Original Article

Brand value, accounting standards, and mergers and acquisitions: "The Moribund Effect"

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ABSTRACT **"The Moribund Effect" is defined as an accounting phenomenon by which the value of a brand that is acquired, measured, and added to the balance sheet by a company remains unchanged no matter how well the brand might perform for that company over time. We describe accounting conventions for brands in mergers and acquisitions and explain the role of brand value. Our main contention is that the subsequent performance and value of an acquired brand should be reported annually in the Management Discussion and Analysis (MD&A) section of a company's annual report. If the intangible asset value of the acquired brand has declined, an explanation should be provided to financial markets as to why this occurred. If there is a gain in asset value, it should be announced and explained to those same financial markets. We also review methodological issues in making such calculations, putting some emphasis on understanding the intangible value from brands and trademarks versus customer-related relationships, and we underscore the importance of marketing in guiding and driving these disclosures.**
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INTRODUCTION

During 2015, a record US$3.8 trillion worth of mergers and acquisitions occurred (Baigorri, 2016). The largest completed deal was Pfizer Inc. and Allergan Plc's blockbuster US$160 billion deal. Two other noteworthy deals announced that year were the proposed takeover by AB InBev of SABMiller for US$106 billion and Dell's merger with data storage company EMC for US$67 billion. It would seem that the growth of mergers and acquisitions is set to continue.

Mergers and acquisitions have a number of business implications for marketing, strategy, finance, human resources – and virtually all areas of business. Our interest is in the implications of mergers and acquisitions for accounting, and from an accounting standards perspective in particular. Accounting standards play a vital role in allowing investors and providers of credit to understand the financial workings of these or any other companies. The canon of standards, of which there are many, guide those who prepare financial statements in what to say and how to say it (see www.fasb.org and www.iasb.org). In particular, they provide guidance as to how financial accounts should be organized and presented.

Many of these deals will have been carried out by companies that are subject to the accounting standards issued by the Financial Accounting Standards Board (FASB) in the USA and the International Accounting Standards Board (IASB) elsewhere in the world. Specifically, the acquiring company will be required to comply with the appropriate accounting standards that deal with business combinations and the impairment of assets. The FASB version is Accounting Standards Codification (ASC) 805 *Business Combinations* issued in 2001, and the IASB version is International Financial Reporting Standards (IFRS) 3 *Business Combination* issued in 2005 (see Sinclair and Keller (2014) for a full explanation of the relevant accounting standards).

One particular set of standards, which deals with *business combinations* or mergers and acquisitions, contains a requirement regarding the accounting treatment of acquired goodwill and intangible assets that have the potential to suppress important information that investors should know. We call this phenomenon, where the value of acquired brands is unchanged for accounting purposes and remains at their transaction measurement over time, "The Moribund Effect."

In this article, we will explain how it came about, its effect on the company's market value, and how it can be seen as conflicting in spirit with the Efficient Market Hypothesis and the manner by which information is absorbed by financial markets. We will explain how this apparent conflict deprives users of the annual financial reports of information they should have if the price of a company's stock is to be fully priced. We finish by proposing how the Moribund Effect can best be dealt with, emphasizing how marketing can play a key role to bring this change about.

BACKGROUND

In the late 1990s, both the FASB in the USA and the IASC (it was a committee at that stage and only became a board in 2001) for the rest of the world issued accounting standards dealing with intangible assets. The FASB standard was SFAS 142 *Intangible Assets*; the IASC standard was IAS 38 *Intangible Assets*. These standards prevail to this day.

The standards contain a line which is unambiguous about how internally generated brands should be treated in annual financial reports:

> 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. (see Sinclair and Keller, 2014, p. 288)

To understand what happened to bring this state of affairs about, it is useful to trace the relevant history of brand accounting.

In 1989, the Accounting Standards Committee of the Institute of Chartered Accountants of England and Wales issued an unprecedented instruction to its members to "cease and desist" the practice of valuing brands and adding them to the assets in the balance sheet. This instruction was confirmed the following year in an Exposure Draft (ED) titled *Accounting for Goodwill* (Power, 1990).

This practice of valuing brands and adding them to the assets in the balance sheet arose during the 1980s when there was a spate of high-value takeovers of companies that owned brands. The accounting convention at the time was to apply the acquired goodwill to shareholder equity and thus make it vanish. But, when one company made a bid for another at a price that would have all but decimated shareholder wealth, the CEO took a different route. He asked his graphic design company, Interbrand, if it could create a model to value brands.

John Murphy, founder of Interbrand, said he could, and he then assembled a team to turn the promise to reality. The original Interbrand brand valuation methodology was used to value the brands that were to be acquired, and instead of deducting the value from shareholder equity, the new assets were added to the balance sheet. Thus, shareholder equity was preserved, and the value of the company reflected the acquisition of a new set of assets.

This new practice did not sit well with the accounting leadership who, having issued their order to cease and desist, established a commission to examine the feasibility of adding brands to the balance sheet. The commission was headed by Patrick Barwise, a marketing professor from the London Business School (LBS). After 3 months of deliberation, the Barwise Commission concluded that the accounting profession was right and that "brand valuation was contradictory to the accounting framework" (Sinclair, 2002). As a result, in most jurisdictions, brands could no longer be considered to be assets under conditions of acquisition or internal development.

FOUR KEY QUESTIONS

Over the 10 years of the IFRS standard and the 14 years of the FASB standard, many thousands (perhaps hundreds of thousands) of mergers and acquisitions transactions have taken place. By extension, there would have been innumerable intangible assets recorded in balance sheets in terms of these standards.

Four key brand-related questions arise in considering the accounting implications of these mergers and acquisitions transactions:

1. *Purchase price premium* What proportion of the purchase price is a premium in excess of the net asset value of the company? The net asset value of a company can be defined as the fair-market value of its total assets minus its total liabilities.
2. *Intangibles and goodwill allocation* How much of the premium arising from the Purchase Price Allocation and Post-Purchase Price Allocation difference, as required by the business combination standards, is allocated to intangibles assets and goodwill? The standards leave no doubt as to what intangibles might be identified and measured. Goodwill is what remains of the premium paid once the

intangibles have been identified and measured.

3. *Nature of intangibles* The standards list over 60 intangibles that might comprise the premium. In reality, only two or three intangibles are typically selected. What are these intangibles, and what is the relative importance of each?
4. *Lifetime of assets* The standards require the preparers of annual financial statements to determine whether the useful life of the acquired intangible asset is finite or the opposite, which in the language of the standard setters is indefinite, not infinite. As is explained in greater detail below, finite lifetime of assets implies there is a finite duration for which it will provide economic benefits; indefinite lifetime of assets implies that the exact duration cannot be determined at the time of the transaction. What is the balance between these two lifetimes, and how is it determined if the intangible has a finite or indefinite useful life?

Because of the large numbers of transactions that have been concluded since the business combinations standards were issued (FASB: 2001; IFRS: 2005), there is no complete database that would allow a comprehensive, conclusive answer to these four questions. Several companies have sampled balance sheets, however, and one firm has even established a database of over 7500 trademark valuations extracted from post-transaction balance sheets. To provide some indication of what the answers to the four questions posed above might be, we highlight some of the findings of the most prominent of these surveys (summarized in Table 1).

While the data in Table 1 allow nothing more than generalized conclusions, some important trends and patterns can be identified, and we are able to use these insights to help answer, at least in part, our four questions.

Purchase price premium

For more than 10 years, the studies suggest that the portion of the purchase price allocated to goodwill and intangibles is regularly over 50 per cent and often exceeds 70 per cent. Recent examples indicate that this trend is set to continue. AB InBevs initially offered a price of US$106 billion for SAB Miller plc, which had net assets of US$19.95 billion at the time. The premium being offered to acquire the business was therefore approximately US$86 billion (81 per cent). In February 2015, Facebook bought WhatsApp for US$19 billion. According to a later filing by Facebook with the SEC, the acquired company had only US$45 million in assets at the end of 2013, so that the purchase price was close to 100 per cent intangible. Dell's initial offer to buy EMC was for a reported US$67 billion. The balance sheet value of EMC's net assets at the time was US$21.9. The premium would therefore have been US$45.1 (67.3 per cent).

Summary In general, studies find that the portion of the premium initially allocated to goodwill and intangibles is regularly over 50 per cent and often exceeds 70 per cent or more.

Intangibles and goodwill allocation

In terms of the business combination standards, the acquiring company must identify the intangible assets that were bought. These are measured after the transaction is completed and listed on the balance sheet as intangible assets. The balance of the premium paid for the company is listed as goodwill. From Table 1, a clear picture emerges as to what the breakdown is between intangibles and goodwill. A

Table 1: Summary of some M&A analyses by select organizations

Source	*Data*	*Key findings*
Houlihan Lokey (2013)	USA M&A only; sample of 511 companies	Average to intangibles = 34% (31%) Average to goodwill = 38% (39%) Total intangible premium = 70% of purchase price Ratio of trademarks with indefinite to finite useful lives = 23:77% Main intangibles: customer-related assets, trademarks, and developed technology
Ernst and Young (2009)	Global M&A activity for 2007 covering 709 transactions	Total premium as percent of purchase price = 70% 47% = goodwill 23% = identified intangibles Customer-related assets = 44% Brands and trademarks = 31%
KPMG (2010)	Analysis of M&A in previous year (2008)	Allocation of purchase price to goodwill exceeds 50%
European Securities and Markets Authority (ESMA) (European Securities and Market Authority, 2014)	A sample of 56 EU issuers of IFRS 3 compliant financial statements	The allocation to goodwill was 54% No figure for intangibles 58% of sample that had allocated to specific intangibles identified customer-related intangible assets In 54% of cases the identified intangible was brand
Markables (2015)	Based on a database of more than 7500 files of purchase price allocation information from M&A activity from 2003 to 2015	The database shows that in exactly 50% of cases, intangible assets are allocated an indefinite life and the other half are allocated finite lives

scrutiny of balance sheets of companies which have undergone this process confirms that goodwill tends to be the larger of the two numbers.

Summary The study findings imply that as much as half of the acquired goodwill is typically allocated to identified intangibles, as described in more detail below. The balance remains as goodwill.

Nature of intangibles

A consistent conclusion from the various analyses is that two intangibles – from a list of over 60 possibilities set out in the standard – are most frequently identified and included: (1) Customer-related relationships and (2) trademarks or brands. Technology is the next most frequently selected intangible, but it is far behind the two leaders (Bahadir *et al*, 2008).

Summary The European Securities and Markets Authority (ESMA) sample found that in 54 per cent of cases, brands were identified as intangible assets and measured. Customer-related intangibles were higher at 58 per cent. Between them, these two represent roughly half of the initially allocated goodwill and intangibles. The other half remains goodwill.

Lifetime of assets

A major feature of the business combination standards is the need to specify the useful life of intangibles included in the transaction. The useful life can be either *finite* (i.e., it has a finite duration after which it will no longer produce the economic benefits that were generated at the time of the purchase) or not. Intangibles with finite lives are amortized over their remaining lifetime.

The opposite of finite (in accounting language) is not infinite; it is *indefinite*. This distinction makes it clear that brands, for example, are unlikely to live forever, but the duration of their remaining useful life is not known at the time of the transaction. Intangibles that are given indefinite lives are measured at the time of the transaction, and the value is added to the assets in the balance sheet as trademarks (brands) with indefinite lives. The asset is re-measured each year as a test for impairment. It is not amortized and could be carried on the balance sheet for many years.

Summary In this case, the survey results are conflicting, with the Markables database indicating that the split is 50/50 but Houlihan Lokey saying the split is 23–77 per cent in favor of finite. The Markables sample (7500) is far bigger and might therefore be more reliable. Regardless, the findings suggest that at least half, and possibly more, are allocated a finite useful life.

IMPAIRMENT AND ACCRETION

To summarize, from a brand point of view, the accounting implications for mergers and acquisitions were (and remain) clear and, for marketing, extremely important. When a merger or acquisition takes place and a premium over net asset value is paid, the premium may no longer be fully allocated to goodwill. The acquiring company has to examine the purchase price and allocate the premium to identifiable intangible assets. Typically, these have been customer-related intangible assets, such as customer relationships and brands (see Table 1).

Once identified, these intangibles must be assigned either finite or indefinite useful lives. In the table above, we show that the proportion of each can vary from 23 to 50 per cent in favor of a finite life. The distinction determines how the acquired assets will be treated in the financial accounts: Acquired brands with finite lives are amortized over the remaining number of years. Brands with indefinite lives are added to the assets in the balance sheet, against the intangible asset line item label. They are not amortized, but tested each year for impairment.

If the asset is impaired – the new valuation is less than the carrying amount – the impairment loss is transferred to the income statement as an expense. Goodwill, which is the difference between the premium paid in the transaction and the sum of the intangible assets, is treated as an asset, and it too is tested annually for impairment. The consequences of impairment are resisted by companies because the loss is transferred to the income statement, thus increasing expenses and reducing profit.

There is no allowance in the standard for the opposite of impairment which is accretion (or gain in value). In business combination accounting, gains in value are not acknowledged. This practice arises in part from historic reason and the fact that the value of assets used to be almost exclusively tangible and would be stated at their cost. They were then depreciated over time in order to reflect their gradual consumption.

Some assets were carried in the accounts, and the principle that most assets depreciate in value over time continued. Hence, each year the value of assets was tested and if the value was less than the carrying amount, a loss was charged to the income statement. To add accretion to this annual test would introduce complex decisions about how the gain should be treated. Reading the opinions of the standard setters and those who use them, there was no interest in attempting this change.

The valuation of the acquired asset is carried on the balance sheet until it is disposed of or fully impaired. This prospect, full impairment and the subsequent hit to the company's profits, might explain why some companies are shifting their identification and measurement of acquired intangibles from brands to customer relationships (see for example Binder and Hanssens, 2015). The marketing function can play a valuable role with another major accounting decision that also needs to be made with mergers and acquisition – when to classify acquired intangibles as trademarks or brands (TB) versus customer-related relationships (CRR). Consequently, it is helpful to provide some perspectives as to how value arising from brands versus from customer relationships is related (Keller, 1993, 2013).

Brand and customer relationships in theory

There is no question that the intangible asset value created by customer-related relationships versus by trademarks or brands is related. In theory, both concepts can be expanded to incorporate the other point of view, and they are clearly inextricably linked. Customers drive the success of brands, but brands are the necessary touchpoint that firms have to connect with their customers (Fournier, 1998; Moorhouse, 1990). Many of the actions that will increase brand value will increase the value of customer relationships and vice versa (Keller and Lehmann, 2003; Srivastava *et al*, 1998; Epstein and Westbrook, 2001). The two concepts are highly related and in many ways, "two sides of the same coin."

Yet, in practice, CRR value and TB value are often complementary notions in that marketers focusing on one or the other can tend to emphasize different considerations. Marketers focusing on creating brand value tend to put more emphasis on the "front end" of marketing programs and intangible value potentially created by marketing programs to attract customers and increase their loyalty; marketers focused on creating value through customer relationships tend to put more emphasis on the "back end" of marketing programs and the realized value of marketing activities to reinforce and capitalize on loyalty of the existing customer base.

Nevertheless, the two concepts theoretically go hand-in-hand: Customers need and value brands; but a brand ultimately is only as good as the customers it attracts. As evidence of this duality, consider the role of the retailer as "middleman" between firms and consumers. Retailers clearly recognize the importance of both brands and customers. A retailer chooses to sell those brands that are the best "bait" for those customers it wants to attract. Retailers essentially assemble brand portfolios to establish a profitable customer portfolio. Manufacturers make similar decisions, developing brand portfolios and hierarchies to maximize their customer franchises.

Effective brand management is critical, and despite the growing interest in customer relationship management, it would be a mistake to ignore its important role in developing long-term profit streams for firms (Madden *et al*, 2006). Some marketing observers have perhaps minimized the challenge and value of strong brands to overly emphasize the customer relationship perspective, for example, maintaining that "our attitude should be that brands come and go – but customers must remain" (Rust *et al*, 2004). Yet, that statement can easily be taken to the logical, but opposite, conclusion: "Through the years, customers may come and go, but strong brands will endure."

Perhaps the main point is that both are really crucial, and the two perspectives can help to improve the marketing success of a firm and may both be crucial intangible assets to identify and measure as a part of a merger or acquisition. One important distinction between the two is that CRR focuses on *existing* customers, while TB additionally accounts for *future yet-to-be-acquired* customers. Moreover, there would seem to be some situations where the value from customer relationships may be a more important intangible asset than the value from brands.

For example, one could make the case that CRR may often be more important than TB for service companies than for product companies, especially in the era of "big data." With service companies, such as firms offering financial, legal, and accounting services, much relationship management occurs and a robust and healthy customer franchise and well-populated database may be critical. Similarly, CRR may also be more important than TB for more mature or established businesses where much has been learned about customers and when they have developed strong ties directly to the company. In that regard, CRR may be more important than TB in any situation where barriers to exit exist for customers and where an entrenched customer franchise is a huge asset.

Brand and customer relationships in practice

The value created by brands and customer relationships is thus closely intertwined, especially when it comes to famous brands. If SABMiller had not spent over 100 years building a famous portfolio of beer brands, it would not today have built such a loyal and profitable customer franchise and would not have been the target of a US$106 billion takeover bid by AB InBev. Some of its lesser brands will eventually be discarded, no doubt, but brand leaders in many markets will continue to provide the new owners with abundant brand-generated cash flows. We argue therefore that powerful brands still exist, and while their importance relative to customer relationships can be explored and even re-aligned, they will remain powerful and strong.

For example, it has been speculated that now that the AB InBev acquisition of SABMiller has been finalized, the new company may have already selected its next target: The Coca-Cola Company. If such a deal were to occur, the post-transaction value that would be included on the balance sheet for the Coca-Cola brand could be in the region of US$83 billion. That number is the average assigned to the brand by both Interbrand (81.5) and Millward Brown (83.8) in their respective 2015 lists of valuable brands.

Had the Coca-Cola Company been bought 10 years ago (2005), at the time that Proctor and Gamble (P&G) bought the Gillette Company, the brand would have been entered on the balance sheet at a value of US$54.5 (again, the average of the values assigned by Interbrand (67.5) and Millward Brown (41.4) in their respective 2005 lists of valuable brands). Over 10 years, these brand values for Coca-Cola show a gain in value of US$28.2 billion. That is a very significant addition to shareholder wealth, and although the addition of the Gillette brand may have led to greater profits for the company during this time, the business combination standards do not allow the underlying accretion in brand value to be shown in the accounts.

In Table 2, we provide a second example based on the purchase of the Gillette Company by P&G in 2005. As Table 2 shows, the brand was valued at the time at US$24 billion. It has been carried in the P&G balance sheet since then at that value. The number ($24 billion) has not been as consistent as this implies due to other acquisitions and divestitures and possible modifications to the Gillette brand portfolio over the period. However, a careful reading of the notes to the accounts implies that Gillette remained the dominant unit within the section: "Brands with indefinite lives" at about $24 billion. During this period, the world economy suffered weak economic

Table 2: Illustrative example of the moribund effect in action: P&G purchase of the Gillette Company in 2005 (2005–2015) (numbers are in US$ billions)

Years	*2005*	*2006*	*2007*	*2008*	*2009*	*2010*	*2011*	*2012*	*2013*	*2014*	*2015*
P&G market capitalization	190.4	202.8	226	181.2	176.1	180.2	183.7	185.5	220.7	218	185.6
Gillette brand value in 2005 (carried on balance sheet at transaction value as per accounting standard)	24	24	24	24	24	24	24	24	24	24	24
Carrying amount as % of Market Capitalization	12.6%	11.8%	10.6%	13.2%	13.6%	13.3%	13.1%	12.9%	10.9%	11.0%	12.9%
Nominal brand value gain of 2% per annum since 2005	24	24.48	24.97	25.47	25.98	26.50	27.03	27.57	28.12	28.68	29.26
Carrying amount grown annually at 2% as % of Market Capitalization	12.6%	12.1%	11.0%	14.1%	14.8%	14.7%	14.7%	14.9%	12.7%	13.2%	15.8%

growth and the 2008/2009 financial crisis. Thus, the illustration is less dramatic than it might have been otherwise.

Nevertheless, we cannot believe that the historically successful marketing skills of the P&G Company would have not resulted in some degree of growth for the famous Gillette brand. Even at a nominal growth rate of 2 per cent per annum, the gradual divergence between the percent of market capitalization represented by the brand can be seen. At that growth rate, the brand would have been worth $29.3 billion by the end of 2015. But, more significant is the absolute brand value difference of US$5.6 billion between actual brand value assuming a nominal growth rate of $29.3 and the recorded brand value of $24 billion. Because this growth (accretion) is not reported in the accounts, this information is not communicated to the investment community, inaccurately implying an inactive brand.

THE MORIBUND EFFECT

These two examples and the principles they illustrate are instructive, and we have coined the term, the "Moribund Effect," to describe this strange phenomenon. According to Miriam Webster Collegiate Dictionary, moribund can mean, "in a state of dying," the sense in which we use the word. The accounting standard would require that the post-transaction value be carried on the balance sheet and tested annually for impairment. As a result, in 2015, the value of the Coca-Cola brand would still be the 2005 value of US$54.5 billion.

The Moribund Effect reflects the fact that brand value remains unchanged, giving the impression to those who use annual financial reports that acquired brands, once bought, are in effect placed on a shelf and ignored. They do not grow in absolute terms or in relationship to the performance of the company. If the company grows over time, because the value of these acquired brands remains at their transaction measurement, their relative weight or percentage of the marketing capitalization of the firm actually *decreases*.

This vivid loss of weight underscores the use of the term "moribund." Logic would suggest that they should, at least, move in step with the company growth rate. In some cases even, where successful marketing has lifted brand revenues and profit above the historic trend, they should grow faster than the company. All of these possibilities are ignored because of the way the business combination standards are worded. Value ignored is value lost.

In large, highly successful companies such as P&G, PepsiCo, AB Inbev, Mondelez, Vodafone, IBM, Unilever, and many more that do acquire brands, the brands that they buy will be placed under the care of a marketing team whose task will be to learn about the new brand and ensure that the brand continues to at least generate cash flows as it did for the previous owner, if not reach even higher levels of growth. There are very rare exceptions when a company might buy a competitor to remove it from the marketplace, but in the vast majority of cases, the objective for the firm will be to use the new acquisition to improve category dominance and as an additional source of revenue.

We would argue that when this is the case, the users of the annual financial accounts would want to know how successful the company has been in maximizing the financial return of this acquisition and leveraging the value of this brand asset. As it is, all they would have available to make that determination would be the balance sheet and the static number sitting there, unaffected by events around it, in a state of apparent moribundity. In these companies, the Management Discussion and Analysis (MD&A) part of the annual report has sections devoted to the activities and efforts of the marketing function. Brand segments and sometimes specific brands are discussed. Depending on the stance taken by the company in any one year, these may or might not provide insights into how the acquired brands have performed (as suggested in Gregory and Moore, 2013).

A POSSIBLE SOLUTION

How might the changing and often increasing value of these acquired brands be measured? Three categories of valuation procedure are usually mentioned when discussing possible measurement methodologies: cost, market, and income. The first two are often discarded because: (a) the task of researching the historic costs associated with a brand, especially one which might be decades old, is simply too daunting; (b) there are no markets for brands and therefore no comparable transactions that can be used as a proxy for value. The income valuation approach, which is based on the time value of money, is most frequently used, and the specific technique most normally employed is called the Relief from Royalty method (e.g., see PWC, 2013; Grant Thornton, 2013; IVSC, 2011).

The notion behind this methodology is that a royalty would have to be paid to the owner of the trademark if it were owned by a third party. Since the trademark is owned by the company conducting the valuation, the value is the present value of the royalties that are saved through ownership, i.e., the royalties the owner is relieved from paying. See Table 3 for a sample calculation.

In addition to being simple (as the example in Table 3 illustrates), it has the virtue of requiring few inputs: gross revenues, a rate of growth, the royalty rate and a discount rate. Yet, from the marketing point of view, the Relief from Royalty method is inadequate because it has no brand strength input. It does not take account of an often critical source of brand cash flows: the customers. Nor does it incorporate the contribution of other stakeholders of the brand, an especially important consideration, for example, with corporate brands.

Its common use by many companies and its ubiquitous appearance in post-transaction financial reports, however, makes it impossible to ignore. It is, at this stage, the *de facto* method of valuing acquired brands. Given its practical importance, we suggest the following modifications to make it more suitable for use as a marketing measurement:

Table 3: Simple example of Relief from Royalty

	y1	*y2*	*y3*	*y4*	*y5*	*y6*
Sales	100,000	105,000	110,250	115,763	121,551	127,628
Royalty rate = 4%	4,000	4,200	4,410	4,631	4,862	5,105
Less tax @ 40%	2,400	2,520	2,646	2,778	2,917	3,063
Present value *Y1–Y5*	10,511				Discount factor	0.627
Annuity (terminal value)	24,007					1921
Brand value	34,518					

In addition to a royalty rate of 4% and a tax rate of 40%, Table 3 assumes a growth rate of 5% per annum and a discount rate of 8%. The brand value in this table, using the Relief from Royalty method, is calculated by first calculating the present value of the after-tax royalty proceeds of years 1–5, using the 8% discount rate, and then adding the annuity or terminal value of the year 6 discounted proceeds in perpetuity.

- The standard setters warn against forecasting long periods such as 10 years due to the inherent risks involved in such long projections. A 5- or maximum 7-year projection is recommended.
- It is clear from the example in Table 3 that the terminal value (dividing the discount rate into the *n*th year after allowing for the discount factor) adds too large a number to the valuation. This is an infinite value; not indefinite. To replace the infinite life approach with one more suitable for business combination post-transaction accounting, we propose that the step down approach, described in "Appendix," be used.
- A value that conformed to these requirements could be updated each year by inserting the actual number in year one and changing the growth rate for the subsequent years to whatever macro- and microeconomic circumstances at the time suggest. Thus, a moving annual valuation can be produced to show how the brand has performed.

As we have noted, measurement of acquired intangible assets is conducted annually for the impairment test. The accountants' only interest is in impairment of value. They are not required to measure *gain* in value, nor recognize it anywhere in the accounts. If the asset is being measured, then the result will be either a gain or a loss. With a simple procedure such as Relief from Royalty, a gain will occur through a lowered discount rate or an increase in revenue. If it is the latter, a shift in revenue growth above the trend will likely be the result of marketing strategy.

Our contention is that the marketing function could make a valuable contribution by adding a section in the MD&A part of the annual report with a measurement update to reflect any accretion and a summary of the marketing strategy of the past year which was deemed as leading to the increase in value. The actual measurement could follow the guidelines proposed by this section.

Besides providing informational value externally to the investment and financial communities, a disclosure of this kind would also help to validate the importance of the marketing function internally within the organization (Germann, 2015; Whitler *et al*, 2015). Ensuring that marketing leadership has a "seat at the table" for top management decision making has been an important concern and priority for many top marketing strategists (Rao, 2012; Welch, 2013).

In assembling this section, management would also want to recognize the contribution of other non-marketing areas of the business that might have led to enhanced brand value, e.g., new technologies or new licenses. Although challenging, identifying all the drivers behind the cash flows attributed to a brand would ultimately provide the most complete and diagnostic view of brand performance and value.

CONTRIBUTING TO AN EFFICIENT MARKET

There is also solid economic grounding for the proposal to recognize accretion as much as impairment. The importance of this (missing) information is implicit in the idea introduced in the 1960s by Chicago University professor and Nobel Prize award winner Eugene Fama (Fama 1970). The Efficient Market Hypothesis (EMH) affirms the efficiency of financial markets by maintaining that stock prices are set at their current level because markets are in possession of all available knowledge and information about the stock. As new information becomes available, all market participants become aware of it, and the price will immediately absorb the new information, i.e., markets are "informationally efficient."

In the 1970s and 1980s, there was controversy about the EMH which resulted in the definition of three phases or levels:

- *The weak level* Stock prices incorporate historic information about the company.
- *The semi-strong level* Market participants add current information from financial journals, newspapers, and press releases that change the value of the stock. All participants have access to the same information and the price response is immediate.
- *The strong level* Market participants are able to gain information that might be considered private or inside information. There is clearly a fine line between what this private information is and what might be considered insider trading – a criminal offense.

Under normal circumstances, investors and lenders would know only about the value ascribed to the acquired brand in the balance sheet at its transaction value. In the examples for Gillette and Coca-Cola above, however, we have shown that investors might be deprived of information critical to placing an accurate value on the company.

We are suggesting that this omission should be overcome and that, accepting that the standard setters are unlikely to allow for accretion, the work of marketing in supporting acquired brands with the same vigor and expertise they apply to the company's own brands, should be reported annually in the MD&A part of the annual report. If the asset is impaired, marketing will need to explain why this occurred. If there is a gain in value, it should be announced to the financial markets which, in keeping with the strong EMH, will incorporate the added value into the stock price as it becomes known.

SUMMARY AND CONCLUSION

We conclude by offering some perspectives and conclusions to our analysis. When we wrote our initial paper on the financial interplay of branding and accounting (Sinclair and Keller, 2014), we covered two distinct – but related – accounting anomalies:

- The main thrust of the paper was to encourage the accounting standard setters to review the omission that brands which are acquired are identified as assets, but brands which are internally generated are not.
- We also drew attention to the business combination requirement that acquired brands are measured at their transaction value and tested annually for impairment. There is no recognition of the opposite; a gain in value or accretion.

We have since given this phenomenon a name: "The Moribund Effect." This is the phenomenon under which, no matter how a company performs over time, the value of the brand that was acquired, measured, and added to the balance sheet remains unchanged. It is carried at its transaction value. Any relationship it might have to enterprise wealth (e.g., as a contributor to the market premium), or any gain in absolute terms, is hidden from view.

This has special implications for investors and lenders (identified by the standard setters as the main users of annual financial statements) and for the marketing function, whose governance of the acquired brand or brands, could appear deficient. The first group is not provided with full and proper information about the assets within the company that drive cash flows and growth; any successes the marketing function has achieved in further building the acquired brands are ignored.

Our view is that companies should adopt the strong version of the Efficient Market Hypothesis and, voluntarily, publish a section in the MD&A of the annual report in which the performance of acquired brands is tracked to show accretion as well as impairment. Our examples earlier are hypothetical, but they are based on real brands and numbers, and they show just how the Moribund Effect can mask true value. It is a marketing function to build brands, and it is the marketing function that should take command of this situation to ensure that the value of brands under their control is properly and fully measured and reported.

Our appeal is not to the accounting standard setters (although we hope they find our ideas interesting), but to the many companies that are, or have been, involved in mergers and acquisitions and who are sitting with moribund brands on the balance sheet. Our exhortation for companies to be more informative about their brands is shared by the SEC leadership. They also ask that company management be more forthcoming in their MD&A section in their annual reports by providing more information of material importance to investor decision making (Securities and Exchange Commission, 2003).

Accounting standard setters recognize the function and value of accounting to “use the language and algebra of valuation to convey information” (Christensen and Demski, 2003, p. 121), but they must make decisions as which information they wish for companies to convey. Here, their position might be that accounting systems were never intended to record every event that could affect the market value of the firm as an asset. Their position might also be that brand value is no different than R&D findings, human capital, etc., in that they are part of the economic value of the firm, but not the book value of the firm. They believe that many events fail the test of recognition – whether an event can be measured with sufficient reliability to warrant inclusion (Christensen and Demski, 2003, pp. 304–305).

In other words, accounting standard setters maintain that accountants have a comparative advantage in recording certain events, but not others. Accounting systems thus reflect those events over which accounting has a comparative advantage and deliberately leave others outside the system. As a part of that reasoning, they additionally maintain that thoughtful investors know to combine accounting information with other sources of information when making judgments regarding valuation. They would categorize brand value estimates from published sources such as Interbrand and Millward Brown as examples of non-accounting sources of information that investors could use.

We recognize too that a case could be made that investors can learn about specific financial valuations of brands from one (or more) of these many published sources.

This analysis and reporting, however, only addresses a very small percentage of the many brands that may be participants in mergers and acquisitions. Different methodologies make different assumptions, and brand valuations from the different published sources may not agree. Management may feel more comfortable with a particular methodology that they could publically identify and put forth if brand valuation were discussed in the MD&A.

Another argument might be made that it would not necessarily be in the self-interest of top management to provide valuations of "home-grown brands" as there may always be a risk of impairment at some point, resulting in criticism or even termination of top management. In today's increasingly transparent world, however, interest from investors, the media, or even consumers in learning more about the internal workings and various financial indicators of companies is likely to remain high if not even further increasing.

In summing up our main contention, the IFRS conceptual framework contains this phrase:

> The scope of financial statements is determined by their objective, which is to provide information about an entity's assets, liabilities, equity, income and expenses that is useful to users of financial statements in assessing the prospects for future net cash inflows to the entity and in assessing management's stewardship of the entity's resources. IFRS (2015)

We suggest that, under the circumstances discussed in this paper, companies are forced by this unintended accounting consequence to mislead readers of the annual accounts. The Moribund Effect denies investors and lenders "the scope" promised in the standard setters own conceptual framework. If the standard setters cannot or will not correct this anomaly, then marketers must.

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APPENDIX: CALCULATING ECONOMIC LIFE

The standards setters make a distinction between intangible assets that have finite lives (patents and copyright with specified lifetimes) and intangibles that have no determinable life time. The distinction is that these intangibles, which are mainly acquired brands, do not have infinite lives. In the language of M&A accounting, these economic lives are described as indefinite and not the antonym of finite: infinite. It is a vital distinction because the infinite version distorts the recorded value.

Depending on the methodology used, valuers will construct a discounted cash flow table projecting earnings from the asset for 5, 7, or 10 years. The duration is largely dependent on the nature and history of the brand that has been acquired. To discount to infinity (a common practice), the *n*th year (6, 8, or 11) is projected, a present value discount factor is applied and then the discounted *n*th year is simply divided by the discount rate. This produces the so-called terminal value, growing perpetuity or annuity. As the Relief from Royalty example shows in Table 3 the effect invariably is to add a number to the initial present value that distorts the total because it is typically a very large number and becomes the dominant component of the transaction value.

Our solution is to decay the *n*th year value, over a period (typically the same as the initial DCF period), and step it down over that period by equal reductions. This is a well-known technique used in property valuation. If the initial cash flow period is 7 years, the *n*th year value is reduced systematically by 1/7th segments until it meets the base line. The value is therefore the sum of the initial present value of 7 years plus the stepped down present value. The sum is the value of a brand with an indefinite life.