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Original Article

A case for brands as assets: Acquired and internally developed

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Roger Neville Sinclair
Roger invented the BrandMetrics on-line brand valuation method that was bought by Prophet Brand Strategy in 2009. Between 2009 and 2012 Roger was an academic partner with Prophet and now consults to the firm and its clients on matters related to brand valuation. Roger is on the Advisory Council of the Marketing Accountability Standards Board (MASB) and is on its Improving Financial Reporting (IFR) task team. Roger has a PhD from the University of the Witwatersrand in Johannesburg, South Africa, where he was professor of Marketing for close on a decade.

Kevin Lane Keller
Keller is the E. B. Osborn Professor of Marketing at the Tuck School of Business at Dartmouth College. Keller's academic resume includes degrees from Cornell, Duke, and Carnegie-Mellon universities, award-winning research, and faculty positions at Berkeley, Stanford, and UNC. His textbook, Strategic Brand Management, has been adopted at top business schools and leading firms around the world. He is also the co-author with Philip Kotler of the all-time best selling introductory marketing textbook, Marketing Management. From July 1, 2013 to July 1, 2015, he is serving as the Executive Director of the Marketing Science Institute.

ABSTRACT **An unacceptable dichotomy hides important information from investors and masks the full contribution brands make to enterprise wealth. Under conditions of merger and acquisition brands are mandated as assets, but when they are internally created they are forbidden to be described as such. The sources of this contradiction are the global accounting standard setting bodies: the International Accounting Standards Board (IASB), the Financial Accounting Standards Board (FASB), and the accounting standards developed to deal with how intangibles are dealt with under different conditions (IASB: IFRS 3 *Business combinations* and IAS 38 *Intangible Assets*. FASB: SFAS 141 *Business Combinations* and FSAS 142 *Goodwill and Other Intangible Assets*). In this article we explain the nature of this contradiction and show that the authorities are aware of it. Since 2001 there have been several attempts to update the standards that created it. However, these have never been seen as a priority and have been aborted before completion. We show that the conflict is caused by a technical anomaly and demonstrate that, by the accountants' own evaluative criteria, the conflict should be resolved. We admit that if this happens there is, at present time, no single acceptable method of valuating brands but we suggest that the foundation is firmly laid for such an approach to be developed. Finally, we make the suggestion that if this financial distortion is resolved it might require the standard setters to acknowledge that asset *accretion* ranks in importance with *impairment*. Our argument is mostly based on an unintended conflict: the change accountants made some time ago from an *historical cost* perspective to a forward looking *current cost* and, in this case, *fair value* measurement approach, is at the heart of the contradiction. The business combination standards feature the new approach; the intangible assets standards feature the old approach. Until this**

Correspondence:
Roger Sinclair,
Prophet, 3d Wolfe St., Wynberg,
Capetown 7800,
South Africa.

conflict is rectified the investment community will continue to miss out on a major source of enterprise value. This extends to boards of directors and their marketing departments being deprived of a key financial metric; one that measures the mediating source of much of the company's revenue and one of the most valuable assets, or sets of assets, any company owns. We intend to show that this situation is easily rectified and that an increase in important financial information instantly justifies the resources needed to bring about this change.

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INTRODUCTION

A patently obvious contradiction exists in the canon of accounting standards that regulate global financial statements. It emerged from a decade of unfinished standard improvement and evolution and is sustained, primarily, because the need to bring two standards into conformity has not been seen as a priority. The financial crisis of 2007/08 precipitated changed priorities in standard modification and these changes were essential to improving financial reporting and some reordering of the research program was justified. But more than 5 years later the contradiction, enshrined in the standard that regulates the reporting of acquired intangibles and the status of internally generated intangibles remains unresolved. Thus, rather like electrons which can be in two places at once, these two standards cause intangibles to have simultaneous conflicting forms.

In this article we will explain the contradiction and how it came about and make a case for it to be resolved. We will comment on the related problems associated with reliable measurement and finally, cover the oddity of impaired intangibles dealt with as delinquent costs when those which gain in value are ignored.

THE CONTRADICTION

In an attempt to meet its commitment to provide investors with useful decision-making information, the accounting standard setters have created two standards that deal with intangible assets and goodwill.

The Financial Accounting Standards Board (FASB)[1] in the United States changed its standard that deals with business combinations in 2001. Since then, SFAS 141 *Business Combinations* (now Topic 805) has required that the fair value[2] of intangibles acquired in a business combination must be measured immediately following completion of the transaction and the value shown in the balance sheet. (It is important to note that the standard setters have drawn a distinction between what they refer to as 'entry' and 'exit' price. Entry is the price at which an asset is bought and exit is the price at which it is sold. Fair Value is measured at the estimated exit price.) If the asset has an indefinite useful life (as will be the case with almost all brands) it is not subject to amortization, but is carried at its cost and tested each year for impairment. Impairment losses (the difference between the carrying amount and the fair value or recoverable amount of the asset) are applied to the income statement which, because the loss is treated as an expense, negatively affects the company's profit. The International Accounting Standards Board (IASB) followed suit in 2005 with its version of the same standard known as IFRS 3 *Business Combinations*.

Both FASB and the IASB also have a standard that deals with intangible assets: FASB's is SFAS 142 *Goodwill and Other Intangible Assets* (Topic 350); IASB's is IAS 38 *Intangible Assets*. These each state that only certain internally generated intangible assets should be recognized as such. They then specifically exclude brands, mastheads, publishing titles, customer lists and items similar in substance. The contradiction is that the business combination standards (SFAS 141; IFRS 3) not only permit, but encourage recognition of assets such as brands (trademarks) while the intangible asset standards (SFAS 142; IAS 38) expressly forbid recognition of the same class of assets because it has not been bought.

An examination of the requirements that cause this difference exposes a level of sophistication in the business combinations standards that had not been reached when the intangible assets standards were drafted. The business combination standards recognize acquired intangible assets, including brands, as cash-generating units that can be identified by a *fair value* measurement whereas, in the older standards, internally generated intangible assets, specifically brands, must be measured according to their *historical cost* and this cannot be separated from the costs of developing the business over all.

IAS 38 *Intangible Assets* develops its case in the following words:

- Paragraph 21 (a): 'it is probable that the expected future economic benefits that are attributable to the asset will flow to the entity',
- Paragraph 21 (b) 'the cost of the asset can be measured reliably'.

What distinguishes this method of measurement from the one that is to be found in the later standards is the word 'cost'.

- Paragraph 24: 'An intangible asset shall be measured initially at cost'.
- In paragraph 63 it is specific: 'internally generated brands … shall not be recognized as intangible assets'.

The reason for this is:

- Paragraph 64: 'Expenditure on internally generated brands … cannot be distinguished from the cost of developing the business as a whole. Therefore, such items are not recognized as intangible assets'.

IFRS 3 *Business Combinations* takes the opposite point of view.

- Paragraph 13: For example, the acquirer recognizes the acquired identifiable intangible assets such as a brand name … that the acquirer did not recognize as assets in its financial statement because it developed them internally and charged the related costs to expense.

NB. The wording in the FASB standards is different but the sense and outcome are the same.

In this standard (IFRS 3) it is deemed acceptable for intangible assets, which are assumed to have been embedded in the goodwill bought by the acquirer, to be measured, not by the *cost* paid, but by their estimated *fair value*. There is no explanation why a brand that has been internally generated over many years can also not be measured by its fair value as they are the same brands. The only difference is in who owned them previously and who owns them now. The significance of fair value as a measurement tool has been given emphasis by the introduction of a standard that deals exclusively with fair value measurement (SFAS 157 and IFRS 13 *Fair Value Measurement*). These detailed guidelines were introduced *post hoc* when it became clear that the application of fair value in business combinations was not generally understood.

In our view this contradiction can be resolved by a change of approach increasingly being applied by the standard setters: the replacement of the extant *historical cost* by *fair value*. A fair value measurement requires the income approach as opposed to the cost method to be employed. This immediately changes the perspective from backward to forward-looking and removes the reasons for the non-recognition of brands. This change has consequences such as the need to recognize the long lived life of brands and the efforts companies make to enhance their value.

INTANGIBLES ARE IMPORTANT

The Chartered Financial Analysts (CFA) Institute, a global organization of investment professionals, states in its 2007 Comprehensive Business Reporting Model that managers should disclose to investors information about intangibles that are not yet reported. This is to expose the true and potential value of the business and would include information about market share and customer retention. To some extent this reflects the view of the Securities Exchange Commission (SEC).

> On 2 March 2001, Robert A. Bayless, Chief Accountant in the Division of Corporation Finance at the SEC, stated:
>
> Speaking of value, intangible assets are very important in this economy. Wide variations between a company's stock price and its underlying book value per share frequently are attributed to the failure of the current accounting model to recognize a company's internally generated intangibles. *Despite the importance that investors evidently place on those intangibles*, a FASB Business Reporting Project Steering Committee observed that *filings by public companies generally lacked meaningful and useful disclosures about intangible assets*. [Emphasis added.]
>
> Bayless recommended that managers disclose the nature of the intangible assets that are important to the business and explain what managers do to develop, protect, and exploit them. CFA (2007)

Four years later the nascent International Integrated Reporting Committee (IIRC, 2011) used the figure below to emphasis the growth and importance of intangibles in modern business (Figure 1).

The implication is clear: enterprise value increasingly has more to do with intangible assets such as brands, customer retention, licenses and franchises than with physical assets like buildings and machinery. Investors know this and are prepared to pay for it.

Since 2001, several organizations have highlighted the importance of intangibles but emphatic as these actions and statements have been, they have not brought about the logical conclusion of all intangibles, including brands, being valued and included in the balance sheet as assets and a source of enterprise worth.

The timeline Figure 2 below traces events since 2001 that draw attention to the importance of intangibles and the need to bring these two standards into line. This trend displays a persistent call for the identification, recognition and measurement of intangibles, acquired and internally generated. Reasons given for aborting the attempts may vary from lack of resources to being taken over by more pressing needs.

DOES THE CONTRADICTION WARRANT THE ATTENTION OF THE AUTHORITIES?

Figure 1 demonstrates quite clearly that, from the investor point of view, intangibles create value for a business In fact at 80 per cent, intangibles create most of an enterprise's value with much of that value hidden, only a small portion is exposed.

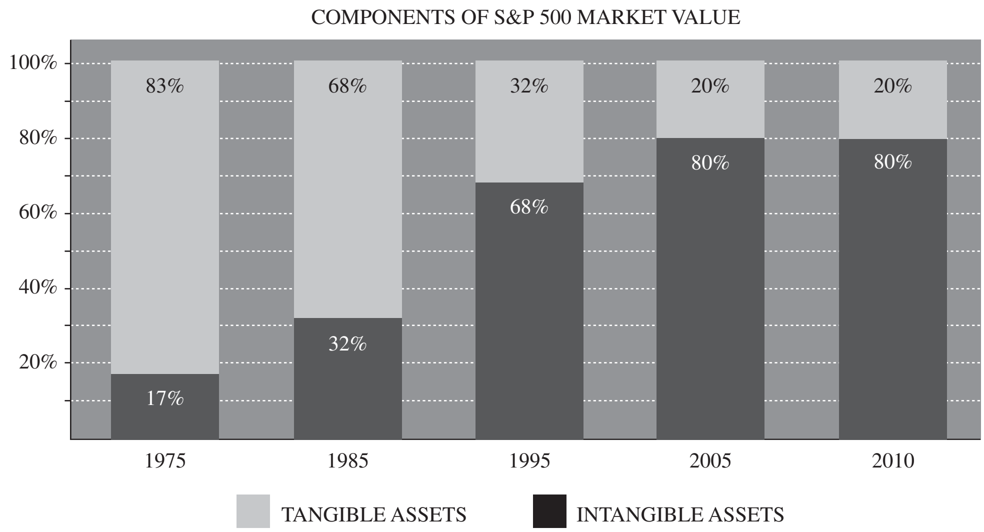

Figure 1: Market to book.
Note: This figure is featured in the IIRC Discussion Paper (2011) and published here with the permission of Ocean Tomo.

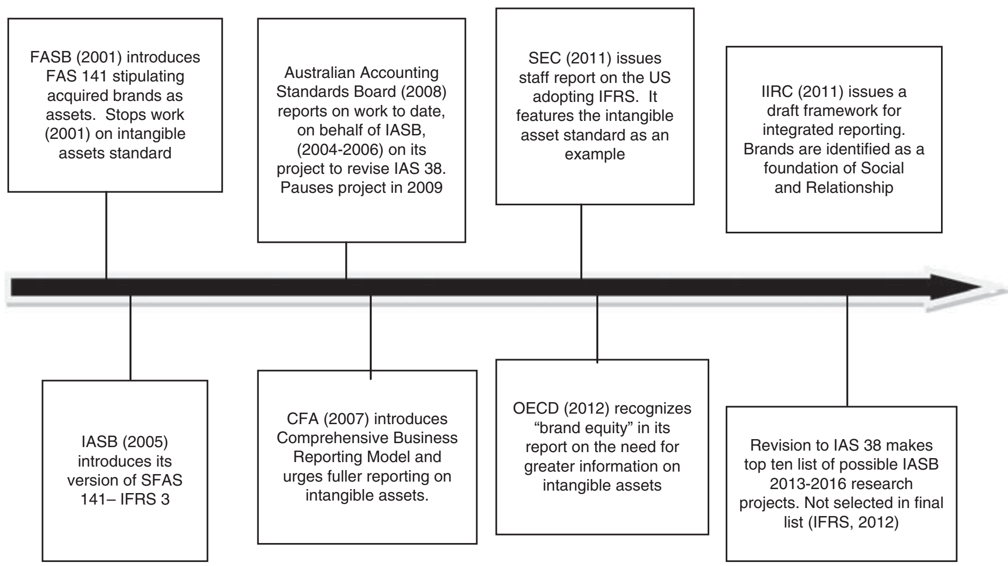

Figure 2: Timeline assembled by authors according to cited sources.

That is the amount that is shown in post-Merger & Acquisition (M&A) balance sheets where the value of the brand has been identified, measured and added to the balance sheet under the heading of intangible assets and clarified in a note to the accounts. (see: Mizik, 2009; Hsu *et al*, 2011; Wiesel *et al*, 2012 for recent evidence of the link between brand and company value).

Since 2001 in the United States under FAS 141 and 2005 in the rest of the world (where IFRS applies), there have been untold mergers and acquisitions, where brands with an indefinite life were recognized and have been carried in the balance sheet at their value at acquisition. They are tested annually for impairment and some might therefore have been written off; however, most brands do not lose value

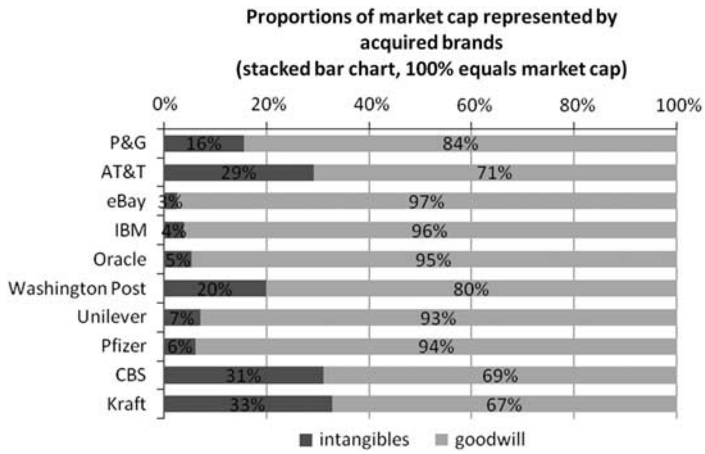

Figure 3: Selected post-acquisition ratios.
Source: Figure assembled by authors, based mainly on UBS (2008).

and many will still be carried at their post-transaction value.

The Swiss bank, UBS (2008), analyzed M&A transactions in Europe and in its report it showed the goodwill and intangible assets being carried in the balance sheets of the firms they examined with the average for all being 4 per cent of aggregate European asset value. Not all companies involved in business combination transactions will possess significant intangible value because many on the list would be companies which do not attract large premiums over net asset value such as miners and heavy industrial firms. This distinction emphasizes the competitive advantages companies acquire over time when they develop intangible assets such as brands (see for example Brealey *et al,* 2008).

Figure 3 illustrates a random selection of companies and in 50 per cent of the cases the intangible portion is under 10 per cent of market capitalization. The rest of the cases show acquired brand or brands having significant value, such as P&G at 16 per cent which is primarily Gillette and Kraft's 35 per cent is primarily Cadbury (bought in 2010).

In order to illustrate graphically the impact of these conflicting accounting standards we employ a single company example, Proctor & Gamble (P&G) and the brand is Gillette. The 2005 P&G purchase of Gillette is interesting because, aside from the status of the acquiring company and that the acquired brand is a famous market-leader, according to the post-acquisition accounts, the deal was nearly 100 per cent made up of intangible assets and goodwill. Table 1 shows how the purchase price of US$53.4 billion was allocated.

Table 1: Gillette post-acquisition balance sheet (US$, bns)

Current assets	5,533
Property, plant and equipment	3,673
Goodwill	34,943
Intangible assets	29,736
Other noncurrent assets	771
TOTAL ASSETS ACQUIRED	74,676
Current liabilities	5,009
Noncurrent liabilities	16,241
TOTAL LIABILITIES ACQUIRED	21,250
NET ASSETS ACQUIRED	53,426

http://www.pginvestor.com/Cache/1001181145.PDF?Y=&O=PDF&D=&fid=1001181145&T=&iid=4004124, Kevin Lane.

In the P&G balance sheet, the Gillette brand falls under the heading of indefinite lived intangible assets. In 2007 the amount being carried was US$29.7 billion (see line item in Table 1) of which 90 per cent was Gillette (US$24.0 billion) and in 2013 the amount being carried is US$26.8 billion (for all acquired intangibles including Gillette). Since there is no allowance for an increase in asset value (accretion) in the current accounting standards, the amount for Gillette will be unchanged. In January 2014 the market capitalization for P&G was US$218 billion and at US$24 billion the Gillette brand accounts for 11 per cent (the difference between 11 per cent and 16 per cent is due to a lower market capitalization when the figure was constructed).

It is axiomatic that an investor would want to know the value of the brands a company owns for two reasons:

- For a company like P&G or any firm that relies on brands for its survival, the value of the enterprise is dependent on its stewardship of these cash-generating assets. An investor would want to know what proportion of the firm's value the main brands in the portfolio represent and how they go about protecting and building these resources.
- The source of a firm's revenue as stated in the top line of its income statement is the customer. In many cases (basic resources such as iron and coal are probably exceptions) the reliability of these income flows depends on the strength of the relationship the customers have with the brand. Most current annual reports fail to show data that supports this, but with the integrated report and expanded exposure in the statutory accounts, greater disclosure of how the customer/brand relationship is managed will initially be demanded and eventually become mandatory.

How this data is displayed for the users of the report will be determined by the accounting technicians at FASB and IASB, but the extant standards provide some guidance of what will happen. In post-transaction accounts, the acquired intangibles are aggregated under a single line item: intangible assets. The residue not accounted for remains under a second line item called goodwill and if internally generated brands are reported as well, they are likely to be aggregated under a third line item called intangible assets.

Detail as to what this item comprises will be reported under notes to the accounts. Several authors have suggested that brand values be dealt with in the narrative part of the annual report or in the Management Discussion and Analysis (MD&A) section (Mizik and Nissim, 2011; Gregory and Moore, 2013). This might serve as an interim measure until such time as the corrections covered in this article are dealt with. But the ultimate aim is to have a number in the balance sheet in the asset section that provides information to investors about the intangible assets the firm has developed and acquired and how they contribute to enterprise wealth.

In developing and issuing the accounting standards that deal with business combination accounts (FAS 141; IFRS 3), the standard setters have made a substantial start (see the previous section timeline and explanation above). But, as Figure 3 shows, this tells only part of the story: nothing is said about the balance; the brands, such as Coca Cola, Kraft, Honda, Colgate and OMO or other intangible assets the firm developed itself. These are what the standard setters describe as 'internally generated' and fall under the standard that deals with intangible assets (FAS 142; IAS 38), they are not recognized in the balance sheet.

During the past decade, the FASB and then the Australian Government Accounting Standards Board invested time and resources to aid in the progression and recognition of internally generated assets. In each case the projects were aborted before they were completed and the IASB stated in December 2007 that this project would be 'paused':

> The agenda proposal was discussed at the IASB meeting in December 2007. At that time, the Board decided not to add a project on identifiable intangible assets to its active agenda because properly

> addressing the accounting for identifiable intangible assets in the near-term would impose a large demand on the Board's limited resources. (http://www.ifrs.org/Current-Projects/IASB-Projects/Intangible-Assets/Pages/Intangible-Assets.aspx)

Although the project was 'paused' in December 2007, the Australian Accounting Board continued its work for another one to two years. This project was stopped at the time of the financial crisis to allow the IASB and FASB to concentrate on the four projects scheduled for convergence at the time: revenue, leases, financial instruments and insurance.

When the Business Combination standards were introduced they were accompanied by guidelines identifying intangible assets that would be considered, post-transaction, as comprising the purchase consideration and these are shown in Table 2. Notice, the first column details 'marketing related IAs', under this is 'trademarks' and these are noted in the text as referring to brands. This extensive list makes it clear that the accounting standard setters are fully aware of the nature of intangible assets and trademarks (brands) in particular. It also gives strength to the notion that a key reason why the standard setters have not updated the intangible asset standard is because it has not been prioritized.

If, under conditions of a merger or acquisition these intangibles are considered sufficiently important to be identified and recognized, it is illogical that the same assets are not recognized as the driving force behind the 80 per cent intangible margin illustrated in Figures 1 and 3 above.

Table 3 shows graphically how important these intangibles are. The values estimated by both Interbrand and Millward Brown (see Table 5) for the leading brands in their listings, even though the numbers are far apart, indicate the extent to which brand value explains a major portion of this margin. If a reliable approach to brand valuation

Table 2: List of suggested intangible assets compiled from IFRS 3 (IE21)

Marketing-related IAs	*Customer-related IAs*	*Artistic-related IAs*	*Technology-based IAs*	*Contract-based IAs*
1. Trademarks, trade names, service marks, collective marks, certification marks[a] 2. Trade dress 3. Newspaper mastheads 4. Internet domain names 5. Non-competition agreements	1. Customer lists 2. Order or production backlogs 3. Customer contracts and related customer relationships 4. Non-contractual customer relationship	1. Plays, operas, balletsa 2. Books, magazines, newspapers and other literary works 3. Musical works such as compositions, song lyrics and advertising jingles 4. Pictures and photographs 5. Video and audiovisual material, including motion pictures or films, music videos and TV programs	1. Patented technology 2. Computer software and mask works 3. Unpatented technology 4. Databases including title plants 5. Trade secrets, such as secret formulas, processes and recipes	1. Licensing, royalty and standstill agreements 2. Advertising, construction, management, service or supply contracts 3. Lease agreements 4. Construction permits 5. Franchise agreements 6. Operating and broadcast rights 7. Service contracts such as mortgage a servicing contracts 8. Employment contracts 9. Use rights (drilling, water, air, timber and routes)

Abbreviation: IA, intangible asset.
[a]The explanatory text in IFRS 3 states that marketers use brand and brand name as synonyms for trademarks and other marks.

Table 3: Investor-driven market premiums for world's top brands

	M. CAP	*NTA*	*PREMIUM*	*% M.CAP*
Apple	479.9	117.8	362.1	75
Google	353.6	53.7	299.9	85
Coca Cola	177.7	5.4	172.3	97
IBM	192.5	−14.2	206.7	107
Microsoft	311.8	61.2	250.6	80
GE	271.5	37.6	233.9	86
McDonalds	96.9	12.5	84.4	87

M. CAP = Market Capitalization; NTA = Net Tangible Assets.
Source: http://finance.yahoo.com/, accessed 26 November 2013.

could be adopted universally (see below in the section 'Is there a better way?' for the authors' proposal), investors would be provided with solid evidence of a major underlying driver of enterprise value.

The best conclusion to be drawn from this analysis is that eliminating this contradiction is not a priority for the standard setters at this time. It will always be the next item on the list after the ones deserving attention as was the case with the IASB's Agenda Consultation process of 2011/12. There are however compelling reasons for attending to the conflict sooner rather than later as the next section will attempt to prove.

REASONS FOR CHANGE

According to the Proctor & Gamble balance sheet for the year ending June 2013, the company had assets valued at US$139.3 billion. Of this amount US$87.0 billion was allocated to goodwill and intangibles (goodwill = US$55 billion; intangibles = US$32.0 billion): 63 per cent of the company's total assets are represented by non-tangibles.

The same balance sheet shows assets less liabilities (shareholders' equity) at US$60.1 billion. If the non-tangible assets are deducted the shareholders are left with Net Tangible Assets valued at a negative US$18.7 billion. In simple language, shareholders' equity is comprised entirely of goodwill and intangible assets, of which the Gillette brand, at US$25.5 billion, is a major portion.

For some years now the market capitalization of P&G on the New York Stock Exchange has been in excess of US$200 billion. Since there are no tangible assets (in fact the value of Net Tangible Assets is negative) the entire market capitalization is represented by intangibles. It seems that the investing public is highly sensitive to the value of intangibles but the accountants remain reluctant to show what these are or to admit that they exist economically.

We have chosen to analyze P&G because it is one of the world's best-known brand-owning companies and, as demonstrated in Figure 3, its circumstances can be extrapolated to many other companies.

To highlight the importance of the imbalance between brands listed as assets when acquired but not internally generated we test the inconsistency against the accountants' own tools: *relevance, comparability, consistency, materiality, representational faithfulness* and *separability*[3] (there are others but these six measures of accounting quality are most appropriate to the case in point). In each instance we give a brief explanation of the term as understood in accounting and then test the contradiction against the measure.

Table 4 demonstrates how contemporary balance sheets fall short of the accountants' own quality criteria because they admit intangible assets that are acquired but reject those that are internally generated.

The authors recognize an often-stated concern in accounting circles that an asset can only have value when it is sold: the price at which it was bought is its value. By introducing the business combination standards this concern has been compromised. An acquisition establishes the price paid for the business. The standard requires that any premium paid for the business over and above the net asset value must be explained. The method is to identify intangible assets

Table 4: Testing intangible assets against the accounting quality characteristics

Characteristic	*Meaning*	*Application*
Relevance	To be useful information must be relevant to user needs. The information should be capable of exerting an influence on decisions that are based on accounting data. The data should have either predictive or confirmatory value to the users.	Brands are the link between customers and the company. The source of the revenue line in the income statement is the customer. Customers buy from the company because they believe the brand they buy will perform as they expect it to and as the company promises and will continue to do so in the future. The company's marketers are responsible for building and sustaining this link. Future cash flows are therefore largely predicated on the relationship customers have with the firm's brands. Information about this relationship with the customer in some form or other should be vital for investors seeking to research the company's prospects.
Comparability	The information presented in the accounts must be comparable over time in future accounting periods and it must be comparable with the information published by other companies.	It is not possible to compare the value of acquired brands over time because they are not tested for growth (accretion), only impairment. Thus they will never be shown at any value greater than their fair value estimate when they were acquired. Equally, because other companies have not been bought or sold, comparison is not possible because the internally generated comparable brands are not recognized as assets.
Consistency	The way the information is presented in the accounts must be such that valid comparisons might be made.	The argument presented under comparability applies here too. There is no consistency because the value of the brand at its acquisition fair value will change relative to the fluctuating market value of the company. If the market value increases, the brand by comparison will decrease as a percentage of the value.
Materiality	Information is material if its omission could influence an economic decision that is based on financial data.	Companies that own brands such as P&G, Coca Cola, Colgate and Unilever rely almost entirely on their brands for their cash flows. Customers buy their brands and the generation of future economic benefits is solely dependent on the relationship the company has with its trade channels and that the consumers of its products have with its brands. Featuring only those brands that have been acquired is depriving the investment community of significant information material to any assessment of the company's market value.
Representational faithfulness	A reference to the need for financial statements to present complete and factual information. In the absence of this there can be no reliability.	The point has been made above that investors and other users of financial accounts are not being given a true picture of the company and how it earns and protects these sources of income.
Separability	'An asset meets the identifiability criterion in the definition of an intangible asset when it … is separable, i.e. is capable of being separated or divided from the entity and sold …' (IAS 38:12 (a))	The business combination standard makes it exactly clear that trademarks are intangible assets that will be identified and recognized and that trademarks are known by marketers as brands. 'Marketing-related intangible assets: trademarks, trade names … brand and brand name, often used as synonyms for trademarks and other marks …' (IFRS 3 IE18-IE21). The standard explicitly contradicts the wording in IAS 38:63/64 and in so doing explains why brands are separable from the rest of the business.

and estimate their fair value. Any unexplained surplus is goodwill. Thus the mere existence of these standards confirms that fair value can be estimated and does not just arise from a sale.

THE PROBLEM OF MEASUREMENT

One condition that cannot be properly met at this stage is the accounting characteristic of *reliability*. There are two interpretations of the term:

- that the information in the accounts should in itself be reliable; must be free from material error and bias and must be of such a quality that users of the accounts can feel that the information is presented fairly and represents the facts.
- IAS 38 (21) states that an intangible asset shall be recognized if and only if:

(a) it is probable that the expected future economic benefits that are attributable to the asset will flow to the entity, and
(b) the cost of the asset can be measured reliably.

It is at least arguable that any intangible asset can be measured reliably. By definition, intangibles have no form that can be measured as a building or piece of land can be measured. But even buildings and land are hard to value, prices per running meter or hectare or the application of capitalization rates are fine to generate a possible value but this, arguably, is meaningless until a transaction takes place. A newspaper company might have a large printing press in its basement which sits in its books at an impressively high asset value, or the machine might have been written off in the books and have no value; in either case the value could not be realized until it is sold. The press that is written off might be sold for many millions and in the light of the fall in newspaper readership it might be impossible to sell the expensive press for anything other than its scrap value.

At this stage a convention should be observed. It is typical when discussing valuation approaches to deal with the three main categories of method: cost, market and income. The printing press example above illustrates clearly the cost approach. Different conditions apply to intangible assets: what did it *cost* to establish the Coca Cola, Google and Apple brands? None of these were bought so there is no price to refer to. Coca Cola was established in the 1890s and has been building its brand ever since; therefore, there is no single cost that could be capitalized to impute its value. Even if it were possible to aggregate all advertising spent on the brand over 115 years, advertising is just one component of what has made the brand the most popular carbonated beverage the world has known. The secret recipe, its universal distribution and ownership of refrigerators are also drivers. Google and Apple are far more recent brands but they too would baffle any attempt to figure out what they cost.

Cost therefore is not a viable option for valuing brands and we can therefore state that capitalizing expenses, such as advertising or Research and Development, would not be a feasible basis for valuing a brand. These expenses are essential for a company to maintain and enhance the brand asset, but that is what they are and should remain, tax deductible expenses.

The market approach by definition requires there to be a market, yet there are no markets in brands. They are infrequently sold and when they are they often are included in the business – the margin of 80 per cent. In the absence of a market to set a reference point, market too is not a valid approach to brand valuation.

Estimating the future economic benefits a brand will generate for its owner through its user community – the income method or valuation approach – remains as the most appropriate and relevant method and

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features in most models in one form or another (see Salinas, 2009).

It is important here to explain the authors' view on the difference between brand and customer equity. In the 1990s the notion became popular that value is created, not by brands, but by customers. In its original conception, customer equity is estimated by applying the present value rule to future customer generated cash flows (Rust *et al*, 2004). This is the customer lifetime value, or retention equity. Thus the focus of marketing attention is on acquiring and retaining customers. But the choices customers make are demarcated by brand names and the customer originated cash flows flow to the company via the brand.

We have just concluded that brands are valued by the income method which capitalizes customer-generated future cash flows. Since the focus of customers in generating a life time value is the brand the company makes available to them, we conflate the two financial analyses. This is consistent with the list of intangible assets set out in the explanatory notes to IFRS 3 *Business Combinations* (see Table 3). We are supporters of the customer equity approach (see Keller, 2008) but consider customer and brand equity to be inextricably integrated from the financial point of view.

Knowing that the income method is the most viable of the three does not make it easy to value brands.

The difficulty is highlighted each year by the publication of three league tables of valuable brands. Three companies: Interbrand, Millward Brown and Brand Finance have methods they use to place values on what they consider to be the world's top brands.[4] Since they have only publicly available data at their disposal and information limited to what is published in SEC filings and annual reports, the results are naturally subject to variation.

The disparities shown in Table 5 underline the point that there is not a single commercial valuation approach that could be used reliably for valuing brands at their fair value. This is not to say that all three are necessarily flawed. The problem is to know which one or ones are more likely to be right or at least helpful.

The most commonly used valuation method for business combination accounting is the Relief from Royalty approach (for example see Catty, 2010). This is an income-based method used by most accounting firms, banks and intellectual property law firms. It is simple to operate and because it is so universally employed is deemed credible and reliable.

It is based on the notion that a company would have to pay a royalty to a third party for use of the trademark if the company did not own it. Because the company does in fact own the trademark the trademark's value must be the capitalized present value

Table 5: Top 10 brands measured by three expert valuation companies (2013)

	INTERBRAND	*US$ (billions)*	*MB*	*US$ (billions)*	*BRAND FINANCE*	*US$ (billions)*
1	APPLE	98.3	APPLE	185.0	APPLE	87.3
2	GOOGLE	93.3	GOOGLE	113.7	SAMSUNG	58.8
3	COCA COLA	79.2	IBM	112.5	GOOGLE	52.3
4	IBM	78.8	MCDONALD'S	90.2	MICROSOFT	45.5
5	MICROSOFT	59.5	COCA COLA	78.4	WALMART	42.3
6	GE	46.9	AT&T	75.5	IBM	37.2
7	MCDONALD'S	42	MICROSOFT	69.9	GE	37.2
8	SAMSUNG	39.6	MARLBORO	69.4	AMAZON	36.8
9	INTEL	37.3	VISA	56.0	COCA COLA	34.2
10	TOYOTA	35.3	CHINA MOBILE	55.4	VERIZON	31.0

Table 6: Relief from Royalty example

	y1	y2	y3	y4	y5	y6
Sales	100 000	105 000	110 250	115 763	121 551	127 628
Rate @ 4%	4000	4200	4410	4631	4862	5105
less tax (28%)	2880	3024	3175	3334	3501	3676
PV (y1 – y5)	12 613				discount factor	0.63
Annuity	28 946					2316
Value	148 439					

of the future economic benefits saved by not having to pay the royalties.

There are three major problems with this approach:

Royalty rate: There is no universally accepted way to calculate the appropriate royalty rate. Some companies in the United States claim to research royalty rates and make them available to valuators. The source of their information is primarily what they pick up in the business pages of the media. By definition this is incomplete because not every licensing deal is reported in the media. Also the rates quoted for a category will have been assembled over time so some will be recent and others could be from years back. Finally, one rate tends to be used for all trademarks in a category; only by applying subjective adjustments can the rate be made specific to the asset being valued. An approach to calculating the rate is sometimes used. It is called the '25 per cent Rule' (Goldscheider *et al*, 2002) and is based on the idea that there should be a fair division of profits between the licensee and licensor and that should be 25 per cent of the ratio between sales and operating profit. This is quite a crude device and while it is specific to the trademark being valued it is also subject to the fluctuations of financial performance.

Use of an annuity for indefinitely long lived assets: To use the Relief from Royalty method, the valuator needs to make assumptions about future growth rates and discount rates. In particular account must be taken of the indefinite life of the asset. In Table 6 we show a typical Relief from Royalty calculation for an intangible with an indefinite, long life. To represent the long life an annuity is used. In some cases intangibles have finite lives. When that occurs, the annuity is not used. In certain countries a tax deduction is permitted by which the annual amortization amount is allowable for tax relief. This is called a Tax Amortization Benefit (TAB) and where it applies the TAB that would have been saved is calculated and included in the valuation.

This example of Relief from Royalty is based on a 4 per cent royalty rate, a growth rate of 5 per cent per annum for 6 years and a discount rate of 8 per cent. The present value of the first five years is 12.613. An annuity is then calculated on the 6th year after a discount factor has been allowed (6 years at 8 per cent = 0.63). Apart from the need to have well considered and justified growth rates and a properly calculated discount rate, the simple division of the discounted 6th year by the discount rate to provide an allowance for the asset's indefinite long life is at best tenuous and yet it accounts for two thirds of the total value.

Brand strength (Kotler and Keller, 2006; Keller, 2008): The risk associated with the future economic benefits that a trademark (brand) generates is directly and irrevocably linked to the utility placed on the brand by the consumers who buy and use it. Marketers call this 'brand strength'. It is a survey-based measure of how consumers feel about the brand, how they behave towards it, how they are likely to behave in the future and how this compares with perceptions and behavior towards the competing brands in the product category. The stronger the link with a brand's users, the more confidence a brand owner can feel about future economic benefits being earned. The opposite applies as well. This would fall under the accountants' criterion of 'reliability' which requires users of accounts to be given data that is 'predictive or confirmatory'. There is no measure of consumer brand strength in the Relief from Royalty method.

IS THERE A BETTER WAY?

If the FASB and the IASB decided now to modify the intangible asset standard to resolve the contradiction, it would take more than a few years to research and finalize the wording then issue a renovated version (although much of this work has been done by the Australian Accounting Standards Board, and as we will show below, we do not believe the change to be especially onerous). When that occurs the standards issued should be accompanied by agreement by the valuation industry on a generally accepted method to value intangible assets and brands in particular that will provide users of accounts with a consistent, comparable and reliable methodology.

As we have shown, there are numerous methods and approaches to valuing intangibles available at this time. The most frequently applied method is Relief from Royalty and companies such as Interbrand and Millward Brown are leaders in the commercial sector of the valuation industry. No common set of principles is available for users to judge which approach will provide the most relevant and reliable value. Our proposal is that criteria be established by global bodies such as the international Valuation Standards Council (IVSC) and The Marketing Accountability Standards Board (MASB). These criteria would conform to the existing requirements set out in IFRS 13 *Fair Value Measurement* and SFAS 157 now topic 820. IAS 36 *Impairment of Assets* also has some useful guidelines. Between them these standards provide a foundation for any universally acceptable approach. Drawing on work already conducted by MASB and the ANA (MASB, 2011), the points below form a sound basis for these principles.

- The financial base should be economic profit because it is generally acknowledged that this class of profit can only be earned when a company has developed sustainable competitive advantages such as brands (see for example Brealey *et al*, 2008). Associated with this will be the use of probability weighted growth rates and discount rates devised in a consistent manner employing the Weighted Average Cost of Capital (WACC) and the Capital Asset Pricing Model (CAPM) (see IAS 36 *Impairment* Appendix A).
- A standard formula must be developed that is used to estimate what proportion of economic profit is attributable to the brand. Several approaches are already available and it will be a matter of building on these to devise one that is universally acceptable and easy to apply (Salinas, 2009; MASB, 2011).
- Brand strength is an essential ingredient for two reasons: as a measure of the risk that future economic benefits will or will not be earned (Rego *et al*, 2009); and to provide a basis against which marketing effectiveness can be judged (Salinas, 2009; MASB, 2011) and marketing expenditure assessed by the net present value (NPV) tool (Copeland *et al*, 2000 give a detailed explanation of NPV and how it differs from present value).
- The approach must include an evaluation of the market environment in which the target asset trades. Measures such as internal and external pressures, competitiveness and price elasticities are crucial to a credible valuation because they provide

an assessment of the likelihood that brands in the category are able to earn profits that exceed their cost of capital (Salinas, 2009; MASB, 2011).

- The approach should be made accessible to all by being online. This would have the benefit of allowing for a database of normative data to be built.This framework would not limit valuers to a single approach but would apply strict criteria by which the method most suitable for the purpose may be judged.

CAN THIS BE ACHIEVED?

The United States based Marketing Accountability Standards Board (www.themasb.org/) has embarked on such a project which it hopes to have complete and available by 2015. It is based on a set of principles which themselves draw on the provisions of IFRS 13. (www.themasb.org/wp-content/uploads/2011/12/BV.rationale.principles.pdf).

Given the support of the FASB, the IASB, the International Integrated Report Committee (IIRC) and the IVSC, which already has a standard that deals with measuring intangible assets, this set of valuation principles could become the generally accepted approach to measuring brands at fair value.

Further, the fact that users of valuations would be selecting the approach from more than one available option, in terms of the new IFRS Conceptual Framework currently (July, 2013) being issued as a discussion paper (IASB-DP, 2013) it will not be mandatory for there to be a single approach:

> A single measurement basis for all assets and liabilities may not provide the most relevant information for users of financial statements.

CONCLUSION

The situation in which two accounting standards are in direct contradiction with each other is untenable. Resolving this might not rank as high as ways of dealing with the global financial crisis, but we have shown that there is concern among important bodies that have over a decade demonstrated that a solution must be found.

The accountants themselves provide a motivation for this to be dealt with in their accounting conceptual framework.[5]

> the objective of general purpose financial reporting is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions about providing resources to the entity. (Conceptual Framework (2010) OB2)

In a financial environment where as much as 80 per cent of company worth is intangible we would suggest that providing estimates of what comprises this margin falls precisely into the category of '*provide financial information …useful to existing and potential investors*'.

By their own measurements of accounting quality, the accountants fall short. By omitting the value of internally generated brands, they violate their own criteria of reliability, comparability, consistency, materiality, representational faithfulness and separability.

They also ignore the perfect fit between a brand and how accountants define an asset:

> A resource controlled by an entity as a result of past events: and from which future economic benefits are expected to flow to the entity. (IAS 38 (8))

Our analysis above shows that the problem is caused by a basic conceptual conflict. In the intangible asset standards the unit of account is *cost*. In business combinations it becomes *fair value*. Requiring internally generated intangibles (brands) to be measured by their fair value as opposed to their cost immediately resolves the conflict. Clearly it is not quite as simple as changing a

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couple of words, there are other implications as we show in the section (pp 2–3) titled 'The contradiction', but retaining the cost measure in intangible assets is perpetuating an approach to accounting that has been superseded and replaced. Its retention warps the usefulness of this particular standard and deprives a large community of accounting statement users of complete, reliable, comparable and material information. The standard also requires that these resources can be reliably measured.

It goes without saying that a properly trademark-registered brand is under the control of the company. Since a brand is the link between the company and its customers (the source of the revenue line in the income statement), it is a resource that generates future economic benefits for the company. A brand is an asset according to this definition. The questionable aspect is whether or not it can be reliably measured. There is no question that brands can be measured, but at this point there is no universal approach that will produce comparable and consistent results. We believe that given the will, this is achievable.

Finally, we have indicated an inconsistency that already occurs in the business combination standard and will become increasingly a substantive problem. That is the matter of *accretion*. The standards currently require acquired brands to be tested annually for *impairment*. The purpose is to see if the recoverable value is less than the carrying amount. If it is, the asset value is adjusted down and the difference transferred to the income statement where it reduces company profits. Brands tend not to lose value. Good marketing would ensure they gain in value. Eight years after P&G bought Gillette, the brand remains on the P&G balance sheet at the immediate post-transaction value. That is totally unrealistic and we propose that brands be tested for *impairment* but also for *accretion*.

We understand that the process of bringing the two standards into line will not be as straightforward as changing a few words, but the current situation cannot be left unresolved. We suggest that the two standard setting bodies embark on an urgent Post Implementation Review (PIR)[6] of their intangible asset standards (IAS 38 and Topic 350) and the changes needed to bring these standards into line with the more modern business combinations standards be identified, re-worked and implemented. (IASB, 2013).

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NOTES

1 The FASB implemented recently a codification of its standards which replaces these notations. For the sake of efficiency for this article, we will not use the new Topic codes because this would require extensive explanation and make the flow described here too complicated. For the record: the new code for SFAS 141 is topic 805 and for SFAS 142 it is topic 350.

2 Fair value is the 'amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction'. IFRS 3 *Business Combinations*, Appendix A.

3 IASB (2013). The Conceptual Framework for Financial Reporting. Qualitative Characteristics: QC1–QC39. NB. 'Separability' is not included in the Conceptual Framework but is in IAS 38 and IFRS 3. We have used it because it is often mentioned as a concern.

4 These three valuation approaches are probably the category leaders. Salinas (2009, p. 45) has identified some 39 proprietary brand valuation methods being offered by 31 providers. The total number of methods she has identified amounts to 63.

5 IASB (2013). Conceptual Framework for Financial Reporting. This document was first issued in 1989 under the title 'Framework for the Preparation and Presentation of Financial Statements'. The conceptual framework is in

the process of being updated and as sections are completed they replace the previous section.

6 PIR is a relatively new operation carried out by both of the standard setting bodies. IFRS 3 will be the second PIR to be carried out. It would be appropriate to conduct a PIR on IAS 38 which is now more than 15 years old.

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