

A New Class of Asset



By Roger Sinclair

Members of the IACVA (International Association of Consultants, Valuators, and Analysts) are called upon to value a wide range of assets: businesses, securities, intellectual capital, and intangible asset of all kinds. The list expanded in 2001 when the US FASB announced its accounting standard FAS 141 and when, a few years later in 2005, IFRS 3 was introduced to the rest of the world. These standards, which are almost identical in wording and intent, added, among other intangibles, brands to the list that have to be valued.

Initially, the standard writers use the term *trademarks*, but this is qualified in the statement to read that brand and brand name are often used by marketers as synonyms. Both trademarks and brands will normally be recognized as assets and should be valued in terms of the standards. FAS 141 and IFRS 3 deal with business combinations, so at this stage only brands that are acquired in a merger or acquisition qualify. That is a paradox because it means that brands developed within a company are not assets. Brands that are bought when a company is acquired are. That makes little sense because a brand either is or is not an asset. This conflict is understood by the accounting profession and is being dealt with. For the time being, this rather strange status quo will remain. In time—perhaps a few years—all brands, acquired or internally developed, will become balance sheet items.

Brands as assets is a 180 degree turnaround from the view accountants previously held, and because it affects the way brands as assets must be treated, the history is worth reviewing.

But first: what is a brand and when does it become an asset?

A trademark cannot be an asset because it does not generate future economic benefits. Consumers do not buy a trademark. Brand marketers decide on a name and have the one they choose registered for legal protection. Graphic designers and brand specialists then devise the brand elements—the logo design, colors, symbols, and slogans. The brand is then launched with accompanying marketing communications which attempt to attract buyers. If it is successful and consumers have tried the brand and like it well enough to buy it again and again, the brand has generated future economic benefits. It has created

brand equity and conforms to the definition of an asset: *An asset is a resource under the control of an enterprise from which future economic benefits are expected to flow to the enterprise* (IAS 38).

Not always an asset

The 1980s was a period of intense merger and acquisition activity. Companies were buying others and paying high premiums over the share price and the Net Asset Value. The premiums were being paid for well known brands—Philip Morris paid \$12.9 billion for Kraft, of which \$11.6 billion was for goodwill; Britain's Grand Metropolitan (now Diageo) added £588 million to its balance sheet when it bought the owner of the Smirnoff Vodka brand. This was the value of the acquired brand. A few years later in 1990, Nestlé paid £2.2 billion for Perrier, nearly all of which was for the global sparkling mineral water brand.

The accounting convention of the day was to deduct acquired goodwill from shareholder equity. However, when the sheer magnitude of these deals meant that the shareholder equity of the company could all but be destroyed by these goodwill write-offs, an alternative approach had to be found. The solution was to value the brands, reduce the goodwill, and treat the brands as acquired assets. This boosted the total asset value of the company and had the opposite effect to the more traditional method.

This new approach did not go down well with the accountants who could not see that brands would qualify as assets, and the practice was brought to a halt in 1989. It took a further twelve years and events such as the Enron fiasco to bring about the change heralded by the American FAS 141.

Turning around the accounting super tanker

Under the new regime, the acquirer has to account for the cost of all the identifiable assets acquired, both tangible and intangible. Any residual is goodwill, but that will now be considerably reduced and goodwill is no longer an asset. The standard is clear that trademarks (brands) will be recognized as assets. What is unclear is how the asset should be valued and treated in the accounts. This is due to another pivotal move. In introducing these standards, the accountants have forgone the age old practice of valuing assets at their historic cost, and have replaced

this with the notion of Fair Value or value in use.

Fair Value is what the asset would fetch in an arm's length transaction between knowledgeable willing parties, less the cost of disposal—market value.

Value in use is the present value of future cash flows expected to be derived from future use of the asset, plus value of ultimate disposal—income approach.

Not your ordinary machine

Both FASB and IASB are working on guidelines as to how fair value should be measured, but these have not at this stage been formally issued. What they should be considering is how brands differ from the assets, with which accountants are used to working. The new standards are outgrowths from existing standards; they use conventional language. For example, wording being suggested includes the phrase, "value in use refers to continued utilization and ultimate disposal." This is not what happened to brands, but is the fate of machines. A machine can be sold for scrap or for further use. When a brand runs its life, it is of no further value because the economic benefits it once generated are diminishing at a rapid and terminal rate. Who would want to buy that? The brand has no salvage value and only in rare cases would a third party be willing to take on a moribund brand.

From published drafts it is apparent that the guidelines will contain four aspects relevant to the valuation of brands:

- A decision as to whether the trademark has a finite or indefinite useful economic life,
- If the decision leads to a Taxation Amortization Benefit (TAB) or the need to allow for a residual or both;
- If impairment testing is the right approach; and
- Which of the approaches to valuation should be used: cost, market or income?

Finite or indefinite

An asset can only be described as having a finite life if there is a contractual, legal basis for determining the balance of its useful life, or if there is evidence from the market that the trademark will have a predictable life span. Examples would be a license that has a set expiry date, a patent that had a life span when it was acquired and is unlikely to be renewed, a license to operate a service such as a broadcast station, or a copyright where

evidence from the market and consumers indicates that it will generate net cash sales for a predictable time period. The ability to determine a finite life for a brand will be the rare exception; most brand owners would have no formal basis to decide that their brand would expire within a set period. The rule should perhaps be that all brands have indefinite lives unless compelling evidence suggests the alternative.

TAB or residual

If an asset has a fixed or finite life, the tax authorities might allow the cost to be amortized over its useful life or the balance of its useful life. If this is the case, a tax amortization benefit must be estimated as part of the value. This is conceptually difficult to calculate due to the circular reasoning that the TAB cannot be known until the value is estimated and the value cannot be estimated until the TAB is known. There are various techniques available to overcome this conundrum. If there is a finite life, it is quite possible the brand has no residual value at the end of the term.

Conversely, a brand with an indefinite useful economic life has no TAB, but will have a residual value. The present value calculation will therefore be for a predetermined time period and a perpetuity will then be calculated on the last year of the period to account for the long-lived nature of the brand.

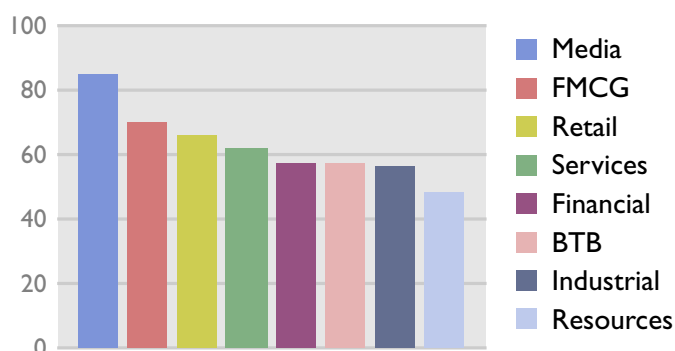
Impairment

An asset with an indefinite useful life is carried in the books at its original value. It may not be amortized. Each year it is tested for impairment to see if its recoverable value has fallen below the amount at which it is being carried. Impairment tests are supposed to use market value as the calculation method. This is not generally available for brands since they are sufficiently unique for there to be no active market. If a difference does emerge, it is entered in the income statement as an impairment loss.

The implication is that the asset will lose value over time or remain the same. There is no allowance for the probability that most brands will grow rather than lose value. Presumably if the impairment test produced a recovery value that was greater than the carrying amount, the balance sheet should be strengthened. My sources tell me that this is what will be introduced in the future, but right now brands are not given their true value.

Brands: a different sort of asset

A successful brand adds value to its non-branded or lesser branded equivalent. The most common way to isolate what the brand adds is by calculating the economic profit—the profit that the brand earns which exceeds the cost of capital. It is generally accepted that this is generated by a mix of intangibles, one of which is the brand. Commercial valuation methods include ways of decomposing the economic profit to identify the portion attributable to the brand.



The percentages in the above table are a local (South African) example of what, on average, proportion the brand represents. This is from a large database of over 350 valuations and indicates the mean scores. Naturally the range would tell a less precise story.

Since it is totally impractical to calculate what it would cost to launch a new brand and bring it to the status of the one being measured—and because there is no market for most categories of brand—both the cost and market method of valuation are inapplicable to brand valuation. That leaves income.

The correct approach is the capitalized present value (PV) of the future economic benefits the resource will generate. Since it has been discussed above that most brands will have an indefinite useful life, the DCF projection must take account of this.

The popular Relief from Royalty method is applied by determining an initial time period (five to ten years) and by adding to the PV of this projection a perpetuity calculated on the final year + 1 (no amortization: no TAB). As the table below shows, the problem with this calculation is that the residual is more than half the final value. That does not seem realistic. Brands are given marketing support to build value. The better they are cared for in the present, the longer they will serve

their owners into the future. This calculation indicates that the true value will be realized only many years ahead. How much credibility can be placed on a valuation where the bulk of the value is far beyond the control of the current brand owner? To say nothing of the frustration of owning a brand that will deliver value to future generations but not to the present custodians.

	y1	y2	y3	y4	y5	y6
After-tax royalty earnings	1000	1050	1103	1158	1216	1276
PV of 5 years (12%)	3940				PV factor	0.52
Residual value year 6	5531					664
Brand Value	9471					

That is not the only problem with Relief from Royalty. It also suffers from the rarity of reliable rate databases and the need to take account of the brand strength—a strong brand would command a higher rate than a weak brand.

It is the nature of the calculation that is at fault, not brands. A brand has a theoretical life cycle. After an initial growth period, it will sustain itself through maturity and eventually decline. When brands die they do so rapidly, because to keep them going quickly becomes a drain on the company's resources. But if a brand is properly supported by marketing and innovation, that moment of decay can be delayed for decades. Many modern brands are over fifty years old and a substantial number are more than one hundred.

Brands generate most of their value in their years of growth. Many famous brands continue earning at a lower rate during maturity, but require a boost in marketing spending and innovation every so often to rejuvenate the brand and keep its customers.

A suitable valuation approach must model this pattern. BrandMetrics deals with this by recognizing two brand facts:

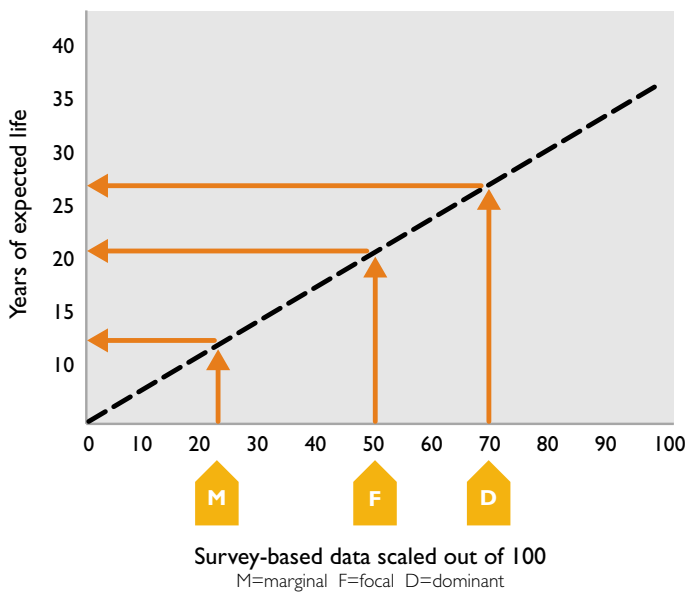
Brands operate in market categories that shape the ability of the brands within it to make money. Each brand is similarly influenced by the characteristics of the category, its stability or volatility, price flexibility, competitors' activities, and external forces such as supply of raw materials, government regulations, and consumer fads and fancies.

Brands are totally reliant on their end users. Any risk associated with a brand's ability to generate an income is rooted in the way the end users perceive the brand intrinsically and in comparison

with alternative, available choices. If consumers lose faith in a brand, it will die.

Analysis of the category characteristics results in a derived number of years of expected life for a notional dominant and marginal brand. All brands within the category are bounded by these two numbers (the maximum is forty years).

The market survey data is computed to array all the brands in the category on a scale of 0 to 100; the strongest brand has the highest score, and the weakest has the lowest score. The model's algorithms transform each score to the appropriate number of years on the vertical scale. Given its survey-based brand strength score, the years of expected life of any brand in the category can be derived.



The figure arising from the economic profit calculation is projected into the future according to the expected life factor described above, using management budgets and forecasts and consensus growth for the country concerned. The franchise run covers the up-front years and decay covers the distant years. The earnings are discounted to present value using the weighted average cost of capital as the discount rate. The brand value is the capitalized present value.

Contrary to Relief from Royalty, this method accounts for between 70% and 85% of value in the up-front part of the model—which for very powerful and long-lived brands can be as long as 15 to 18 years.

In conclusion, professional valuers will have to include brand valuation in their portfolios because they now are officially assets. In time, both those acquired in business combinations and those which are home grown will require valuation. Brands have characteristics not found in most assets, and which need special treatment. Currently most professionals employ the Relief from Royalty approach for this purpose, but as brands assume more importance, the weaknesses inherent in this method will become increasingly apparent. Alternatives are emerging and valuers will have to decide which of these is the best choice.

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