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FINANCIAL AND MARKETING MANAGEMENT: SHOULD THEY BE CONSOLIDATED?

Financial Statements: Where is the cash coming from?

Most of us have seen countless financial statements, whether we meticulously review these to make lending decisions, politely listen to an audit report as a Board Member of a nonprofit organization, or scrutinize them because they reflect the financial performance of our own business. While engaged in the process of absorbing the information contained in a financial statement, has it ever seemed odd that revenues are frequently summarized in a single line, while expenses may be detailed over several pages? The sources of cash flow, customers or clients, are generally ignored. And yet determining what future cash flow will be requires an investigation of where it comes from – the market.

Understanding future cash flow involves knowledge of why customers buy now, why they might buy more often, and who else might buy the products and services and for what reasons. Tim Ambler, Senior Research Fellow at the London Business School, in the July/August 2004 issue of *Corporate Finance Review*, argues that making the connection between marketing and financial performance depends upon the application of eight principles.

1. Does the business routinely research end-users for trends in usage and the reasons for it?
2. Has internal strategy, such as R&D, been aligned with external market indicators?
3. Has the company quantitatively defined “success”?
4. Is there a business model that connects marketing activities, marketing success and the bottom line?
5. Is quantified marketing information regularly reported to management *and integrated with financial information?*
6. Are marketing results compared to those forecasted in business plans?
7. Are they also compared to the performance of key competitors?
8. Is the assessment of marketing performance related to adjustments in the value of market-based assets (i.e. brand equity or reputation)?

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Consciously or unconsciously "marketing" is company-wide

Ambler identifies three types of marketing:

1. internal culture
2. professional
3. advertising and promotion

Every employee in a business, consciously or not, engages in activities that win customer or client satisfaction. The more conscious, energetic and pervasive that this "culture" is, the more successful the business will be. In this context, everyone is a "marketer."

"Professional" marketing is reserved for marketing professionals, who may have responsibility for market research and new product specifications. They discover market opportunities and bring products or services to market. Sales are also the responsibility of specialized professionals.

Advertising and promotion involve expenditures. Often, incremental increases in sales are compared to these expenditures to evaluate the return. However, these specific aspects of marketing should be evaluated, not as standalone, but as integral components of a broader range of marketing activity, comprising both professional efforts and the business's internal marketing culture. If either the professional efforts or the company's internal marketing culture are deficient, advertising and promotion will never be cost effective.

Where Does the Value of Marketing Show Up on the Balance Sheet?

A primary goal of marketing is to increase the value of a company's "brand equity". This intangible "good will" asset consists of customer or client loyalty, the reputation of the company and its products or services, and the competitive advantages associated with them. Brand equity, according to Ambler, is "the upstream reservoir of cash flow, earned, but not yet released to revenue."

Marketing inevitably includes employees, because through their direct interactions with customers or clients or their impact on innovation and competitive advantage, employees create brand equity.

Brand equity is sometimes defined as "customer lifetime value," the projected revenue stream from existing products or services and existing customers over the predicted time span of the market viability of the products or services. The limitation of CLV is that it is based on current products or services and current customers or clients. It does not account for the potential of increasing brand equity through innovation. It is marketing's job to define that innovation.

Measuring the Results: The CFO's Responsibility?

Management must keep track of marketing activities and quantify their success. Data is required for management to fulfill its responsibility. The measurement of the success of

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marketing efforts and the upstream revenues it creates is a statistical process, which may best be performed by that component of a company that relies most heavily on numerical information – the financial department. The integration of financial and marketing information offers a number of advantages.

1. Objectivity. There is no incentive to distort the information to satisfy requirements of accountability, as there might be if the marketing department was generating the reports.
2. Quantitative evaluation is often not a high priority of Marketing Professionals. In contrast, the financial department should be adept at providing consistent management information.
3. The financial department reports on the business as a whole. It can monitor internal, company-wide marketing activities, and not just the activities of marketing professionals.
4. The costs of generating data about marketing performance should be separate from the costs of professional marketing activities and of advertising and promotion.
5. The involvement of the financial department should result in their being more cognizant of and attentive to revenue sources, not just costs.

What Management Must Know

Reporting must, of course, measure the effect on sales of increased or decreased expenditures for advertising and promotion. In all cases, because markets are finite, there must come a point of diminishing returns, and that point must be identified.

Reporting must include an evaluation of the cost of all phases of innovation from ideas to implementation. Innovation for its own sake is unproductive. A determination of incremental sales resulting from innovation is critical.

An important, but difficult element of marketing to evaluate, is internal marketing. How effectively is management marketing to employees? How effectively are internal marketing efforts being converted into productive innovation, cost-effectiveness, quality, and positive customer or client interaction? In other words how much are these efforts resulting in an increase in the value of brand equity?

In the end, who is better equipped to evaluate the relationship between marketing expenditures and profits, or the increase in the value of brand equity, than the Chief Financial Officer?

----John C. Stillwaggon, CPA, CGFM

Editor's Note --- John is a Partner in the firm's Grove City Office. He specializes in the governmental and nonprofit niche, heading up the Nonprofit Services Group. He is also a member of the firm's Marketing Committee and participates in the planning and implementation of the firm's marketing activities.

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Tax Implications for Your Business Renting Property that You Own

Frequently business owners have their businesses rent property which they personally own. There are a variety of reasons to separate the ownership and use of real properties - estate planning needs, liability limitation and accommodating the needs of investors or lenders.

Logic would seem to dictate that, when both the business and the real estate are wholly owned by the same person, there should be no tax consequences. The owner is basically paying rent to himself, so the transaction has no economic substance.

Logic Superceded by IRC 469

However, applying IRC 469 can often result in a different outcome. IRC 469 was adopted to prevent shifting of active business income to passive income. It applies to C corporations that are subject to section 469, as well as S corporations and partnerships.

IRC 469 states that if a loss results from a separate activity of renting real property to the owner's business entity, it is classified as a passive loss. However, net income from property rented by a taxpayer to a trade or business in which the taxpayer materially participates is not treated as passive income. The application of this ruling produces interesting results.

Passive Loss not Applicable to other Non-passive Income

Consider a taxpayer who rents an industrial building to an S corporation that he wholly owns. The taxpayer is not a real estate professional because he spends more than 50% of his time conducting his manufacturing business. As a result of high repair costs, the taxpayer lost $100,000 on the rental of his property in year one. Because the rental activity is a per se passive activity, the taxpayer is limited to deducting a special allowance of $25,000 against non-passive income. The remaining $75,000 is carried over to the following year as a passive loss if the taxpayer has no additional passive income.

The $25,000 special allowance applies to those who are at least a 10% owner of the property and actively participate in the management of the property. It is limited if the owner's modified adjusted gross income exceeds $100,000.

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In the subsequent year the rental property produces a $30,000 profit. Because the profit is recharacterized as non-passive income under IRC 469, the taxpayer is only allowed to use $25,000 of the prior year suspended passive loss, due to the special allowance rules, and carryover the remaining $50,000 loss.

Recharacterized Rental Income

Another interesting example involves a taxpayer who owns both an industrial building and an apartment building; he is the sole owner of an S corporation engaged in manufacturing which in turn rents the industrial building. He realized $50,000 in net income from the rental of the industrial property, but lost $50,000 on the apartment building. The taxpayer cannot offset the loss against the gain, because the gain is considered non-passive under IRC 469. Because the taxpayer is not a real estate professional, the apartment building loss is considered passive. All the taxpayer can do is to apply the $25,000 special allowance to the loss from the apartment building and then carry over the remaining $25,000 as a passive loss to the following year.

---Kim Trimpey, CPA

Editor's Note --- Kim is a Manager in the firm's Grove City office. She presented the material included in this article originally as a component of tax seminars presented to other professionals and sponsored by the Land Grant University Tax Education Foundation, Inc.

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