9	34,9
Regularly send me useful information	7,1	12,8	31,6	35,1
Awareness (free recall)		55,4	87,8	91
Awareness (aided recall)		90	95	95
BKS		5,32	14,19	16,33

NB. It should be noted that these data were sufficiently biased that Liberty conduced fresh research in order to provide more accurate information. At the time of writing the new data was not available.

These results are weighted 0,9 : 0,1 in favour of white policy holders. With this weighting Sanlam is clearly the dominant brand. When the weightings are removed Old Mutual becomes the leader. The marginal BKS was calculated from the weakest scores recorded in the survey and resulted in a BKS of 0,09

Table 22. BKS calculated on Liberty respondents only

Criteria	Import.	Liberty	Highest competitive scores
Efficient customer service	7,8	52	16
Financial well-being	7,8	54	9
Accessible - easy to do business with	7,7	52	14
Meet my changing financial needs	7,6	58	12
Products /services to help me realise my dreams	7,6	58	10
Expert financial advice from reps.	7,6	56	14
Regularly send me useful information	7,1	45	18
Awareness (free recall)		75	87,8
Awareness (aided recall)		90	95
BKS		23,54	6,44

The marginal brand on the same basis as above scored 0,49

7.3.5 Brand valuation

(The calculation of the BKS is as shown above in the Black Cat example)

Applying the formula from Chapter Six, 6.10.2:

$$Y_B = Y_M + \frac{(Y_D - Y_M)(BKS_B - BKS_M)}{(BKS_D - BKS_M)}$$

Y_B = 7,87 + $\frac{(32\text{-}7.87)(15\text{-}1)}{(19\text{-}1)}$

Y_B = 7,87 + $\frac{24,4 \text{ X } 14}{18}$

Y_B = 26,85

The uninterrupted franchise run is half of the expected life, or 13,42 to which the decay formula is applied.

Using the two sets of BKS scores from the tables above the Liberty brand value for the year 2000 is between R926 263,400 and R1 117 337 900. The difference is brought about by the expected life that results from the different BKS scores. The higher value is generates a franchise run of sixteen years and an expected life of 48 years. The lower value generates nine and twenty-four respectively.

To test the values for reasonableness the short valuation procedure described earlier was applied. This produced a value based on a five year

projection, using the same cost of capital for the discounted cash flow and to estimate the perpetuity, of R1,041,000 000.

7.3.6 Lessons learnt

Insurance companies by law are forced to maintain a capital amount sufficient to cover their liabilities. This amount may be invested for the insurers a own account. In a brand valuation this can cause a problem as was the case with Liberty. We found that the surplus in the 1999 year inflated the profit by a substantial amount. The profits were equally harmed in the following year due to a major turndown in the value of stock market share portfolios. There are two possible solutions to this problem which has its roots in government regulation and the fortunes of the stock market and is outside the control of brand management. First is to standardise the return by using an 11% return which is the average return of the JSE over twenty years. The second is to remove the amount altogether. If this is the course chosen, it must not be forgotten to remove the investment asset as well, from the balance sheet.

7.4 ESKOM

This case example is limited to the financial aspect of the valuation because it exemplifies a range of problems that need to be dealt with in reaching the Brand Premium Profit in a credible and reliable manner. A comment is also made on the unique problems that arose regarding the research element.

7.4.1 NOPAT

Eskom is a government owned utility that has been regulated but which during the years 2000 and 2001 has been converted into a limited liability

company with share capital. It is intended that the energy sector will be partially liberalised to allow for competition and the institution is preparing itself for this eventuality. However, energy is seen by the ruling government as a basic human right and Eskom has had to devote resources to carrying power to communities throughout the country regardless of the economic impact on the company. For example, in 1994 Eskom undertook to reduce the real price of electricity by 15% between the years 1994 and 2000 and achieved the electrification of 2,391,684 homes between the years 1991 and 2000.

This history and present reality produced several challenges in calculating the basic data needed for the valuation.

a. The previous government had invested heavily in energy, through Eskom primarily for political reasons. The threat of sanctions and isolation existed for many of the forty years during which Apartheid was official policy and became a reality during the late 1980s. Consequently the government capitalised on the cheap coal available in what then was the Transvaal. Numerous coal burning power stations were constructed to feed the national network, far in excess of the country's normal needs. According to the annual report for the year 2000, total assets were R73 billion.

   To give a perspective to this amount, the after tax profit for the same year was R1, 7 billion. The cost of capital of 13% applied to this figure gives R9,5 billion. This, in valuation terms, results is a negative premium profit of R7,79 billion.

In discussion with the financial management of the corporation it was agreed that the assets applicable to the brand were only the power generating assets and these should be shown at cost. This reduced the capital employed to R43 billion.

b. Eskom formally changed its tax status on 1 January 2000. As from that date it became liable for income tax. However the company had agreed with the Receiver of Revenue, that its social commitments and accumulated accounting looses could be set off against its tax liability and that this would apply until about the year 2004 when the set-offs are scheduled to run out. At this stage Eskom will start paying tax, but at a reduced rate, only paying full tax in about 2006 or 2007.

Table 23: Cash Flow projections for the years 2000 – 2004

	2000	2001	2002	2003	2004
Net profit	3213,0	3341,0	3313,0	5663,0	6369,7
Add back interest and finance charges	2915,0	2540,0	2549,0	1947,0	1674,0
NOPAT (no tax paid)	6128,0	5882,0	5862,0	7610,0	8043,0

Source: ESKOM Corporate Finance Department

In Table 23 the net profit before tax is shown. In terms of the approach outlined in the previous chapter, interest and finance charges have been added back because they are not part of the cost of building and maintaining a brand, but depreciation has been retained above the line as a proxy for long term asset replacement.

The net profit figures for 2001to 4004 were the forecasts supplied by ESKOM Corporate Finance department. They were extracted from the budget for the year 2001 and the five year business plan. On investigation it was established that the inflated NOPAT figure for the year 2000 is due to a depreciation add back of some R800 million. It was agreed that this was an abnormal charge and that it would be realistic to take the weighted average of the three years 1998 to 2000 as a more accurate figure for the 2000 year. This produced a figure of R5, 562 billion, which has been used in the calculation. The 28% jump in profits between the years 2002 and 2003 was the anticipated incremental earnings that would flow to the corporation from its international activities. This has since been officially adjusted and it was agreed to use a more conservative 10% increase for this period.

Because of the need for electricity and the already advanced plan to take Eskom power to countries far to our north an optimistic growth trend can be anticipated. Hence a constant growth rate of 5% per annum, less 30% to allow for income tax that ESKOM will start paying from about 2004/2005, was used. Growth from 2005 and beyond is therefore 3,5% p.a.

7.4.2 Capital Employed and Cost of Capital

The capital employed was extracted from the 1999 financial statements as shown in the table below:

Table 24: Book value of assets (plant only)

Division	Asset value
Generation	24 044 000 000
Transmission	5 499 000 000

Distribution	13 451 000 000
Total	42 994 000 000

The Cost of Capital was estimated by ESKOM Corporate Finance Services. Based on a 0.40 : 0.60 debt to equity ratio the cost of capital was estimated at 12,79% and rounded up to 13% (see the Liberty example of how this is calculated). The cost of capital we calculated using BFA was 13%.

7.4.3 Calculating the Brand Premium Profit

The dilution process took place over two months via the Internet. A panel of eighteen ESKOM senior managers was recruited and each one responded to a series of questions based on the Delphi technique. First they were asked to propose a list of probable drivers of ESKOM incremental profits. These were analysed and reduced to the most frequently mentioned ten.

A second list was sent to the panel which was asked to rank the ten in order of importance. These were analysed and reduced to a list of the six most frequently ranked items. In the next round the panel was asked to allocate one hundred percent (constant sum) across the six to indicate the relative importance of each resource. Finally the panel was asked to award points out of ten to each to indicate the influence of the brand on each resource. The results are set out below.

Table 25. The ESKOM Resource Set and Brand asset value

Resource	Relative Importance	Brand Influence	Weighted Score
Financially sound	20,8	5,5	11,4
Size and dominance	17	6,7	11,39
Brand image	11,8	5,1	6,0
Price charged	15,4	4,8	7,4
Cost management	21,6	4,6	9,9
Lack of competition	13,4	5,6	7,5
Brand asset			53,6%

Conducting the dilution process by email has both positive and negative implications:

a. In terms of the requirements of the Delphi (see 6.6.3.1.) approach it achieves the objective of having experts provide their opinions beyond the influence of their peers. Each respondent works individually and only becomes aware of what the others have said when he or she receives the next round which shows the consensus view.

b. Because each respondent is working alone, they are inclined to procrastinate and a considerable effort is needed to recover the entire set of responses. In fact, some rounds have to be closed without the full panel participating.

Given time this is not too much of a problem. When the valuation has to be completed in a specific time period, this is highly problematic. The solution is to conduct the exercise in a

workshop and complete the entire process in a single sessions. This produces its own problems such as finding a time when the same number of high level executives can attend. It also requires a skilled facilitator to ensure there are no undue influences exerted on the group by a strong willed, opinionated or senior member.

7.4.5 Brand Knowledge Structure (BKS)

ESKOM commissioned commercial research in order to establish the Brand Knowledge Structure. Based on a research brief prepared by BrandMetrics the survey was administered to a sample of 265 respondents selected from lists supplied by ESKOM. Each division provided names of existing customers and users of the respective service.

The structured questionnaire included measures of awareness of the various ESKOM divisions at both spontaneous and prompted levels. A list of forty service delivery and customer care statements, developed from preliminary qualitative research, was presented and respondents were asked to rate these firstly in terms of the relative importance of each and then the extent to which they perceived the item to be delivered by the division which they had experience (Generation, Transmission, Distribution or Eskom Enterprises).

Because the valuation methodology has been designed for commercial use, it is subject to typical operational constraints such as limited finance. As a consequence the research is seldom ideal and the valuer has to adapt the data to fit the frameworks in the model. This frequently manifests in the variations in research methodology used to acquire the consumer based survey data.

In the case of Eskom, special research was commissioned within the budget set for the task. Eskom has a procurement policy which states that only companies on its approved list may tender for the work and if only one company submits a tender by the closing date, it must be awarded the contract. In this case three firms responded to the brief, two of which withdrew because they were unable to produce their tender by the date stipulated. By default the third company was awarded the project.

While the research company achieved its targeted sample objectives and produced the results on time (in itself a feat due to the size of the sample and the fact that several interviews had to be conducted in foreign languages), the data presentation was not in a form that allowed it to be fitted easily into the model. For example, contrary to an early injunction, too many attributes were tested and it became extremely hard to isolate the most important of these. The solution was to reduce the size of the list through factor analysis from which the reduced number of factors shown in Table 27 emerged.

Table 26: Factor Analysis

Factor	
Market Sensitivity	Sensitivity to market needs
Operational efficiency	Functional and technical ability
Reliability	Accuracy, on time statements, prompt creditor payments
Responsiveness	Prompt problem solving, fast repair and maintenance

	Advising about power interruptions, constant power delivery
Assurance	Sufficient network capacity, technologically competent

The relatively poor quality of the data makes it unhelpful to show here the way the data were used in constructing the BKS. Suffice to say, due to the robust nature of the valuation model, it was possible to manipulate the data to produce BKS scores and therefore a brand value. Eskom has no intention of using the valuation as a benchmark. It was to contribute to strategic decisions regarding the future of the Eskom brand name and the valuation and its process achieved this goal.

7.4.6 Lessons learnt

Under commercial conditions, valuers are rarely provided the ideal information with which to conduct a completely efficient valuation. They must be willing to extemporise and work with what is available.

The methodology has been designed for operational use. It is a robust set of procedures to which variable forms of data may be fitted. At the BKS input level the model needs a set of single number scores to set the expected life distances . It needs a dominant, marginal and object brand. If these scores can be extracted in a credible manner from the data provided, the model will produce a value. It is up to the valuer then to qualify the value with a note explaining the data deficiencies and explaining how they were manipulated to

produce the inputs needed. They must also qualify the value with a suitably worded caution.

7.5 Additional lessons learnt

Many lessons are being gleaned from the increasing range of brands being valued by this methodology. Generally speaking, these enhance the model's ability to produce valuations with wider applications and with greater efficiency. In this section some of the more significant lessons are described under the headings: finance; dilution; expected life ; and Brand Knowledge Structure (BKS).

7.5.1 Finance

7.5.1.1 Non brand revenues.

The model stipulates that revenues should be those attributable to the brand. This specifically excludes, for example, revenues earned by a fast moving consumer goods manufacturer who adds marginal profits (or losses) to the brand, by including sales of "Dealer Own Brands" made for retailers. Two examples demonstrate that this is prevalent as well in other areas.

a M-Net is a subscription TV station with its own production facilities. Its outdoor broadcast units, of which it has two, are rented to other users when not being used by M-Net. This brings in additional revenues. Initially it was thought that these revenues should be excluded from the valuation calculation. Subsequently they were included on the basis that the asset had been included in the capital employed and that this additional revenue constituted part of the return on capital employed, particularly since the units are clearly branded M-Net and do a

promotional task for the brand even when not being used on the brand's business.

b NBS and Liberty are financial services organisations. They each have insurance products that are sold under other names. Liberty for example has Crusader, which is the name used for insurance sold by the Standard Bank to cover mortgage bonds. Customers of Standard Bank are told they have to insure the bond. The documents are in the name Crusader, which is Liberty. This income was so far removed from the brand that the revenues were excluded from the calculations. Conversely the NBS, which has a similar scheme, uses NBS Insurance as the name of the mandatory insurer. Because of the branding, the revenues were included in the calculation. The test for inclusion is if the sale of the insurance adds value to the brand which is the case for NBS but not for Liberty.

7.5.1.2 Abnormal items in the income statement

The first run of the NBS profit calculations produced a negative Brand Premium Profit (BPP). Examination of the income statement showed that there had been a large bad dept write off in the year. A study of the three previous yeas satisfied the valuer that this write off was abnormal. The abnormality was therefore smoothed by taking a weighted average of the base year and the two years before. The weighting favoured the base year and penalised the more distant year. The calculation was three times the base year, plus twice the previous year, plus one times the third previous year, divided by six. This produced a positive BPP.

7.5.1.3 Capital employed

Businesses which are seasonal and which require a build up of inventory prior to the season or seasons should be viewed differently to those which are constant through the year . Demand for Black Cat peanut butter does not vary significantly over twelve months. The Sunday Times and Financial Mail are stable spiking on high news days only. Conversely Nike shoes have high and low seasons and management has to plan for this: building up inventory prior to the season and incurring debt to finance it. Accounts receivable and payable increase accordingly. The same applies to beverages such as Coca Cola which has high levels of sales during hot months.

This pattern has a marked effect on the capital employed and requires a careful examination of the monthly trading accounts.

In the case of Nike for example, the balance sheet entry for inventory, debtors and creditors in the end of year accounts was recorded at a high point resulting in an over stated capital employed. This had the effect of increasing the cost of capital and thus reducing the incremental profit and BPP. If the monthly inventory and net of accounts payable and receivable are averaged and used instead, a different number results which in this case was favourable to the brand valuation.

Permission was not granted to include the Nike figures here but, as a principle, it is important to note that this aspect must be looked at and if justified, the average taken rather than the end of year number.

7.6.2 Dilution

Dilution is the term given in this model to the percentage by which incremental profits over the cost of capital are further reduced to extract the portion attributable to the brand (see 6,6). The term dilution was chosen early in the model's development and probably gives the wrong impression of what the process does. It has been used now on many valuations and has become part of the *lingua franca* of brand valuation. It would at this stage be quite hard to change it to something more appropriate.

Table 27. A Selection of Dilution Percentages

Brand Category	Dilution %
Exterior wall paint	71
Weekly newspaper	88
FMCG – frozen foods	82
FMCG - spreads	71
TV Station	70
Parastatal - Power	54
Insurance	51
Ready Mix Concrete	49
Bank	61
Athletic shoes	71

Table 28 shows the dilution scores that were derived from both email and workshop Delphi studies for a range of brand categories. Three major points arise from experience:

a Because of the nature of the Delphi process the accusation can be advanced that these scores are subjective. In a sense they are because they arise from the opinions of the participants. This highlights the need for rigour in conducting the Delphi exercise. If it is conducted among as large as possible group of representative and knowledgeable people, and the stages are conducted methodically , intuitively correct scores emerge. The facilitator has to take a firm stance when a strong minded senior executive tries to influence the other members and under these circumstances it is best for each member to complete each stage individually and confidentially. Submitted forms are then summed and averaged. Clearly if the process is conducted by email, this problem is avoided, but other obstacles such as procrastination, then intervene.

b The difference between the high scores achieved for newspapers and consumer goods and insurance companies and industrial goods reflects accurately the nature of each type of business. While a leading newspaper stands or falls by its name and its ability to attract readers, advertisers and journalists, a ready mix company owes its success as much to location, favourable access to quarry materials, and pricing agreements as it does to the brand name and associations with it of quality and reliable delivery. In fact in broad terms this is explained by the discussion in Chapter Two on salience and brand image (Figure 3). The brands with low dilution scores are an even balance of salience aspects and brand image, whereas the brand with high dilution scores will tend to be more image driven.

c Allied to the previous point is the fact that *fmcg* brands and other consumer goods have dilution scores in the 70s and not higher. The athletic shoe is Nike and this score may appear to be low for such a

powerful brand. The explanation is that while the brand is clearly important in driving superior profits, this cannot be achieved without, *inter alia*, a constant source of design innovation, favourable manufacturing costs, distribution and optimal pricing. With newspapers, the brand dominates all aspects of the business.

7.6.3 Expected Life

This exercise which sets the time markers for both Dominant and Marginal brands, is usually combined with the dilution workshop. It does take much time to be complete, but must be carefully considered. If the dilution process is conducted by email, a special team of knowledgeable people must be assembled to conduct this project. Two key lessons have been learned from conducting this exercise:

a The wording on the questionnaire does not always apply in all cases. In some instances it is advisable to tell the participants that the wording is to guide them in their answers. The key is the numeric, one to five scale. Participants should revert to this scale if they find the semantic descriptions misleading. Thus under "bottom end churn" the answer lies along the scale with a score of one indicating low barriers to entry and five indicating barriers of monopoly proportions.

b The four factors are capable of being answered by reference to factual information. This should be encouraged where possible in order to reduce guessing and subjectivity.

7.6.4 BKS

It has been shown in this chapter that weighting plays an important role in brand valuation. In both dilution and the BKS final calculation the numbers are weighted according to the formulae being used (Chapter Six, 6.6.3.3; 6.8.3). In the Black Cat and Liberty examples shown earlier weighting is again used to account for the different usage patterns of varying user group segments.

In order to obtain an accurate picture of the brand and the varying usage and sales patterns that develop around it attention has to be given to how the data should be weighted. In the interest of objectivity and reliability some core rules are set out below:

a Weightings should be factually based as far as possible. For example if it is know, as it is with Nike in South Africa, that its three divisions (shoes, clothing and equipment) sell and return a net profit in the proportions of 67 : 29 : 4, this is a usable weighting for combining valuation components.

b Because of South Africa's racial diversity, race is invariably a factor in why and how people use products and services. Sensitivities to race in this country have driven some companies to stop recording the race of their customers. This is the case with Liberty. This is now recognised as an omission and will be reversed in due course. When the racial mix of the user base is known as was the case with M-Net whose subscriber base is 0.9 ; 0.1 in favour of whites, this can be used as a weighting when combining the BKS data into a single score.

c In a valuation currently in progress (permission has not been granted to name the brand or feature the data in this thesis) the customer based research was carried out separately among existing users of the financial service and potential users of the service. If the results were simply summed this would not reflect accurately the strength of the brand and its value among its core of loyal users. The solution was to choose a weighting so that customers already acquired are given more importance than those who use competitive firms.

Attempts have been made to quantity the difference between acquiring new and retaining current customers. What is clear is that a current customer is worth more to a firm than one still to be acquired. Peppers and Rogers (1993) construct an argument which puts the advantage at a ratio of 5 : 1. In other words it costs five times more to acquire a new customer as it does to gain repeat business from a current one. In the case mentioned here, a more conservative view was taken in order to represent the data more accurately for the valuation. To be conservative, a ratio of 4 : 1 was used.

It must be stated that (a) and (b) above are more reliable weighting factors than (c). It would however, provide a warped input into the valuation if the survey based data were not manipulated in some way as explained. It is essential though for details of the weighting, its source and how it has been applied to be set out in detail in the documentation that accompanies the valuation.

7.7 Concluding discussion

At the time of completing this thesis (September 2001) the methodology had been applied to fourteen brands with a total value of R7,6 billion. A further

six, including world leading brands such as Nike and Coca Cola, are in progress and more are due to commence. The applications range from law firms, retail travel outlets, a correspondence college, in addition to the brands mentioned in this chapter.

Arising from these valuations are a number of general observations, some of which will lead to further work on refining aspects of the approach:

7.7.1 Most of the uses have been for marketing purposes: ranging from measuring the effectiveness of marketing expenditure, to aiding in strategic planning, and communicating with the finance function. Other uses have been to set a price on a brand to be sold; for use as a tool for tax structuring; to test the premium over NAV set on the share price of brand owning companies; to place values on two sets of merging law firms to settle fee differentials, and the methodology is currently under evaluation by two multi brand owning companies with a view to adopting it as a management reporting tool.

Since the bulk of valuations were initiated subsequent to September 2000, there is no record of repeat usage to track progress against the benchmark. This is the stated intention of most, and *The Sunday Times* has now conducted a follow up study. Whether brand valuation will become a standard procedure remains to be seen. The survey carried out in October 1999 (Hudson and Sayers 1999) indicated that 53% of the sample of financial managers interviewed felt that it would be beneficial to do so. Until there is a statutory need however, such as an accounting standard, brand valuation will remain in the realm of choice and will be used according to the whim of senior management.

7.7.2 The BKS scores were extracted from a variety of sources. While most of the research was conducted by well known research houses there is little symmetry in the way the results are obtained and reported. The formula accounts for this in that it is the distance between the dominant and marginal brands and the BKS scores for each that sets the expected life and that therefore almost any reliable measure of relative distance would suffice. The ideal would be a standard approach. However, this is unlikely because of the commercial nature of the valuation application and the cost involved in conducting special research. From this point of view the flexible nature of the model is an advantage. It does require though that the valuer is conscious of the implicit dangers of having to adapt a range of research types to fit the model.

7.7.3 While the method could be criticised for not having been tested empirically and being based on previous research as reported throughout this thesis, it should be pointed out that the commercial application of the methodology has been examined by among others the valuation department of KPMG in Johannesburg and London; the taxation, treasury, accounting and corporate finance divisions of ESKOM; the actuarial departments of both Sanlam and Liberty. This is in addition to the various finance and marketing specialists in the companies for which valuations have been conducted.

7.7.4 Support for the validity of the methodology can be gleaned from the tests for reasonableness conducted for each valuation. This is a hybrid of the approaches taken by both Interbrand and Brand Finance. The Brand Premium Profit is projected for between five and ten years depending on the market position/s of the brand/s and discounted to present value using the cost of capital as the discount rate. A

perpetuity is added to the capitalised value representing the long lived nature of brands. In most cases the value that this procedure produces is within a close range to that produced by the Wits method.

The question is often asked if a similar value would have been obtained if, for example, Interbrand, had conducted the valuation. Since the methodology has as much to do with informing brand owners on how to increase or defend the value as the brand value figure itself, it provides some comfort to be able to state that Interbrand would have produced a similar value. In fact it would be counter productive if the question could either not be answered or if widely divergent values were indicated.

Chapter Eight – Conclusions

8.1 introduction

Brand equity found its way into the marketing lexicon in the late 1980s. Its purpose was to focus the attention of the marketing fraternity on the asset value of the brands under their charge. In hindsight it seems extraordinary that this was necessary because the value of brands to companies had long been acknowledged. Entrepreneurs from the late 1800s gave names to their products in order to differentiate them from others. Obvious examples are Coca Cola, Beecham's Liver Pills, Kodak, Sunlight Soap, American Express Travellers Cheques, Heinz Baked Beans, Lipton's teas and Ivory Soap (Hart and Murphy 1998). These became valuable properties for their owners.

Advertising was the tool they used to communicate the brand to the public. Casson (c1920) said:

> *"The art of profitable advertising is to get people more interested in the goods than the price." (p. 9)*

The focus on brands and on advertising as its major communication and persuasion tool, became confused during the second half of the twentieth century. The birth of the marketing academic might well have brought this about. By devising the marketing concept and by instigating expanding areas of academic research and study, the business of making profits out of branded products became immersed in complex science and business school curricula.

This thesis has attempted to cut through the problems facing marketing and to re-focus attention on creating shareholder wealth from innovation and initiative. By linking the brand to the balance sheet through a

valuation methodology, marketers are forced to concentrate on the only reason for a business to exist: to maximise investor wealth.

At the outset, in Chapter One, it was stated that the central objective of this research was two-fold. Its purpose was:

a To examine the available valuation methodologies in the light of the expanding needs for which they are, and will in the future be, needed.

b To develop an alternative approach that is suitable for South African use, which merges marketing inputs with financial and accounting frameworks, which can withstand academic scrutiny, is acceptable to formal bodies such as the tax authorities, accountants, corporate financiers, and which bridges the divide between marketing and finance.

In this concluding chapter, the wide ranging study conducted in fulfilment of those objects, is summarised, main conclusions are drawn, limitations expressed and areas for further relevant research suggested.

8.2 Summary and discussion

Brand equity has been inconsistently defined but the most commonly understood explanation is that it is the value that a brand adds to a non-branded version. The merger and acquisition activity of the 1980s was about this. Companies bought other companies because they owned famous brands. They were, and still are, willing to pay premiums over and above the net realisable value of the company to add these brands to their stable. There are multiple benefits the most important of which are:

a It is often cheaper to buy an established brand with distribution, consumer awareness and associations and a loyal consumer following than it is to develop a new product and create a brand from it. The rate of failure of new brands is three out of four and the cost of each new product launch, excluding the research and development costs, is estimated to be in the region of $100 million. Therefore $400 million has to be budgeted for one successful new brand (Aaker 1991).

b Buying established brands increases the channel power of the new owner, giving them greater negotiating leverage with retailers. And it boosts the company's line up of profitable brand leaders (Reed 2001). This was one of the main reasons given by the chairman of Unilever, Sir Niall FitzGerald, for spending $28 billion on acquisitions during a brief period in 2000.

This has little to do with marketing and the marketing function. These are decisions taken in the boardroom along with capital expenditure and staffing issues. The analysis in Chapter Two casts an unfavourable shadow on marketing as its struggles with organisational structure, falling brand loyalty, increasing pressure from both price sensitive consumers and hard nosed retail buyers. It is suffering from a loss of power as companies adopt a market orientation thus spreading the responsibility for the development and protection of brands away from the marketing function to a management led, inter-departmental activity.

While the accounting profession has not yet resolved its problems over the recognition of intangible assets and goodwill in financial statements, it is moving in that direction. The recently established (January 2001), full time directorate of the International Accounting Standards Board (IASB) has nominated nine accounting standards as priorities for its attention. One of these deals with Business Combinations (in SA it is A.C.131). This standard, among other things, deals with intangible assets and goodwill and sets out how they should be

treated in the balance sheet and income statement. In addition the IASB has listed a further sixteen standards that are receiving attention by associated bodies around the world. Among these is one that deals with intangible assets (in SA it is A.C. 129). The implications are that the accounting profession is conscious of the inadequacies of its current guidelines and rules. Under pressure from capital markets for more useful reporting and from its own members for a change from historic cost to value based accounts (Eccles et al 2001; Osterland 2001), it may be assumed that in the foreseeable future brands will be accounted for in financial statements.

Since the early 1990s during what became known as the "Brand Debate" the possibility of brand values appearing in notes to the accounts, or the narrative section of the annual report, if not in the balance sheet itself was being mooted (Power 1990). This has started. For example Barlows, a long established conglomerate with an industrial and resource orientation, announced in its 2000 annual report that it was changing its name to Barloworld and adopted the slogan of Brand Power. Tiger Oats changed its name to Tiger Brands and rid itself of many of its commodity products and shifted attention to a trimmed down portfolio of core brands. If the accountants change their standards to admit brands as assets or at least report on the value they create, the role of companies as custodians of brands will be greatly enhanced.

Notwithstanding the attention being placed on brands by financial markets, accountants, economists and the legal profession, they remain rooted in consumer memory. The package, logotype, colours and slogan are simply the symbols of recognition (Keller 1997). The true source of brand equity is stored in the memory of the consuming public placed there by the company's communications and by the publics' own personal experiences of the product.

This fact has troubled the early brand valuers because talking to financial people about what they call the "soft" issues is "wishy-washy" (see Chapter One). They

avoided any input into their model that reflected how consumers thought about the brand. As recently as August 2001, this view was reiterated by the editorial writer of BusinessWeek in the introduction to its survey on the Best Global Brands (Shepard 2001). He said:

> *"In developing our rankings, we avoided the vagaries of consumer perception surveys, which can change on a whim. Instead, we undertook a vigorous financial analysis ..." (p. 1)*

Later in the editorial he contradicts this view by claiming that leading brands prevailed in previous downturns because management resisted the temptation to "trim their marketing budgets" and continued with brand building and keeping brand profiles high. The biggest proportion of the marketing budget is invested in marketing communications, split 50:50 between classical media and sales promotion, in the USA (Shimp 1997). The conclusion from this is that the perceptions of the consumers of the brands must be reinforced for the brand to survive.

The main valuation methodologies being used internationally at present fail to account for this key aspect of brand equity. It is the strength of the brand in consumer memory that adds value to the non-branded version. People must be aware of the brand name and they must associate it with attributes that are sufficiently important to them to make them want the brand, keep on buying it and using it, and even be willing to pay a price premium over the category average to acquire it. Significantly, none of the valuation methodologies that were developed in response to the MSI initiative incorporated it either. And yet both Aaker (1991) and Keller (1993), who have been central to the development of brand equity research and development, have placed the consumer at the heart of the concept.

The approach to brand valuation proposed in this thesis and explained in Chapters Six and Seven, is designed to overcome this shortcoming. It is

soundly based in accounting and corporate finance theory, but it merges a measure of Brand Knowledge Structure with Brand Expected Life to make this the lever to the value of the brand. It is grounded in the known benefits of brand loyalty that result in:

a a willingness to pay a premium price;

b consumers who will buy the brand regularly and who can easily (relative to non users) be persuaded to increase usage and purchase frequency;

c lower marketing costs since it is cheaper to keep existing customers than it is to acquire new ones;

d satisfied customers talk favourably about their brand and encourage others to try it.

These advantages are captured in the expected life of the brand and increase or decrease the capitalised, present value of the projected flows of brand incremental profit.

At the time of writing the methodology has been applied to fourteen brands with a total value of R7,6 billion. (At the time of the second submission in March 2002 this figure had risen to more than twenty with three valuations being conducted in the United Kingdom for British companies.) The primary use of the valuation has been to evaluate marketing and to aid marketing strategy planning. It has as well been used for tax structuring purposes (Eskom), to justify keeping an historic brand name (NBS), brand sales and purchases (I and J – not included in Chapter Seven), and to present to market analysts (M-Net). Uses for which it could be put include trademark protection and litigation, estimating a premium over Net Asset Value (NAV), and for inclusion in financial statements.

In the proposal for this thesis (May 1996) it was stated that the aim would be to:

" ... produce frameworks and mechanisms that will be capable of general use by South African financial and marketing management."

It was not envisaged then that the methodology that would emerge would not only achieve acceptance in South Africa by the marketing, accounting, capital market and taxation communities, but would also be adopted internationally as well.[i]

8.3 Limitations

There are several limitations to the scope and nature of the project, the most important of which are listed below:

8.3.1 The methodology is based on the discounted cash flow approach to valuation. While this approach is widely used in both finance and accounting circles, it suffers from the vagaries of assumption and forecasting. This approach is no less afflicted and while every attempt has been made to minimise the subjectivity involved in a forward looking estimate this remains as a qualification and limitation.

8.3.2 This study has taken place at the leading edge of academic study and has meant that in some areas there was little in the literature to draw on. One such area is the link between the brand in memory and its economic life. The concept is intuitively correct and intensive searches through the literature have produced support (Chapter Six, 6,7 and 6,8). But more work is needed to prove empirically that the relationship does exist and that it can be measured.

8.3.3 Brand valuation by its nature is a commercial opportunity. Since the advent of brand valuation in the mid 1980s, Interbrand has published widely on the technique, but the secret nature of how the method worked

has remained undisclosed. The only methods that have been described in detail are those initiated by the MSI project, none of which have lived beyond their initial publication.

8.3.4 The brand equity literature makes it clear that it is consumer perceptions and attitudes that drive brand value, but this requires market research, and there is some anxiety about the reliability of most attitudinal survey methods. This has been reinforced by the courts in Europe where according to Kearney and Mitchell (1997), judges are now asking for market surveys in support of trademark dilution and consumer confusion claims. This has placed pressure on the market research industry to examine their methodologies in order to introduce greater reliability.

8.3.5 Even though the recently adopted accounting standards incorporate intangible assets under certain conditions, there is still an inhibition to viewing brands and the marketing investment that builds and maintains them, as assets.

8.3.6 It was stated in Chapter Seven but is repeated here that the methodology is designed for use in operational conditions. Constraints are frequently placed on the valuer by the brand owner such as less than ideal market research and financial limitations. The model is a series of frameworks linked mathematically. As long as the basic requirements of the frameworks are met and the linking equations left intact, these commercial considerations and business realities can often be accommodated.

8.4 Areas for future study

Some rich areas for further study have emerged from this work, among which are:

8.4.1 Examinations using data from research companies such as A.C Nielsen, coupled with qualitative studies could form the basis of a more substantive link between Brand Knowledge Structure (BKS) and Brand Economic Life.

8.4.2 The mechanism employed in this methodology that establishes the distance between the dominant, marginal and brand being valued is a combination of a forecasting technique (Delphi) and survey based qualitative data. Further work needs to be conducted on more stable metrics than those currently being used and which do not call for the commissioning of expensive market research.

8.4.3 The methodology is capable of being used to evaluate the effectiveness of the marketing budget in that it can be related to gains (or losses) in brand value. What is not possible is to decompose the marketing budget and demonstrate the effectiveness of each component (e.g. advertising, public relations, sales promotion etc.) on the value. This is theoretically possible, but further work is needed to devise reliable approaches and linkages (see 1.2.b).

8.4.4 Brand valuation measures only one of the elements of the overall raft of intangible assets. Others are human capital, know how, research and development, institutional knowledge, computer programs, patents and others. CFO (2001) a magazine published for Chief Financial Officers, publishes an Annual Knowledge Capital Scorecard in which it evaluates various companies using a method developed by Baruch Lev of New York University. A demand clearly exists for valuation methodologies to deal with these and other areas and the methodology presented in this report could be adapted for these purposes.

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[i] The London based Added Value Group is currently (March 2002) using the model for one of its clients and the WPP Group is proposing to purchase the methodology.

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