Marketing Accountability Standards Board
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A rationale and proposed set of principles for brand valuation

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Background

Many marketers and financial professionals believe brand valuation is a marketing imperative essential to the management of brands. However, given the variety of brand valuation methods available to measure brand value, the values that these methods produce vary considerably. The Top Brand lists produced and published annually are the public face of brand valuation and yet the three main rankings (Business Week, Financial Times and the Brand Finance on-line list) are inconsistent in the values they estimate and each brand's place on the ranking. Even more concerning is that the brands that appear in one list do not appear in another; and, the direction of change is frequently different. Because these lists are derived from publicly available data and do not draw on internal management data sources, they are unable to provide information on the drivers of brand value. Their strategic use as a management tool is therefore limited and they cannot therefore be as accurate as a commissioned valuation when inside data is made available to the valuator.

Because of the growing importance of knowing the value of brands, many in the marketing community believe we must have a set of standards for brand owners to use as a reference point when evaluating brand valuation methodologies. These standards would ensure that the method used was soundly based on acknowledged valuation principles and that the resulting value would be valid and credible and could be measured consistently over time.

While not all marketers agree that brand valuation is an imperative, and some even doubt that it has practical use (even though, as a consequence of accounting standard IFRS 3 acquired brands must be valued and placed on the balance sheet), this report will develop a case for the valuation of brands, illustrate its main uses and set out a series of principles on which brand valuation standards may be built.

Part one - Why value brands? Who uses valuations?

Brands and enterprise value

Cash generating units are defined as the smallest identifiable group of assets that generate cash inflows that are largely independent of cash inflows from other assets and groups of assets (IFRS 13: 63). Enterprises draw their value from all the cash generating units the business has developed. Cash generating units can be physical (e.g. machinery, buildings and vehicle fleets) and intangible (e.g. brands, internet domain names, customer lists and contracts, royalty and licensing agreements and software programs).

If brands are seen as cash generating units, as indeed they are, they contribute directly to enterprise value. For many years, this has been acknowledged by investors who factor brands into the price they are willing to pay for a company whether as a stock price or to buy the business.

The concept of cash generating units helps to overcome any distinction made between brands as single entities or as part of a portfolio. In either case the brands are cash generating units.

- **Single brands**
  Companies such as motor vehicle manufacturers might have a single brand name (e.g. BMW) under which all its models are marketed. In this case the value is the total of all the models/sub-brands that fall under the parent name. This total portfolio value contributes to enterprise value

- **Category brands**
  A company such as Proctor & Gamble does not use its corporate name to market brands but has a variety of brands with different names that are collectively sold in category portfolios (e.g. snack foods or hair care). In this case the category portfolio contributes to enterprise value.

In both cases the brand or brands within a portfolio are cash generating units that in aggregate contribute to enterprise value.

This premise (brands as cash generating units) is recognized in the financial and investment communities. Whether it is for post-merger accounting; taxation; trademark litigation or other reasons, boards of directors, shareholders and investors are using brand valuation. Most valuations commissioned for financial or reporting purposes, however, are conducted by accountants or banks – not by marketers. These valuations, which are viewed by the investment community and which appear in annual financial accounts, have no customer or brand strength input and the function in the business charged with managing the brand has no involvement with the valuation. The consequence of this misalignment of functions is that investors would not be able to judge the firm and its marketing function as stewards of the brand asset.

There is an additional level of brand valuation that plays a role in enterprise valuation: the **corporate brand**. While the P & G name does not contribute directly to the value of its product brands that do not use its name, the P&G corporate brand does contribute to the value placed on the firm by the investing community. This serves a dual function: the inherent value of the corporate brand and as a bulwark against reputational destruction. Research by companies that specialize in reputation has established that there is a strong correlation between reputation and the corporate brand. There is some evidence that when reputations suffer, as was the case with BP and Toyota in 2009/10, reputation swings are faster and deeper than brand; indicating that corporate brands can play a moderating role on the damage done to reputation when a calamitous event takes place.

Increasingly, management will judge brand investment decisions by the contribution they make to present value and future economic benefit and ultimately to the worth of the company.

Marketers should, therefore, embrace this concept (that their work should be designed to influence economic benefits) because it makes them more relevant to the business purpose, allows their actions to be evaluated and judged according to sound business principles and provides them with acknowledged financial tools to justify and motivate their plans*.*

Benefits of brand valuation - to marketers
Given a valuation that is valid, credible and generally acceptable, the benefit to marketers is powerful:

- **Marketing Effectiveness** – Brand valuation can be used as benchmarks for measuring the effectiveness of marketing programs and tracking progress over time; it can relate an improvement brought about by planned marketing actions to either short term cash flow acceleration or enhancement of long term cash flows through the strengthening of consumer bonds with the brand.

- **Portfolio Optimization** – It can be used strategically to evaluate the number of brands or products in a portfolio and aid in pruning, rationalization and portfolio optimization;

- **Positioning Strategy** – It can provide guidance in selecting the most economically attractive positioning from a set of alternatives.

- **Investment Justification** – It can be used to evaluate and justify expenditure requests by using the NPV rule since the valuation methodology is based on the time value of money (present value)

- **Communication Tool** – It can be used to communicate the outcomes of marketing programs to financial and general management since brand valuation is a financial management tool.

- **Investor relations** – A corporate brand valuation can illustrate the intangible value that the corporate brand contributes to the market premium. Because a company's reputation can suffer from publicized negative events a strong corporate brand can act as a brake on the extent of the damage. The corporate brand is not a cash generating unit in the same way that product brands are and when it is a factor, it is best accessed by a top-down valuation as opposed to the bottom-up aggregation of brands as cash generating units.

- **Asset Management** - Finally, it is probable that brands will become balance sheets assets at some time in the future (both acquired brands which already are, and internally developed brands, which presently are not). At that stage marketers would want to be responsible for all aspects of brand asset measurement and for continuing management of the asset.

Others use brand valuation as well.
Because brands are seen as assets by the investor and finance communities brand valuation is used extensively for non-marketing purposes. Among the uses, the following are the most frequently conducted:

- To value a brand (trademark) after a merger/acquisition in terms of an accounting standard that requires this. The value is deemed to be part of the cost of the deal and the value is recorded in the notes to the post merger accounts.

- Trademark litigation where an amount is claimed or awarded in a trademark infringement case.

- In some jurisdictions brands (trademarks) are used for tax purposes where a royalty is charged for the use of the brand in its various markets and the cost therefore becomes an allowable expense against taxation.

- Some corporate entities charge their subsidiaries a royalty for the use of the corporate brand. Valuations are used to work out the royalty.

It is significant that these valuations are rarely conducted by the marketing based brand valuation firms. Banks, IP specialists and accounting firms are normally commissioned to do the valuation work and they use a method that has no marketing input whatsoever. The most common approach used by banks and accounting firms is Relief from Royalty which is based on the following premise:

> *If a firm uses a brand name which it does not own it would have to pay a royalty for the right to use the name. Since the firm does indeed own the brand it is relieved from paying that royalty and what it saves is the value of the brand. The royalty is typically applied to turnover projected over five years at a growth rate and discounted to present value to which is added a terminal value based on perpetuity.*

It should be noted that:

- in practice the five year DCF present value tends to be the smaller part of the valuation with the larger portion (as much as 70%) coming from the perpetuity.

- The royalty rate used is often sourced from firms that claim to know what royalty is charged for product classes. Selection of the rate is at best subjective

Part two – The Principles

By definition, measuring something that is intangible will require some degree of judgment on the part of the valuator. Brand valuation cannot be a precise science. To a lesser or greater extent all twelve principles below will require judgment. In its Comprehensive Business Reporting Model (CFA, 2007) the CFA states that at every level of accounting and financial reporting some estimates, assumptions and judgments are required (see also IASB, 2010:OB11). Users can make their own assumptions about the outcome, if the estimates, assumptions and judgments are fully disclosed with reasons and supporting evidence. The MASB principle which covers this is BP #1. The valuator can aid this judgment by conducting sensitivity analyses.

The twelve basic principles are based on two fundamental assumptions: that the brand being valued has an indefinite expected economic life and that the valuation will be based on the income approach to measurement. A third assumption makes allowance for the Corporate Brand which differs from product brand but which plays an important role in the enterprise value.

Because this is a first draft there are certain areas that require qualification and further work. The endnotes should therefore be read as an integral part of the proposal.

General Assumptions

GA #1.The indefinite life assumption

Brands are long-lived assets that generate future economic benefits. They are seldom created with finite lives (exceptions being, for example: cinema films, products produced specifically for events such as the Olympic Games and pharmaceutical drugs whose patents expire after a finite number of years)[i]. This has important implications for accountants (under conditions created by IFRS 3) because an asset with an indefinite economic life and especially one which tends to grow rather than decline in value over time will rarely be subject to annual impairment. [ii]

Brands will therefore invariably be considered to have indefinite economic lives. (IAS 38: IN9).

GA #2. The valuation approach assumption

Generally, it is considered that there are three ways to value an asset: market, cost and income. Market assumes an open listing of transactions so that the price paid for a similar brand can be used. There are no markets in brands. Cost assumes that the cost to replace the brand is equivalent to what it cost to build it. That clearly is not the case and it would be impossible, for example, to accumulate the cost of building the Coca Cola brand.

Because brands generate future economic benefits and have indefinite economic lives, the most appropriate approach to measuring them is the income approach. This employs the time value of money and usually, but not always, refers to the present value, discounted cash flow method.

Valuation methods will invariably be based on a present value, discounted cash flow risk adjusted income approach. [iii]

<u>GA #3. The Corporate Brand assumption</u>

The worth of an enterprise is the sum of a number of cash generating units which equal the value of the enterprise. The investment community often ascribes additional, incremental value to the business in the form of a market premium. It does this, *inter alia*, to acknowledge the advantages the firm has built which allow it to negotiate preferential raw material prices; acquire favorable leases for property; employ top talent; have a recognized lobby voice with authorities and regulators; have negotiating power with distribution channels due to its volume of business; and, innovate through research and development. These benefits are captured in the stock price and market capitalization which frequently exceeds the calculated or economic value.

In addition to the valuation of product and service brands as cash generating units or groups of cash generating units, the corporate brand adds incremental value at the investor level.

Basic Principles

<u>BP #1. The disclosure principle</u>

For a valuation to be valid and credible the method by which the valuation was calculated must be fully disclosed including all assumptions and calculations.

In BP #4 and BP #10 and BP #11 attention is drawn to the need for disclosure.
If brand valuations are to be accepted by the investment community and be respected by company management all aspects of the valuation must be disclosed. It is acceptable for this to be on a confidential basis if aspects of the methodology are proprietary, but it is axiomatic that for a value to be credible the users of it must know how it was conducted. In the event that a valuation will be used for public use such as taxation, accounting, merger and acquisition, investor relations or litigation, the workings of the approach must be fully and publicly disclosed.

<u>BP #2. The economic base principle</u>

The basis of a brand valuation should be the calculation of economic profit. It is known that companies that consistently earn profits that exceed their cost of capital have created sustainable competitive advantages that ensure this. Brands are known to number among these advantages. (See Brealey, Myers & Allen, 2008:308 for an explanation of economic profit)

The cost of capital uses a return based on the operating assets that are required to market the brand. This is often a simple addition of Property, Plant and Equipment, inventory and accounts receivable. Accounts payable reduce the operating capital requirement and for this and other reasons is deducted. The return is usually based on the WACC and the product of capital employed x WACC is deducted from the Net Operating Profit After Tax (NOPAT). (See GP #7) (See Brealey, Myers & Allen, 2008:241 for an explanation of WACC and how to calculate it.)

BP #3. The brand contribution principle. [iv]

The valuation methodology shall have a component that works out the portion of economic profit attributable to the brand. It will do this by relating consumer related brand strength/preference to the generation of economic profit.

Economic profit is generated by a combination of intangible assets; not just brands. The valuation must estimate a percentage which is applied to economic profit to represent the brand portion. This is by its nature subjective and there are several ways in which it is done. By definition the brand portion must take account of the strength of the brand.[v] This must then be applied to some measure of the resources that create economic profit. Because of the subjective nature of this number the system used must be transparent, logical with some degree of statistical validity.

Also, due to the subjective nature of the calculation sensitivity tests must be conducted around a variety of outcomes with a mid-point used in the final calculation. The final percentage should be compared to previous results for the category.

BP #4 The expected economic life principle

The valuation method should attempt to model the complete expected economic life of the brand.

GA #1 states that brands have indefinite expected economic lifetimes and GA #2 predicts that the income approach be used. Given these two basic assumptions the valuator should attempt to model the entire economic life of the brand. This is accomplished in a variety of ways: using a fixed period DCF plus perpetuity; applying a multiple to the brand portion of economic profit or working out the growth phase of the brand to which is added a theoretical decay curve.

It is acknowledged that there are and always will be several approaches and the key necessity to be able to judge each one is full and open disclosure (see BP #1).

BP #5. The brand strength principle [vi]

The valuation method must have a component in the model that uses brand strength as a driver of value.

Future economic benefits are generated because the company has acquired customers who will exchange cash for ownership, or use, of the brand. Brand strength, measured by reliable and valid market research (see MASB MMAP standards), is a crucial input to any valid valuation. The brand strength measurement, relative to other players in the category, is an indication of the likelihood that future cash flows will be earned (see BP #8). It is also a powerful indicator of the brand's expected economic life (see BP #4): the stronger the brand relationship or bond with its consumers the further into the future brand earnings can be projected.

BP #6. The Environmental influences principle

The valuation method must have a component that incorporates an evaluation of the relevant environmental factors that are outside the control of the marketer.

In addition to the nature and strength of the brand relative to its user-base the brand is also affected by environmental factors. Government regulations, licensing requirements, unanticipated competitive activities, raw material supplies, health issues and political events all have an impact on the performance of a brand. These tend to be unknown but as is the case when developing a business or marketing plan, the value should include an assessment of the key external influences and include these in the adjustments for risk (see BP #8).

BP #7. Discount rate principle

The Weighted Average Cost of Capital (WACC) comprising a risk free rate, a market related risk premium, a market beta, and a cost of debt weighted by a debt equity ratio is commonly used for valuation purposes. If a WACC is not used there must be a valid explanation of why not and of the alternative employed.

It is common practice among valuators and appraisers to use the WACC for both economic profit calculations (see BP #2) and as the discount rate for present value calculations (see GA #2). The WACC is preferred because it is understood by most users of valuations and because it is built up from a number of reliable inputs. In cases where the brand is owned by a company that is not listed and therefore some components are not readily available it is acceptable to use proxy companies which are listed to obtain these inputs.

BP #8. The risk principle

Risks specific to the brand that might impose a negative impact on the cash flows should be taken account of in the cash flows and not the discount rate.

Historically, valuators identified specific risks and applied to them risk percentages which were added to the market based risk premium. Thus a WACC of 13% could rise by an additional amount sometimes as much as 5 percentage points, thus severely dampening the value. The trend has move from the discount rate to the cash flows themselves and to a device known as "probability weighted" cash flows.

This uses possible risks (and opportunities) that lie in the immediate future (one or two years) and applies a probability weighting to the cash flows that these events will occur.

Thus a normal projection based on historic trends might have a 0.6 weighting with weightings making up the balance of 0.4 being applied to lower or higher projections depending on their likelihood.

BP #9. The growth rate principle

The short term growth rate should only exceed the average for the three previous years if there is credible justification to do so. Longer term growth rates (after two or three years) are unpredictable and should therefore be the sum of an expert panel consensus of gross domestic product and inflation depending on whether the rate is to be real or nominal.

The valuator has to project the earnings from the brand portion of economic profit at appropriate growth rates for each period of the discounted cash flow projection.

Typically the management budget for the current year is used and forecasts from the business plan (if there is one) for more distant years are examined to see if they are suitable and reasonable. The rule must be conservatism and a cynical view of ambitious company forecasts should be applied.

BP #10. The source of data principle

When possible the data used in a valuation should be from observable sources.

Since it is most likely that unobservable inputs will be used in brand valuations because observable data are not available, the source of input data must be fully disclosed.

The Fair Value measurement guide, issued by the International Accounting Standards Board (IASB), IFRS 13, has three levels of data source: Level 1 refers to data from observable sources (i.e. the stock market) where precise numbers are available from trades at the time of the valuation. Level 2 is also observable but uses trades that are similar or close to the asset being valued. Level 3 allows for unobservable inputs because assets such as brands are not traded and no observable data will be available. Level 3 inputs will tend to be management data, market research and historic performance figures. These are permitted by the standard as long as the nature and source are fully disclosed in the valuation report.

BP #11. The consistency over time principle

Valuation techniques and the source data used should be applied consistently so that the valuation may be reliably replicated over time.
In many instances a valuation will be conducted as a base value for future growth. This can only be possible if the source data will be available in a similar format each time the

valuation is conducted. IFRS 13 makes allowance for changes in the approach (clause 65), if the result is that the valuation is more representative of fair value, in other words the value is improved. If the change results in a material revision to the valuation, this together with the reasons for the variation, must be disclosed.

BP #12. The multiple markets and segments principle

Valuations that deal with multiple markets, market sectors and product brands should employ the Pareto Principle valuing a sample of representative markets, sectors or product brands to arrive at a value that can be extrapolated to a total.

It is not economically or practically feasible to value a brand in all its markets, across all the sectors in which it or variants trade, and all the brands within a large portfolio. In these circumstances the valuator with the agreement of the user of the valuation will select those markets, sectors or brands that are most representative of the total.

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End notes

[i] If the brand has a finite life the number of years in the DCF projection will match precisely the remaining number of years to termination. In some jurisdictions the tax authorities allow for intangible value to be amortized over the finite number of years. In these circumstances the valuator needs to perform a Tax Amortization Benefit (TAB) schedule and add the present value of the benefit to the DCF value.

[ii] Impairment is an accounting procedure specifically concerned with intangible assets. It is a hang-over from when goodwill was recognized as an asset which it no longer is. If an intangible asset is acquired and appears on the balance sheet as an asset, its value must be tested annually to see if the value is still the same as the original value (the carrying amount) or whether it has lost value (impaired). Any impairment loss is added to the income statement as an expense. Because companies consider brands to be long-lived assets that will generate future economic benefits, they will rarely record a negative value if subjected to the annual accounting test of impairment. The opposite is more likely to be the case: brands will increase in value over time (formally known as accretion) so that their balance sheet value will regularly exceed their carrying amount.

[iii] Should there be a market in the type of brand being valued the rules of Mark-to-Market would apply and these principles would , generally speaking, not. It is unlikely that any justification to use the cost approach could reasonably be advanced.

[iv] Strictly speaking this principle does not comply with the criteria for being a basic principle because there is no agreement on how to develop the driver measurements. This aspect of valuation is so critical to the result that a standard must be developed. The principles are clear: the drivers of economic profit must be identified and the influence of relative brand strength on each must be calculated.

[v] This principle has been stated in an open manner because there are several ways in which brand strength or brand preference is used in the variety of valuation approaches: the standards will have to be more precise in where and how these crucial measurements should be applied in the valuation methodology.

[vi] Views differ on the use of brand strength, brand preference and brand equity to describe the relationship between the consumer and the brand. It is an important metric. For this project it has been decided to use “brand strength” as the term that described this research based relationship. It is acknowledged at this stage that this view is not universal. This must be the topic of discussion as the standards are developed so that a uniform approach can be adopted.