Marketing Finance
Marketing Finance
Turning marketing strategies into shareholder value

Keith Ward
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Preface

The objective of this book is to place marketing finance clearly within the context of the marketing strategy of a business. Strategic management, for the vast majority of commercially focused companies, is aimed at creating shareholder value. Nowadays, the creation of shareholder value for most of these companies is centred around their marketing strategies. This should mean that great emphasis is placed upon ensuring that these critically important marketing strategies do, in reality, create shareholder value.

Unfortunately, for many companies, developments in both information technology and management accounting have led to an increasing gap between the marketing strategies and the management accounting systems used within these companies. Relatively recently, I have been encouraged by the introduction into several leading companies of ‘marketing finance managers’; typically these were financially trained managers who were physically moved to work alongside their marketing colleagues. In some cases, this role has been interpreted as ‘accounting for marketing’, which means deciding how to code up the marketing director’s expense claim so it can be posted to the general ledger! This is not marketing finance as it is dealt with in this book.

The book does not attempt to deal comprehensively with all the detailed aspects of marketing strategies, marketing planning, etc.; these have each been the subject of many books already. Neither is this a book on detailed accounting rules (financial accounting standards, etc.). It deliberately tries to sit in the middle, exactly where the true marketing finance manager should sit; however, as you will realise as you read the book, sitting in the middle is not the same as ‘sitting on the fence’. I have strong views on most issues relating to marketing finance and these are clearly expressed in the body of the book. These views have developed over the 30 years that I have spent being deeply involved in the interface between marketing strategy and finance.

The essential role for financial evaluation and control as part of the marketing planning process is now accepted by leading companies and, in some cases, the marketing finance manager works closely with the marketing research team to help develop a much more ‘fact’ based marketing strategy. For many companies, particularly in the fast moving consumer goods industries, this process started by measuring and managing brand values but the latest area of
focus is on customer relationships. However for many companies, the marketing strategy is still product based; therefore each of these strategic thrusts is considered in detail.

The book is structured around the analysis, planning and control concept that underpins strategic management, marketing planning and management accounting. However, when properly applied in practice, these separate phases become somewhat blurred and overlapping; therefore it is no real surprise that the same has happened to the structure of the book. It seemed silly to talk about a brand evaluation process or valuing customer relationships without at the same time considering how to control such a marketing strategy.

Hopefully the book will stimulate some new thinking by both marketing and finance practitioners about how marketing finance should be implemented. My aim was neither to turn accountants into marketing managers nor vice versa. After all nasty definitions can be applied to both by the other side: an accountant is someone ‘who knows the cost of everything and the value of nothing’ while a marketing manager is someone ‘who overvalues everything and doesn’t care about the cost’. If a marketing finance manager can sit in the middle by understanding both shareholder value and customer value as well as the right costs to take into consideration for each strategic marketing decision, then it will be a truly value-adding role in any business.

I sincerely hope that the effort involved in writing this book proves worthwhile by providing you, the reader, with benefits that also outweigh the cost incurred in buying it. I would like to thank my wife, Angela, for doing all the figures, and my long-time secretary, Sheila Hart, for coming out of retirement to type the text (she can at least read my handwriting).

Keith Ward
Part One

Overview
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1 Creating Real Shareholder Value

Overview

The overriding aim of a company is to create value for its shareholders on a sustainable basis over the long term. In order to create this value, the company has to develop and then exploit one or more sustainable competitive advantages, which will allow it to earn super profits on a continuing basis.

Most modern sustainable competitive advantages are the result of the successful implementation of marketing strategies (e.g. brand building, customer loyalty development, market segmentation). These marketing strategies normally require significant long-term upfront investments which must be regarded as high-risk expenditures by the business, because if they do not work, the expenditure is often irrecoverable.

It is therefore vitally important that these strategic marketing investments are rigorously financially evaluated prior to their commitment and properly financially controlled during their economic lives. This can only be effectively achieved by an integrated marketing finance approach. If, however, these marketing strategies are very successful they can create the most valuable assets owned by most modern businesses, which are represented by intangibles such as brands, marketing knowledge regarding customers and channels, technical know-how, patents and licenses. These intangible assets can produce very high rates of return for many years, if they are managed properly. Therefore a strategically oriented marketing finance system is needed to evaluate and control these assets, if the business is to optimise the shareholder value generated.

Real shareholder value is created by earning, on a sustainable basis, a rate of return exceeding the risk-adjusted required rate of return for any particular business. This can be measured in several interrelated ways: as the net present value of the future expected cash flows from the business, using the required rate of return as the discount rate; as the economic profit, or residual income, earned in a particular year (this is the excess return over the required rate of return for the business in that year); as the total shareholder return achieved by the investors in the company on an annual basis, this is the total of any dividend yield received from the company plus or minus the movement in the share price during the year.
The total shareholder return is the only truly externally based measure of value creation, but if it is not backed up by the internally focused value measures, the shareholder value creation may not prove to be sustainable. This has been clearly demonstrated by the spectacular but painfully short-lived boom in telecom, media and technology share prices at the end of the 1990s. Massive, but very speculative increases in these share prices (with correspondingly massive capital gains to their shareholders) were very rapidly followed by even more spectacular falls in many of these share prices, as it became clear that most of these companies were simply not capable of delivering, even in the long term, the levels of return on which their high share prices had been based.

If real shareholder value creation is to be sustained over the long term, the critical marketing assets must be fully developed and then properly maintained over their economic lives. A sensible approach in marketing finance is therefore to distinguish between development and maintenance marketing expenditures, as their objectives are significantly different. The objective of development marketing expenditure is to create a valuable long-term asset, and hence the returns from this type of investment will be received over the economic life of the asset. Conversely, maintenance marketing expenditure is designed to keep the existing marketing assets in their present valuable condition. Consequently the returns are much more short term, and it can be argued that the failure to spend adequately on maintenance is often reflected very rapidly in declining sales revenues and profit streams.

Introduction

At present many businesses feel themselves under attack from several sides. On one hand, investors often complain that their ‘financial returns’ generated from investments in these businesses are woefully inadequate, while financial markets and their regulators are becoming paranoid about the validity of the financial results being disclosed by large companies. On the other hand, environmental groups and even consumer associations are vociferously complaining that commercial corporations are achieving excessive profits at the expense of the environment and/or by cynically exploiting their consumers. These businesses may also be oppressed by excessive government interference; many small businesses feel severely constrained by an increasing burden of government-imposed regulations, while multinational corporations face increasingly zealous tax authorities seeking to set aside their internal groupwide transfer pricing arrangements.

Inside these businesses, there is also great pressure for change and a correspondingly high level of stress and potential for conflict within the organisation. Marketing departments are increasingly being challenged to justify their expenditure levels in terms of ‘economic added value’; growth in sales volumes,
sales value or even market share is no longer a sufficient justification for an increase in this year’s marketing budget. Indeed, some companies do not seem able to identify specific links between most of their marketing activities and their long-term strategic objectives; in such circumstances, it is not surprising that the marketing budget is being ever more rigorously challenged.

Similarly many finance and accounting departments are also struggling to define their future role within the new business paradigm. The staggering increases in the potential both for automating routine transaction processing and also for outsourcing to specialist suppliers the remaining workload has transformed the role of internal finance personnel. They are being challenged to change not only their focus but also their organisational structures. The strategic challenge for finance is to move from a transaction processing and management reporting focus located on the periphery of a vertically structured, functionally based organisation to a strategic decision support focus integrated within the key horizontal business processes of the new twenty-first century organisation.

Nowhere is this challenge more important than in the interface between marketing and finance. In many businesses, the marketing and finance functions can often find themselves in apparent direct conflict, often due to a lack of the close working relationship which finance has developed with other areas of the business, notably operations and production. Indeed, it can be the case, in some companies, that marketing managers feel that the main interest of their financial colleagues is to stop them spending money. Conversely, it can appear to these finance managers that the principal objective of their marketing colleagues is to spend as much money as possible on increasingly esoteric advertisements, very expensive trade and consumer promotions, higher customer discounts, etc.

This conflict can be disastrous for the business as increasingly the long-term sources of value creation result from the successful implementation of marketing strategies. For many industries, simply controlling the production side of the supply chain is no longer a sufficient condition to achieve long-term value creation. Indeed many businesses are deliberately exiting from the actual production of the products that they sell, as they see this business process as distracting their focus from the real sources of added value. These marketing led sources of value creation include market segmentation, branding, customer loyalty, and strategic partnering with selected channels of distribution. Clearly, if the business is to achieve its long-term objectives in this type of competitive environment, it is essential that its marketing expenditures are well directed and effectively controlled.

Such effective control can only be exercised if the marketing and finance areas work together in one integrated partnership. A significant challenge facing the finance function in many businesses, therefore, involves changing their perceived involvement in marketing activities from that of a cost-adding
constraint to that of a value-adding, enabling partner. In an increasing number of businesses, this is being achieved by creating the roles of marketing finance managers, who are physically located in the marketing area and are seen as part of the marketing management team. As such, they should automatically be involved in the development of the marketing strategy, its implementation, subsequent modification and ongoing control. Ideally, they will share several management performance measures with their marketing colleagues, yet they have a clear financial responsibility to remain objective in their financial evaluations of proposed marketing expenditures.

Whether or not a particular business adopts this marketing finance manager role, this book argues for a very closely integrated link between marketing and finance. In far too many businesses, the marketing strategy and the financial plan are like a bad, jointly composed musical. The music is composed by one party, and the words are written completely separately by another person; then, and only then, the two are put together! The words of the marketing strategy can often seem to bear no relevance to the financial numbers in the business plan. Even more scarily for investors, there sometimes seems to be no marketing-based explanation for the actual financial performance of the company that is revealed to the world’s capital markets in the company’s published financial statements.

A marketing finance approach requires a financial involvement in at least two closely related but distinct aspects of marketing activities. Prior to the actual commitment by the organisation to spend money, a rigorous financial evaluation should be carried out. This is because true financial control can only be exercised in advance of any legally binding, financial commitment; once committed, the business will incur cancellation charges, or even have to pay the full cost, if it changes its mind. This financial evaluation compares the proposed expenditure against the potential benefits, taking into account the risks involved in the particular activity. This evaluation should include any other potential ways of achieving these particular objectives of the business.

The financial evaluation process should also indicate how the success/failure of the expenditure can be assessed, and how quickly this assessment can be made. It may be possible to improve the overall probability of success before having to commit the majority of the expenditure; this may be achieved by undertaking marketing research activity. This risk-reducing type of marketing expenditure should itself be evaluated financially, and any early warning indicators of success/failure should be identified. Any marketing activities where such early warning indicators can be identified are significantly lower risk than those where ‘success’ can only be assessed after all the expenditure has been incurred. If the initial expenditure has clearly failed, the business can avoid incurring the rest of the already doomed expenditure as long as early and effective financial controls have been identified.
Marketing finance can therefore be regarded as two interrelated processes of financial evaluation and control, and these processes are developed throughout the book. Much of the challenge relates to putting financial values to well-established marketing activities and objectives. Within the marketing area, many specific control measures have been developed to evaluate and control a wide range of marketing activities. Indeed, different marketing objectives are achieved by very specifically aimed marketing techniques. Unfortunately, far too often, these very different marketing approaches are financially controlled using a single financial measure, which is consequently often inappropriate. A key objective of this book is to highlight how appropriately tailored financial measures can be used when a marketing finance approach is implemented.

This is exacerbated because the most common financial performance measures consider the efficiency with which the activity has been carried out, rather than the effectiveness with which it has achieved its pre-determined objectives. An example using advertising expenditure may make this clearer. The ‘efficiency’ of purchasing media advertising (whether TV airtime, newspaper space, etc.) can be measured in terms of the ‘cost per thousand’ potential customers reached by the campaign.

**EFFICIENCY IS DOING THINGS RIGHT**

**EFFECTIVENESS IS DOING THE RIGHT THINGS**

However, such an efficiency-focused measure says very little about how ‘effective’ the advertising expenditure was in terms of achieving its pre-determined objectives. The specific marketing objectives for this advertising campaign could range from creating brand awareness, through changing the attitudes of potential customers or stimulating trial by new customers, to increasing the rate of usage by existing customers – each of which would probably use a different style of advertising communication.

In marketing terms, the achievement of any of these different objectives should be measurable, e.g. any increase in brand awareness can be measured by testing the level of brand awareness before the advertising activity, and re-testing afterwards. Thus, marketing can normally ‘prove’ whether it has achieved its marketing objective, e.g. raising brand awareness from 30 per cent to 40 per cent within the target group of consumers. The key marketing finance question is whether achieving this objective by spending £5 million on advertising was financially worthwhile.

The brand awareness both before and after the campaign could be tested in order to see if the marketing objective was achieved, and the efficiency with which the £5 million of advertising was purchased could be assessed. However, the money has not necessarily been effectively spent unless the benefit of increasing consumer awareness by 10 per cent has been financially evaluated as being worth well in excess of the £5 million cost that is to be incurred.