

Determination of Fair Value of Intangible Assets for IFRS Reporting Purposes

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1. Introduction. SFAS 141 (2001) and IFRS 3 (2005) have changed the status of brands in the context of accounting for mergers and acquisitions. Prior to the introduction of these new versions the extant standards were quite clear that brands would not meet the recognition criteria for inclusion in the balance sheet as assets. As the IVSC Discussion Paper (DP) explains: the Illustrative Example, provided by the IASB in support of IFRS 3, delineates five “types” of intangible assets which are further broken down into “sub-types”. In 3.6.1 sub types such as trademarks and trade names are introduced. What is not stated in the DP is the explanation that follows (in the Illustrative Example) in which brand and brand names are acknowledged as synonyms for trademark and trade name. This distinction is covered in 4.35 of the DP but under a separate section.

Since brands are now assets when they are included in a business combination ways of valuing them must be developed that take account of their special characteristics. In this submission we hope to demonstrate that brands do have characteristics worthy of special consideration and that valuation professionals might have to adopt some unfamiliar approaches to do full justice to this form of intangible asset.

2. Brand Characteristics. Most assets have finite lives. Their useful life can be readily predicted and many depreciate in value over that period. Brands are the opposite. In most cases it is the intention of their owners that they should have indefinite lives; even if this ultimately proves not to be the case. Therefore their useful lives cannot easily be determined; but neither is it axiomatic that their lives are indefinite. By definition their value must increase over time or they would be discontinued.

The basis of this apparent contradiction is the relationship that brands build with their users. Brands are favoured over their competitors because the users (consumers) think the brands of their choice are superior and will perform more reliably than alternative options. For some brands the relationship is strong; others it is weak and marketers have

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learned to their cost that the relationship can very quickly disintegrate or be destroyed.

Consumers will pay a price premium for a brand because they think it imbues them with status or because they believe it works better than alternatives. In 4.8 of the DP it is stated that “confectionery brands are differentiated through differing tastes, source of ingredients and quality.” This implies that image is not a factor. What is missed here is that consumers will pay a premium for Cadbury, Quality Street or Bar One based on how that brand is structured in their memory; not just on their rational assessment of the brand’s functional qualities. They will be aware of the brand name and will associate it strongly and favourably with positive attributes, which will be more than just functional and that, in their mind, make the brand unique. These attributes might, for example, include brand heritage, imagery, implied status and self-enhancement.

Once it is acknowledged that brand success is determined by the way the brand is seen by its users (a view that is stored in memory), the truism will be accepted that the stronger the relationship between the consumer and the brand the greater will be the value that will accrue to the brand asset.

The term Prospective Financial Information (PFI) is used in the DP to describe projections of turnover, operating profit, cash flows or other measures of forecast income streams. In brand valuation theory brand income is inextricably linked to the brand’s relationship with the consumer. The source of future economic benefits *is* the consumer and the amplitude of the income stream is directly connected to the strength of relationship between the consumer and the brand. The risk of future income being earned (or not) is almost entirely dependent on this relationship.

The primary function of brand marketing is to attract customers to the brand and then keep them for their lifetime. Brands such as Coca Cola, Kellogg and Cadbury have outlived their consumers many times over.

3. Brand valuation. Over the past twenty years several proprietary brand valuation methods have been developed (see Keller, 2007). Because they were conceived as commercial products they have not, understandably, been adopted by valuation professionals. Relief from Royalty is the preferred methodology of most valuation professionals: an approach that we think is inappropriate and misleading. The main reasons for this view are set out below:

- Because Relief from Royalty is based on turnover the approach ignores brand profit. In fact it is quite possible for a brand to have healthy turnover and be very sick at the bottom line.
- Contrary to the DP (6.30 – 6.31) Royalty Rates are not readily available and quite often the rate used is based more on judgement than reliable sources. Further, it has been our experience that the method described in the DP by which the validity of royalty rates are checked (6.42), is seldom used and neither is the rate tested to

ensure it is not so large that it destroys the profit that the fictitious franchisee would earn.

- There can be no doubt that the Coca Cola brand will be more valuable than a lesser known cola. Relief from Royalty proponents will typically use a single rate regardless of the relative market strength of the brands in the category they are valuing.
- Most valuers using this technique capitalise the saved after tax royalty stream and then add on a perpetuity to take account of the subject brand's indefinite life. This is before the tax amortisation benefit (TAB) is calculated and added (5.27). In our view, this is a very crude way of achieving the value since the perpetuity is frequently as much as twice and more the capitalised present value of the saved royalties.

In the light of IFRS 3 and SFAS 141 and the need to value brands acquired in a business combination, it makes no sense to ignore the aspects of brand equity models that could lead to more credible and accurate valuations. The leading brand valuation methods use the same finance tools that are described in section 5 of the DP (i.e. time value of money; discounted cash flow, multiple of earnings), but augment and complement these with specialised marketing inputs.

In this paper we will cover the use of economic profit, brand contribution category analysis and market surveys.

4. Economic Profit. The DP describes Premium Profits or Incremental Income as intangible asset valuation methods (5.39 to 5.43). This approach is consistent with the definition of brand equity adopted at the Marketing Science Institute (MSI) conference on Defining, Measuring and Managing Brand Equity: "Brand Equity is incremental cash flows resulting from the product with a brand name versus that which would result without the brand name." (Leuthesser 1988).

The problem with this approach is the ability of the brand valuer to obtain valuation inputs for the non-branded version. In 5.43 the example is a brand, but it is doubtful that the valuation professional would be able to acquire the valuation inputs for the non-branded product. Either there is no such thing in the category, or the competitor who owns the non-branded version, would not make the data available (see 6.48).

One solution would be to use the corporate finance tool of economic profit. This concept was popularised by New York consultancy Stern Stewart and called Economic Value Added (EVA). It is however a concept that was recognised more than 200 years ago by Adam Smith.

Assuming that brand accounting includes an income statement and balance sheet (and if not these can be constructed from available data using the accounting device of allocation) the inputs as listed in 6.7 are readily available. Working capital (WC) is obtained from the balance

sheet, Net Operating Profit After Tax (NOPAT) from the income statement and the discount rate would be the company Weighted Average Cost of Capital (WACC) (6.74) suitably adjusted to take account of brand unsystematic or special risks.

Economic profit is the profit earned which exceeds the opportunity cost of capital.

$$EP = NOPAT - (WC \times WACC)$$

According to most corporate finance text books these profits are unsustainable because if the company's assets earned more than their opportunity cost of capital, the company "would expand or firms outside the industry would try to enter it". (Brealey & Myers 1996) In reality most companies today earn and sustain economic profits.

Brealey & Myers explain that these profits come about only if a firm has developed some special advantage such as "some degree of monopoly or market power". They expand by stating that one source might be that "customers are prepared to pay premium prices." Customers will only do this if the brand knowledge that they hold about the brand in memory is such that they feel justified in doing so. In other words they feel the brand will provide them with superior benefits to the available alternatives.

When a brand earns economic profits it can be assumed that the portion of NOPAT that matches the cost of capital is the equivalent of a non-branded product and that the economic profit is the excess profit generated by intangible assets owned by the firm including the brand. Therefore Economic Profit would be a suitable proxy for premium profit or incremental income.

5. Brand contribution. If economic profit is the excess profit generated by intangible assets owned by the firm including the brand, it is necessary to isolate the portion attributable to the brand. The commercial approaches mentioned earlier have developed ways of achieving this. Since these are components in proprietary models it is not appropriate to explain them in this paper. They are described in chapter 10 of Keller (2007)
6. Market surveys. In 6.10.22 of the DP market surveys are listed as sources of useful information for post business-combination accounting. Market surveys conducted by marketers are used to measure the strength of brands as described in 2 above. Keller (2007) has described the way consumers think about brands as Brand Knowledge Structure. This comprises awareness of the brand name and an association with awareness of positive attributes that the consumer would gain from use of the brand. Brand Knowledge Structure both qualifies the brand for consideration and differentiates the brand from other choices.

For surveys to be useful they must be conducted in a manner which is statistically reliable and consistent over time.

Using techniques described in Keller, it is possible to reduce the information acquired by means of a market survey to scores that rank the brands within the category by their Brand Knowledge Structure relative strength. Knowing the brand strength provides valuation inputs that are useful in dealing with, for example, market expectations (6.8.2), expected life (6.8.5) and whether the brand has a finite or infinite life (6.9).

In the commercial applications described in Keller (2007) market surveys are used in conjunction with other inputs to determine the expected life of the brand within a defined category.

7. Category analysis. Trend data from a variety of normally available sources will assist in determining the nature of the category or defined market segment. It is instructive to know, for example, if the category is characterised by stable or volatile market share; how the brands within the category have behaved over time and, if the category supports or destroys operating profit margins by price cutting, trade discounts and promotional deals. Other sources such as those listed in 6.10 of the DP are used to establish if, and the extent to which, the category might be susceptible to external forces such as government regulation, problems with the supply of raw materials, currency fluctuations, the local and world economies and social problems such as HIV/AIDS.

This analysis is then used to determine whether the category supports or inhibits the ability of the brands that compete within it to earn sustained economic profits or not.

8. Summary. The new standards (SFAS 141 and IFRS 3) make it clear that brands are assets when they are part of a business combination. As academics in the field of brand equity, we believe that brands have special characteristics which influence the way in which they should be valued. For example, it is our contention that trademarks or brand elements (name, logo, colours and slogan) have no value until a body of consumers becomes aware of the brand name and its elements and are willing to spend money on buying and using the brand. Thus the consumers create an income stream that can be measured.

It is the consumer familiarity with the brand and their willingness to buy and use it repeatedly that creates economic profit in that consumer brand preference is a special advantage that generates a profit that exceeds the brand's opportunity cost of capital. This is a proxy for premium profit.

Two valuation inputs influence the strength and longevity of the discounted cash flow projection: the survey based measure of brand strength and an analysis of the brand category which determines the extent to which the competing brands are able to earn this class of profit. It does this by evaluating the stability or volatility of the category.

Finally, brands are not alone in generating economic profit and approaches are needed to identify which resources do drive economic profit and what role the brand plays in this.

So as not to include proprietary techniques in this response we refer instead to Keller (2007) in which these approaches are described.

9. References

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