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Article

Valuing brands under royalty relief methodology according to international accounting and valuation standards

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ABSTRACT

The aim of this paper is to introduce a statistical procedure to value a brand by means of which firms may be able to determine the level of implicit royalty that they would charge for the use of their brand, applying multivariate techniques from market references. The study has been based on a statistical contrast of the royalties paid in Spanish franchises belonging to three different industries: food, health and beauty and fashion. Each industry has been segmented using cluster techniques, and then, through linear discriminating analysis, a model is proposed to explain the royalty paid according to certain economic figures of the companies. The implicit impartiality in the development of the model means that it could be generally accepted by analysts, consultants and companies who need to determine the value of a brand.

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Introduction: an approach to the problem of intangible assets

In the last three decades some authors, such as Lev (1989, 2000, 2001, 2005), have shown the gradual increase between firms' market value and their book value. Other authors, such as Brown, Lo, and Lys (1999), or Dantoh, Radhakrishnan, and Ronen (2004) also warn about how equity and profits have lost relevance for explaining the market value of American companies. In the Spanish case Sánchez and Espinosa (2005) introduce a measure of the intangible value not explained by financial economic magnitudes of the firms, but paid in the prices of business transactions (around 50%). Rubio, Rodríguez, and Maroto (2013) find for the pharmaceutical and biotechnology sectors that these quantities paid and unexplained are higher than 69%. All these works suggest a change in the business model: this has moved from a system based on industrial production to another one in which firms base their success on knowledge.

Despite the fact that International Accounting Standard: IAS 38 (2008) forbids the recognition of internally generated intangible assets, in business combinations the International Financial Reporting Standard 3 (2008) states that the purchasing company will have the obligation to identify and measure each one of the assets and liabilities deriving from the operation performed, including even tangible and intangible assets.

Such assets will be quantified by their fair value (IAS 38, 2008; IFRS 3, 2008), which is defined in the IFRS 13 (2011), "Fair Value Measurement", as the amount for which each asset can be exchanged or a liability canceled between the concerned parties properly informed. The transaction must be performed on mutual independence terms, including market expectation and, at the same time, excluding the synergies for a particular buyer.

There is a wide typology of academic and professional intangibles and brand valuation proposals, as well as their contribution to the value creation process for the company, from different areas of expertise. In marketing and management: Kapferer (1992, 2004), Park and Srinivasan (1994), Aaker David (1996, 2000),

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Ratnatunga and Ewing (2008) and Jourdan (2001), and in finance: Smith (1997), Damodaran (2002), Reilly (1999), Lev (2001) are outstanding among others. For its part, the accounting standards, and the guidelines of the International Valuation Standard Council, impose a specific hierarchy in the valuation criteria: market and income methodology. If none of these could be used, then the replacement cost methodology would be applied. So the most important business consulting agencies in the world apply this hierarchy.

The royalty relief is based on the measurement of the license payments, from a market database, which has been saved as a consequence of having the ownership of the asset. The interest of this method is that it can be considered as a market-income methodology. Therefore, the accounting standards place it as the most important compared to the other methods, but there is no such academic methodology that supports its use.

The goal of this paper is dual: on the one hand, applying multivariate techniques from market references, to check whether in the Spanish franchising market the royalties paid are efficient in reflecting enterprises' performance. Then, they could be an important tool for assessing brand. On the other hand, we introduce a statistical procedure adapted to the international standards of accounting and valuation of intangible assets, by means of which any firm could obtain the level of the corresponding implicit royalty from market references and the fair value for the brand.

This paper is organized as follows: after the Introduction, in the second section the theoretical framework and hypothesis, as well as the importance and the problems involved in the calculation of the royalty relief are analyzed. In section three the data and the statistic model are developed. In section four we deal with the applications and results of the model and, finally, the article ends with the conclusions and final remarks.

Theoretical framework and hypothesis: the importance and the problems involved in the calculation of the royalty relief

Despite the efforts that have been made, there is still a large heterogeneity present among all the methodologies developed (Cerviño, Martínez, de la Tajada, & Orosa, 2005; Salinas, 2007). Specifically, market methodologies involve the use of multiples, which will depend on prices paid in previous transactions. Nevertheless, one problem of this method is the absence of a database about prices paid for individual intangible assets.

Likewise, income methodologies have had greater academic and professional growth. A royalty-saving method is one of the most common typologies, especially used to assess brands and patents, and it is the one that has been introduced in different ways by consultant agencies such as Brand Finance (2000), Whitwell (2013), Intangible Business and AUS Consultants or Consor (Salinas, 2007).

Other income methods frequently employed for intangible assessment are: the multiple periods earning excess of return, incremental cash flow and real options. The first one is built on operating cash flows of the enterprise, and from these, the charges of the other contributory assets (tangibles and intangibles) will be deducted in order to determine the cash flow arising from the excess of return. Authors such as Smith (1997) or Lev (2001) and consulting agencies like Brand Economics (2002) base their proposal on this technique.

Concerning the incremental cash flow method, its main goal is the measurement of the increase of these cash flows due to a price premium in goods and services sold by companies or savings that come from the ownership of the intangible asset. Some academics, such as Damodaran (2002), Reilly (1999) or Fernández (2007) have developed this methodology. Consulting agencies such as Interbrand[1] or BBDO (2001, 2002), through the division Brand Equity, also have used it in many modalities. Alternatively, the real options method includes uncertainty and risk as variables in the valuation of the assets depending on companies' management capacity. Among the authors who have proposed this technique in diverse variations Myers (1977), Amram and Kulatilaka (2000), Schwartz (2003) and Rubio and Lamothe (2010) are worthy of mention.

The great problem when valuing brands among all the methodologies shown above is to properly delimit the corresponding flow. Brands also include psychological aspects or symbolic constructions in the users' minds on the basis of which future expectations about their functioning will be generated, which is very difficult to measure and capture objectively.

We can define brand value as the incremental utility or added value to the product by brand name (Bigné, Borredá, & Miquel, 2013; Kamakura & Russell, 1993; Park & Srinivasan, 1994). In this sense, Kapferer (1992) proposes a hexagonal brand identity prism reflecting internal aspects: brand physique, personality, culture, and other external ones: relationship, reflection and self-image. Aaker David (1996) concluded a brand measure, called "The Brand Equity Ten", based on aspects such as loyalty, perceived quality, association or differentiation measures, awareness, but also, the behavior on market measures that represent information obtained from market-based information rather than directly from customers: price and distribution indices and market share.

Many times the so called brand strength is used to summarize all the qualitative brand aspects, a score of 0–10 that places a particular brand against the competitors. The strength of the brand is used in model valuation, at the same time being a multiple of the profit corresponding to the brand, such as the Interbrand proposal or, in other cases, it also serves to assign an implicit royalty, like that proposed by Intangible Business Ltd. (Salinas, 2007).

Bello Acebrón, Gómez Arias, and Cervantes Blanco (1994) defines the brand image as "the set of partnerships developed in the imaginative power of the consumer, enabling the brand to reach a higher sales volume than if you do not have a brand name". In this line, some authors have explored the relationship between brand affiliation and firm performance (Park & Srinivasan, 1994), between prices and higher quality brands (Cerviño, 2004; Sivakumar & Raj, 1997), others, in terms of competitiveness (Fernández, 2011), and finally between important brands and shareholder value (Cerviño, 2004; Doyle, 2001). So, it is clear there is a relationship between qualitative brand attributes, and quantitative variables such as prices, market share, and higher profits, then, quantitative variables could also explain the brand value in an impartial form.

For its part accounting standards, specifically the IFRS 13 (2011) explains that "a fair value measurement requires that the valuation technique(s) used should maximize the use of relevant observable inputs and minimize unobservable inputs". It establishes a fair value hierarchy that is categorized into three levels of inputs; level 1 inputs are quoted prices in active markets for identical assets, level 2 are inputs other than quoted prices included within level 1 that are observable for the asset, either directly or indirectly. Level 3 inputs are unobservable inputs for the asset or liability, but these inputs will have to be used to measure fair value whenever relevant observable inputs are not available.

In general, to have an active market for intangible assets is very uncommon. Therefore, since there is not an active market relative to purchase and sale of brands, the accounting standard puts the royalty relief method as the most important compared to the other methods listed above, especially in business combinations, since

[1] Technique described in Motameni and Shahrokh (1998) and in Ratnatunga and Ewing (2008).

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