

# I NTANGIBLE ASSETS - HANDLE WITH CARE

## THE BRAND-NAME DEBATE HAS JUST BEGUN



by WAYNE LONERGAN

*Lack of clear directions about accounting for intangibles has led to misunderstanding and abuse. Recently renewed comment and an exposure draft have shed light on the problems.*

U ntil the recent unprecedented level of takeover activity and the introduction of various accounting standards on the subject, companies had little concern for the intangible component of an acquisition price. It was simple either to classify it as goodwill (without even considering whether intangible assets other than goodwill may have been acquired) and capitalise it in perpetuity on the balance sheet, or to write it off as an extraordinary item. Neither treatment affected profit.

However, with the introduction of the accounting standard on goodwill, and the mandatory annual amortisation of goodwill against profit, the search for a loophole began in earnest. Brand names and other identifiable intangible assets suddenly appeared on balance sheets.

The release in late 1989 of Exposure Draft 49 (ED49) on Accounting for Identifiable Intangible Assets (Identifiable Intangibles) threatens to change the playing field again.

ED49 says, among other things, that purchased identifiable intangibles

- must be brought to account and properly classified (ie, they can no longer be hidden under the general description "goodwill"); and
- must be brought to account at the cost of acquisition.

The NCSC was also concerned that the obligations placed on com-

pany directors by paragraph 269(7)(c) of the Companies Act 1981 and Codes were not compromised. Under this section, directors are required to ensure that the book value of a non-current asset does not, having regard to its value to a company as a going concern, exceed what would have been a reasonable price for that asset. The commission believed, and experience confirms, that identifiable intangibles included in the balance sheets of certain companies fail to meet that test. This is due, in part, to the use of invalid and incomplete valuation methodologies.

About internally developed identifiable intangibles, ED49 says:

- they may be brought to account, and if so must be appropriately classified; and
- if they are brought to account, then it must at the "current cost", determined by an independent valuation, at which they would be obtained in the normal course of business.

In essence, the exposure draft, if it becomes a standard, will require

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separate values for, and annual amortisation of, all identifiable intangible assets that are brought to account.

While the valuation of identifiable intangibles should be subject to the same rigorous theoretical and practical considerations as any other business or security valuation, correct valuation methodology is not widely understood and in some cases has been grossly abused.

The extent of the misunderstanding and abuse is so widespread - and likely to be even more so following ED49 - that the NCSC has issued a draft policy statement on the valuation of identifiable intangible assets.

This paper examines the various valuation techniques that have been propounded, focusing on their application to brand names, and assesses their relative economic logic and practicality.

## Valuation considerations

The value of any asset is determined by the future earnings or cashflow that can be expected from its use or sale. Valuation of an asset in the absence of a market in comparable assets requires the ability to make a reasonable estimate of its future net economic benefits.

In reality, relatively few transactions involve just the intangible assets. Where the transaction involves a company or business, which it normally does, it is difficult to attribute an accurate, separate value to the various components.

The search for comparable transactions also highlights a fundamental error in methodology where the identifiable intangible is assessed as the difference between the cost of purchase and the fair value of the net tangible assets and liabilities. This approach fails to distinguish between identifiable and unidentifiable (eg, goodwill) categories and fails to cross-check the calculated value against other valuation criteria.

The difficulty of assessing the economic benefits expected from individual identifiable intangible assets, and segregating them from the benefits of the other assets of a business, can be expressed in three levels:

- the asset being valued may have a clearly identifiable cashflow, such as a royalty stream or lease pay-

## WHAT ARE THEY?

There is no generally accepted definition of an identifiable intangible asset. However, ED49 defines intangible assets as non-monetary assets without physical substance, which can be individually identified and specifically brought to account.

They would include such assets as brand names (on which this paper concentrates) licences, trademarks, mastheads, franchises, distribution agreements, patents, customer lists and similar assets.

ments, that can be quantified with reasonable accuracy;

- where an asset is employed with a number of other assets, the difficulty and cost of allocating the future economic benefits to the individual assets needs to be considered with respect to the benefits of the valuation; and

- the future economic benefits may be so highly dependent on the other assets in the business that the intangibles cannot be properly segregated and should be valued in combination.

## Traps for the unwary

Various "conventionally accepted" methodologies apply to the valuation of identifiable intangible assets. However, no single formula will be appropriate in all circumstances. Indeed, the NCSC requires — and anyway the prudent valuer should consider—the use of a number of methodologies with each being cross-checked against the others. The methodologies commonly adopted can be sorted into three main categories:

- comparable market transactions;
- historical or replacement cost;
- economical benefits methods which include:

- gross profit differential
- excess profits
- relief from royalty
- marginal cash flows

A review of their characteristics and limitations shows that the single most dangerous trap in valuing identifiable intangible assets is a reliance on one valuation methodology to the exclusion of all others.

## Comparable market transactions

While actual transactions can be regarded as reliable evidence of value, identifiable intangibles are normally exchanged as part of the sale of a company or business and there is little or no secondary market in them. It is therefore unlikely that there will be comparable sales to refer to. Even if there are "comparable" sales, comparisons are generally difficult because of the individual circumstances of each transaction, particularly:

- where the transaction recognises a special value to the purchaser (eg, Rowntree/Nestle);

- if one or both parties to the transaction (or the observer of the transaction) were not fully informed and/or did not act prudently;

- if economic conditions generally, and rates of return in particular, have changed;

- if the parties did not have comparable negotiating abilities;

- where the degree of comparability between the assets being valued differs.

On balance, comparable sales are an ideal test, but they can only rarely be identified.

## Historical or replacement cost

The use of historical cost to value intangible assets is derived largely from accounting and not valuation practice. Clearly, the value of an identifiable intangible is derived from its future economic benefits and not its cost.

In particular, historic cost ignores the effect of inflation; it ignores the time-cost of money; it implicitly (and incorrectly) assumes a direct relationship between cost and prospective profits; it may be distorted by differing accounting policies and/or arbitrary amortisation policies; it may place an excessive valuation on less-successful brands at which high levels of expenditure have been directed; and it may place low values on successful brands on which there has been relatively little expenditure or where the owner has "struck it lucky".

Accordingly, historical cost is not an appropriate valuation methodology.

However, the current replacement cost of an identifiable intangible may be relevant to the valu-

**Figure 1: Gross profit differential method**

	Brand A	Generic
Sales (units)	500	200
Gross profit (per unit)	\$2	\$1.5
Marketing costs	\$250	\$50
The only difference between the brands is the established name of Brand A.		
Gross profit – Brand A	500 x \$2	1,000
Marketing		(250)
		750 (a)
Gross profit – Generic	200 @ \$1.5	300
Marketing		(50)
		250 (b)
Gross profit differential	(a) - (b)	500
Less: Tax @ 39%		(195)
		305
Capitalised Value	(\$305 x PER 8)	2,440

**Figure 2: Excess profits method**

	\$M
Future maintainable profits (after tax)	6
Net tangible assets	20
Required rate of return	20%
<i>No other identifiable intangibles (etc)</i>	
	\$M
Future maintainable profits (after tax)	6
Rate of return on NTA \$20M @ 20%	4
Excess profits	2
Capitalised value \$2m @ 20%	10

ation process where the only barrier to entry is the cost of establishing a comparable brand. In these circumstances the replacement cost (net of tax), if reliably determined, would represent a maximum value.

A method, already commented on, which is commonly used to value identifiable intangible assets has been to determine the fair market value of the business and to subtract the fair value of the net tangible assets employed in that business. The resultant intangible component has then been allocated to the identifiable intangible assets.

This method, however, fails to take account of any proportion of the total value of the business that may be contributed by other intangible factors.

It is also clearly unacceptable because it fails to make the fundamental distinction between identifiable and unidentifiable intangible

assets. Nevertheless, this method would generally place an upper limit on the value of identifiable intangible assets.

Another method, the capitalisation of historic profits, determines the value of a brand name by multiplying its historic profitability by a factor assessed after examining relative strengths of the brand. While this method recognises some of the factors that should be considered in the valuation of a brand name, it has major shortcomings:

- being based upon the historic profitability of a brand, it does not take account of future profit growth or decline attributable to the brand;
- net tangible assets fundamental to the generation of profits are not separately assessed when total profits are used as a base for the valuation, resulting in a significant over-valuation;
- the selection of the price-earn-

ings multiple is made without reference to the established markets for securities, and accordingly this method will not allow any reconciliation between the total value of the business and the values of its components, including brand names.

In many cases, past performance will give a pointer to the future. However, given that the fair market value of an asset is based on its future net economic benefits, not the past, this method has a critical failing.

### Economic benefit methods

The gross profit differential method is most commonly used for trademarks and brand names. In this methodology, the profits of a branded product and an unbranded or generic product are used in the calculation of value. Both the prices and volumes need to be considered and full allowance must be made for the maintenance cost of the trademark or brand names. However, because of difficulties in defining the relevant components of gross profit, the method usually focuses on sales-price differentials, adjusted for differences in marketing costs. (See Figure 1 for example.)

This method is almost impossible to apply with the high degree of reliability required by a prudent valuer or prudent preparer of financial statements. Its major limitations are:

- The gross profit differential does not explicitly consider the net tangible assets employed and a reasonable required rate of return on those assets.
- The gross profit differential may be a reflection of factors other than the trade mark or brand name, such as cost efficiencies in production or economies of scale.
- Information about the cost, volumes and marketing expenditure of the other products may not be available or reliable. This could be the case where the products are retailed through mass outlets.
- It may be difficult to find a suitable non-branded or generic product for comparison. Even if there is a similar generic product it may have differences in quantity, quality or availability.
- Rarely is there much empirical evidence on price elasticity or substitutability of the branded and generic products.

■ It is sometimes difficult to know how much of the margin difference is attributable to the brand name and how much to other factors.

■ No allowance is made for changes in relative market shares over time (eg, where a generic competitor has only recently entered the market).

■ The gross profit differential method implicitly biases valuations in favour of industries in which variable costs are a low proportion of total costs.

In the **excess profits method** the current market value of the net tangible assets employed is calculated. Then an estimated rate of return is used to calculate the profits required to induce investment into those net tangible assets. Any return above those profits is considered to be attributable to intangibles. This return is then capitalised. (See Figure 2.)

However, care must be taken in allocating this capitalised amount between the individual identifiable components and any remaining unidentifiable component, which by its nature must represent goodwill.

This methodology is a variation on that of valuing the business as a whole and subtracting from that value the current market value of net tangible assets employed. In either case, one method should be reconciled with the other; ie, the sum of the parts cannot exceed the value of the whole. Although this method theoretically relies on the future economic benefits obtained from the use of the assets, it has the following major limitations:

■ The required rate of return may reflect risk and other factors which cannot be separately assessed with precision.

■ The method itself does not allocate between any constituent components, such as different brand names.

■ The valuation of some of the tangible assets employed may also incorporate some of the intangible value (eg, plant and machinery may be valued on the basis of "value in use").

■ Information about technological developments from potentially competitive products maybe unavailable or difficult to assess.

■ The assets being valued may not be employed in the best possible manner.

■ Asset values and reported profits may be calculated on different bases.

**Figure 3: Relief from royalty method**

Future maintainable profits (before tax)		\$15M	
Royalty alternative		5%	
Sales		\$100M	
Net tangible assets		\$25M	(a)
PER		6	
		\$M	
Implied royalty	\$100M x 5%	5	
Capitalised value	\$5M less 39% tax x 6	18	(b)
Future maintainable profits (before tax)		15	
Less: Implied royalty		5	
		10	
Less: Tax		4	
Implied future maintainable profits after royalty and tax		6	
Value of whole business	\$15M less 39% tax x 6	\$55	M
Comprising			
- Net tangible assets		25	(a)
- Value of brand name		18	(b)
- Goodwill		12	Balance
		\$55	M

■ Theoretically, any company earning an excess profit margin will generally have that margin eroded over time by competitive pressures.

■ Branded products, if successful, generally have the benefit of lower depreciation charges (because of fully depreciated assets or assets acquired at a lower historic cost base) and the benefit of the learning curve at all levels of operation.

■ The required rate of return may be taken into account in setting the sales price of the product.

The inherent theoretical and practical difficulties associated with this method suggest that caution should be used in adopting it as a primary valuation methodology. However, if the valuer recognises these limitations, the method may be useful as a means of cross-checking other methods or placing a maximum limit on the value of a brand name.

In the **relief from royalty method** an estimate of a comparable royalty is based on the nature of the asset and the industry in which it is employed. The estimated "savings" resulting from the ownership of the asset are then quantified by either the net present value or capitalisation methods. This method can also be used to cross-check the allocation of the intangible value determined by another method into its components. (See Figure 3.)

This method has all the limitations inherent in most "rule of thumb" valuation methods. These include:

■ the failure to recognise the variation in the future economic benefits which would result from different intangible assets;

■ the possibility that reference rates may be out of date and do not properly reflect current economic conditions;

■ the normal rates are established on an average of a number of transactions about which detailed information is not usually available;

■ reasonability tests of the maximum acceptable royalty rates, profit cover of royalty and percentage of total intangible value are highly subjective;

■ full details of other licensing arrangements (including any limitations on the use of the licence) are rarely available;

■ most licence arrangements incorporate an exclusive non-competitive geographic market and hence contain an element of locational goodwill.

The amount of royalty may be calculated on the basis of comparable market royalties (where they exist and where the information is available) or on the basis of a notional maximum royalty.

However, the use of actual royalties (net of any costs incurred by the

licensor in maintaining the licensing arrangements) may understate the royalty that a licensee would be prepared to pay (and hence under-value the brand, etc). The actual royalty may also have been set many years ago and be out of date. Further, the actual royalty being paid may incorporate other factors (eg, goodwill, location, etc).

Although royalties can be calculated on many variables, the most common is total revenue. Unless the royalty is calculated solely on net profits after tax excluding the royalty, the liability to pay a royalty would increase the risk inherent in the future cashflows and, accordingly, must be taken into account in establishing the appropriate discount rate or capitalisation rate.

If an implied or theoretical rate is being used, care must be taken to establish that the level of the royalty is reasonable, both in absolute percentage terms and the number of times the royalty is covered, and having regard to the expected profitability and cashflows of the business, and that the reconciliation of the total value of the business with its individual components is reasonable ("reasonableness" is clearly a highly subjective concept).

On balance, the valuation method may be applicable where it is appropriate, but allowance should be made for its limitations.

The **marginal cashflows method** calculates the value of the marginal cashflows that result from the use of the intangibles, using either the capitalisation or net present value methods.

In some instances, for example in valuing a lease, current market rates and future cashflows, and the period over which they are expected to remain, might be readily determined. In other cases it may be difficult or impossible to quantify the marginal cashflows which result from an individual intangible asset. (See Figure 4.)

This method is the most rigorous and theoretically preferred method. In practice, however, it can be the most difficult for which to obtain reliable information. It may imply a degree of precision beyond that justified by the data.

### Other considerations

**Capitalisation versus net present value.** To convert recurrent economic benefits into an assessed fair market value, the valuer may either capitalise the recurrent benefit, or project the benefit into future years and determine the net present value of these projected economic benefits.

In both instances, it would be expected that for identifiable intangible assets with long expected lives, both methods would produce similar values. However, where the asset has a relatively short expected life, the net present value of future benefits would clearly be more appropriate.

**Cross-checking the valuation.** Having selected an appropriate valuation methodology and determined a fair market value, the valuer may need to compare that value with others obtained by different

methods, after allowing for their theoretical and practical limitations. Cross-checking should confirm the value indicated by the preferred methodology.

**Reconciliation of the valuation.** Where an identifiable intangible asset is material to the value of the business as a whole, the fair market value of the business should be reconciled to the fair market values of the identifiable net assets, comprising the business (both tangible and intangible) and the resulting goodwill. A review of the reconciliation should ensure that all the assets and liabilities have been properly valued and that there is sufficient allowance for goodwill if necessary (the accounting recognition of goodwill is subject to the requirements of ASRB 1013).

**UK views.** A recent study for the UK Institute of Chartered Accountants revealed that brand valuations were based on inherently hazardous methodology, and concluded that it would be unwise to continue to allow brands (whether acquired or internally generated) to be included in the balance sheet.

The study concluded that it was effectively impossible to separate identifiable intangibles from the business as a whole, to ascertain their worth, in a way that would meet the accountants' test of measurability.

The study could find no valuation method in which it had any confidence because the methods relied extensively on assessments of an uncertain future. No separate, identifiable market existed in which brands (and other intangibles) could be traded. It also found there was little popular support of brand valuations, with City analysts finding little use for them and providers of finance ignoring them. The study also noted that more brands fail than survive, by a ratio of about 80-20.

The UK accounting bodies are now considering outlawing brand-name values from company balance sheets (although disclosure by way of note will still be permissible).

**The future of ED49.** ED49 has aroused intense debate. More than 100 submissions have been made to the Accounting Standards Review Board (including a detailed submission by the Securities Institute of

**Figure 4: Marginal cashflow method**

Patented technology giving cost savings over four years of patent.

Weighted average cost of capital 15%

	Cashflow (net of tax)			
	Year 1	Year2	Year3	Year4
Cashflow with patent	15	20	27	12
Cashflow without patent	12	14	18	10
	3	6	9	2
Net present value @ 15%	2.6	4.5	5.9	1.1
Total net present value of marginal cashflow		*\$14		

(\*assumes nil exit value and cash receivable at year end)

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# BRAND NAMES *Continued from page 21*

Australia). In its present form, ED49 has several major weaknesses.

The most serious is that it will permit the revaluation of internally generated identifiable intangibles. It will permit the manipulation of the profit-and-loss account by the deferment of expenses which, under present accounting rules, have to be written off, thus allowing the unscrupulous to inflate reported profits. ED49 is also totally out of step with overseas thinking on the subject (which includes a total prohibition on the recognition of internally generated identifiable intangibles).

Whatever final form ED49 takes, it will almost inevitably retain some unsatisfactory features.

## Conclusions

There are four fundamental criteria that must be satisfied if an identifiable intangible is to be classified as an asset and be allocated a fair market value. These criteria require that the asset must be separately identifiable, protected (or capable of protection), transferable, and

enduring in nature.

Valuation methods based on historic cost, historic profits and the value of the business less net tangible assets are not acceptable. Other valuation methods should be used only after taking into account their practical and theoretical deficiencies.

In the current economic environment, the pressure from some directors on valuers to obtain first, any answer, and second, the highest possible answer, will be intense. This will be particularly likely where, for example, a company is in takeover "play" or the directors wish to increase the shareholders' funds (perhaps to meet borrowing requirements or to avoid seeking shareholders' approval for certain transactions).

Further, significant unfavourable tax consequences may occur if inappropriate values are attributed to identifiable intangibles.

The valuer must ignore these pressures and ensure that detailed criteria and internal controls are established and adhered to. Any

valuation — and this applies equally to shares and property — requires judgment, skill and the application of a body of general principles. However, the application of these general principles is much more critical in the valuation of identifiable intangibles.

Both the NCSC and ED49 concur that an identifiable intangible asset should only be brought to account where:

■ it is probable that the future benefits or service potential embodied in the asset will eventuate; and

■ the asset possesses a cost or other value that can be measured reliably.

The NCSC has quite correctly concluded that if an identifiable intangible asset fails to meet one or both of these fundamental criteria, it should not be recognised in the accounts.

The correct principles which should be applied to the valuation of identifiable intangible assets are understood by only a handful of people in the marketplace. Directors, lenders, investors and analysts should therefore treat values attributed to identifiable intangible assets with extreme caution. □

# SECURITISATION *Continued from page 32*

tal market participants eager to establish securitisation structures should be cautious in the development of contracts and structures, taking a conservative approach from both the accounting and regulatory perspectives.

For example, participants would be well advised to establish purchase and sale agreements which limit the potential for put options or recourse provisions.

Where recourse provisions are considered necessary, the recourse should be quantified and limited. The following matters should also be considered:

■ Any losses over and above the credit enhancement would need to be borne by the securitisation vehicle.

However, this could be hedged by mortgage insurance and the extent that mortgages or other debt instruments would be acceptable for acquisition on a loan-to-value basis.

■ The sale of mortgages or other debt instruments should be effective from a legal point of view. A mini-

mum requirement would be for the mortgage documents or other debt instruments to be transferred in a registrable form and a caveat to be lodged against the property or assets.

■ Where the servicing of the debt or mortgage instruments is retained by the originator, the structure for holding the assets should be reviewed. It should ensure that the servicing rights and obligations are not caught in the overall discussion of such vehicles in the financial statements of financial or other institutions.

Given the uncertainties accompanying the development of securitisation transactions in Australia, and the absence of defined rules and regulations, care should be taken in planning for such structures and transactions.

Despite the difficulties, the opportunities for securitisation transactions continue to grow in Australia — but perhaps not at the pace at which some commentators have suggested. □

# MARKET CHAOS

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random fashion.

Values of  $d$  are then plotted against their corresponding values of  $n$ . If prices are chaotic the value of  $d$  reaches a limit regardless of  $n$ . The point at which this limit is reached gives the number of factors or variables in the non-linear model. For completely random prices, the value of  $d$  just increases in line with increases in  $n$ , since such prices do not tend to cluster in any identifiable pattern.

Such techniques are only now being applied to security price data. A lot of work is yet to be done. Initial results appear promising although not conclusive. □

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