ACCOUNTING FOR BRANDS

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FOREWORD

This publication is the fourth of an "Emerging Issues" series which has been initiated by the Research Committee of The Institute of Chartered Accountants of Scotland. The series is addressed to everyone with an interest in accounting and financial management - and in today's world that is an extensive constituency!

At a time of change and of increasing interest in accounting and financial matters, the Research Committee believes that the series will provide an explanation of issues which are particularly topical. The books in the series will, however, be written in such a way as to be understandable to readers who are not familiar with extensive academic theoretical literature. Although primarily intended for accountants, treasurers, bankers, civil servants, directors, managers and investors and their advisers, they have also been found useful for students and the interested layman.

This particular publication provides an overview of recent developments in the practice of accounting for brands. It is a subject which is currently attracting considerable attention and debate. The Committee commends this book for study and discussion in the interests of better understanding; the opinions expressed by the author are, of course, his own.

The Institute of Chartered Accountants of Scotland
Jack Shaw
Convener, Research Committee
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PREFACE

This book was commissioned by the Research Committee of The Institute of Chartered Accountants of Scotland, in response to the considerable recent interest in accounting for brands. The book provides an overview of current requirements and practice in accounting for brands.

I developed an interest in accounting for intangible assets such as brands during a three-year period that I spent in my firm's technical department. My interest has developed further over the past three years, which I have spent in our corporate finance division. From time to time that corporate finance work has involved an assessment and negotiation as to what companies are "worth", according to various measures of financial performance and position. The recent debate has made it clear that accounting for brands can be a key issue in mounting or resisting a takeover bid. As such, it has important commercial implications as well as being an interesting theoretical issue.

The views expressed in this book are my own and are not necessarily those of Deloitte Haskins & Sells. However, I would like to acknowledge the support I have had from Deloitte, in encouraging me to develop my interests in how companies report their financial position and performance.

I would also like to thank Eddie Hodgson and Peter Holgate of Deloitte and Professor David Tweedie of Peat Marwick McLintock for reviewing early drafts of this book and for contributing to the development of my thinking on this issue. Thanks are also due to Karen Jewers for her patient and efficient processing of the words.
PREFACE

Any errors or inconsistencies in the text are of course my own, and should not in any way be attributed to the present state of financial reporting in this country.

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September 1989
1. INTRODUCTION

There has been considerable controversy in the UK recently regarding accounting for brands. Several large companies have attributed values to their brand names and have included these values in their balance sheets. This apparently innovative accounting treatment has led to widespread comment and debate in the financial press.

The Accounting Standards Committee ("ASC"), the main accounting standard-setting body in the UK, has published its preliminary views on the issue and it is in the process of preparing further guidance.

The purpose of this book is to provide an overview of current requirements and practice in accounting for brands. The scope of the book is limited to a personal view of the issues involved. The book refers to accounting for other intangible assets, but its main focus is on accounting for brands.

The rest of this chapter comments on the key features of brands and outlines the main influences that lead companies to consider accounting for brands. Subsequent chapters comment on the current regulatory environment and on practical and theoretical implications.

What is a brand?

There is as yet no standard definition of a brand for accounting purposes. It seems to be generally accepted that a brand is a recognised name, such that consumers perceive that the related product is preferable to other similar products. That perception provides a competitive advantage to the owner of the brand, allowing the owner to charge a premium price for the product. However, a brand is often more than just the name of the product. A brand may also include the know-how that is needed to create the product. This approach can be illustrated by considering the
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Transferability of a brand. For example, if a well-known brand of malt whisky was to be sold by one distiller to another, it seems likely that the sale would have to include not only the brand name, but also the details of the product "formula". This know-how would be an essential element in ensuring that the product could continue to be differentiated from its competitors.

Although the brand is related to the product it is not the same as the product. Consequently, in considering the costs and revenues relating to a brand, care must be taken to avoid confusion with the costs and revenues relating to the underlying product.

Why account for brands?

The key reasons why companies might choose to account for brands are summarised below.

1. Several companies have included brand valuations in their balance sheets in an apparent response to the threat of a hostile takeover bid. Accounting for brands is perceived as strengthening a company's balance sheet, thus making it more able to fend off unwanted suitors. In an active corporate scene, acquisitive companies and their advisers are constantly seeking "undervalued" companies. The buying company seeks to exploit the bargain element in the target company, either by achieving a relatively high annual return on capital employed or by selling off component parts of the business. In these circumstances, management of a potential target company may consider that its share price is too low because it does not fully reflect the value of the company's brands. Consequently, management has an incentive to account for brands in an attempt to increase the share price and therefore deter would-be predators. This approach relies on the implicit assumption that the market does not attribute an appropriate value to a company's brands unless these brands are incorporated into its balance-sheet.
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2. An acquisitive company may have a similar incentive to account for its own brands in an attempt to increase its share price. The company can then use its more highly-rated shares to finance a paper-for-paper acquisition, rather than using hard cash to finance the deal.

3. Another reason for accounting for brands is to increase a company's borrowing powers, within any existing constraints imposed by its articles of association or by its providers of loan capital. A company’s borrowing powers may be restricted by reference to its levels of debt in relation to its share capital and reserves. Accounting for brands may increase reserves and so may allow a company to increase its borrowing.

4. By accounting for brands a listed company may not need to seek shareholders’ approval for certain transactions. The Stock Exchange requirements for shareholders’ approval and for circulars to be sent to shareholders are based on certain size tests, one of which concerns the company’s assets. If a company capitalises its brands and hence increases its assets, then it may be able to execute significantly larger transactions such as acquisitions without the need for shareholders’ approval or circulars.

5. Accounting for brands may be attractive to groups that seek to avoid high goodwill figures. By attributing fair values to brands that it acquires on the purchase of a business, a group will reduce the calculated figure of goodwill on consolidation. Brands can then be revalued in the balance sheet in subsequent years, whereas goodwill cannot be revalued. Consequently, by accounting for brands a group retains greater flexibility in its accounting options. However, this flexibility may only be attractive if brands are considered to require little or no depreciation. If brands are depreciated, then the effect on the profit and loss account is the same as if goodwill had been capitalised and then amortised (assuming that the useful lives of the brands and the goodwill are the
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same). If brands are revalued and then depreciated, then the charge against profits will be greater than if goodwill had been capitalised and amortised. If brands are revalued but not depreciated, then the group can strengthen its balance sheet without adversely affecting its profits.

The commercial pressures outlined above have been the main factors in causing companies to consider whether and how to account for brands. These practical pressures have led the accounting profession to consider whether accounting for brands has a valid theoretical justification.
2. THE REGULATORY ENVIRONMENT

The main regulatory influences on financial reporting in the UK are company law and accounting standards. This chapter describes how these influences affect the valuation of brands.

Company law

The legislation relevant to accounting for brands is contained in the Companies Act 1985, and in particular in Schedule 4 to that Act. The current position on brands as outlined below is unlikely to be changed significantly by the Companies Bill that is presently going through Parliament.

The model formats for the balance sheet in Schedule 4 to the Companies Act 1985 include a heading for "Intangible assets", which has a sub-heading for "Concessions, patents, licences, trade marks and similar rights and assets". Intangible assets has a separate sub-heading for "Goodwill".

Note (2) to the balance sheet formats states:

"Concessions, patents, licences, trade marks and similar rights and assets

Amounts in respect of assets shall only be included in a company's balance sheet under this item if either:-

(a) the assets were acquired for valuable consideration and are not required to be shown under goodwill; or

(b) the assets in question were created by the company itself."
Note (3) to the balance sheet formats states:

"Goodwill

Amounts representing goodwill shall only be included to the extent that the goodwill was acquired for valuable consideration."

Consequently, the Act makes it clear that a company may include purchased and internally created brands in its balance sheet. A company may include purchased goodwill, but not internally created goodwill, in its balance sheet.

Paragraph 62 of Schedule 4 indicates that, with certain exceptions, the consolidated accounts of a group shall comply with the requirements of the Act as if they were the accounts of an actual company. The comments in the previous paragraph therefore apply to groups as well as to companies.

Under Schedule 4, intangible assets such as brands must be valued in accordance with either the "historical cost accounting rules" (paragraphs 16 to 28) or the "alternative accounting rules" (paragraphs 29 to 34). These rules apply to brands as follows.

Under the historical cost accounting rules, the amount to be included in respect of a brand is its purchase price or production cost, subject to any provision for depreciation or diminution in value (paragraph 17). If a brand has been purchased, then its purchase price for balance sheet purposes is to be determined by adding to the actual price paid any expenses that were incidental to the acquisition (paragraph 26(1)). If a brand has been developed by the company, then its "production cost" is to be determined "by adding to the purchase price of the raw materials and consumables used the amount of the costs incurred by the company which are directly attributable to the production of (the brand)" (paragraph 26(2)).
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The concept of "raw materials and consumables" may not be particularly relevant in considering the production cost of internally created brands. However, it seems that the historical cost accounting rules allow companies to include expenditure incurred directly or indirectly in creating brands. Such expenditure might include salary costs of employees who were involved in creating the brands. Such expenditure might also include amounts paid to third parties who assisted in developing the brands.

If a brand has a limited useful economic life, then its purchase price or production cost (less any residual value at the end of its useful economic life) must be depreciated over that life (paragraph 18).

If a brand suffers a permanent diminution in value, then its carrying value in the accounts should be reduced accordingly (paragraph 19(2)). If the reasons for making any such reduction cease to apply, then the carrying value of the brand can be reinstated accordingly (paragraph 19(3)).

Under the alternative accounting rules, brands may be included at their current cost (paragraph 31(1)). That current cost then becomes the starting point, instead of purchase price or production cost, for calculating the depreciation charge (paragraph 32(1)). "Current" indicates current at the balance sheet date, and so if brands are included at their current cost then they must be revalued annually. Goodwill, on the other hand, is not permitted to be revalued (paragraph 31(1)).

The Act does not define what is meant by current cost. However, the Act distinguishes between current cost and market value. Paragraph 31(1) of Schedule 4 states that "Tangible fixed assets may be included at a market value determined as at the date of their last valuation or at their current cost". Although that sub-paragraph deals with tangible fixed assets, it seems clear that market value is not an acceptable legal synonym for current cost. Consequently,
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although the alternative accounting rules permit companies to revalue their brands, that revaluation must be based on current cost principles rather than on market value. However, the application of current cost principles may sometimes result in a valuation that is equivalent to the market value.

In the absence of a statutory definition of current cost, it is likely that the courts would be guided by the advice developed by the accounting profession. The ASC's latest guidance on current cost is contained in "Accounting for the effects of changing prices: a handbook", issued by the ASC in September 1986. The handbook does not have the authority of a Statement of Standard Accounting Practice, but it may be considered to be indicative of best practice.

The handbook states:

"... the current cost of an asset is the lower of:

(a) its net current replacement cost; and

(b) its recoverable amount, that is, the higher of:

(i) its net realisable value, and

(ii) the amount recoverable from its future use (i.e. its 'economic value')" (Appendix I, paragraph A1.4).

The handbook says that the same principles apply to the determination of intangible assets as for any other assets. The handbook recognises however that it may be impracticable to estimate the current replacement cost of intangible assets. It states that in these circumstances a company should "... consider alternatives such as the application of a broad-based index or, in the last resort and if the amounts involved are not significant, the
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continuing use of the historical cost carrying values" (Appendix 1, paragraphs A1.49 and A1.50).

The handbook omits to mention that it may also be impracticable to estimate the net realisable value and the "economic value" of intangible assets such as brands. The handbook offers no guidance on how to estimate these values. In the absence of such guidance, it might not be surprising if companies made some fairly broad assumptions as to the net realisable value of their brands. Companies might consider that, other than in exceptional circumstances, the net realisable value of their brands was at least as high as the net current replacement cost. In these circumstances, there would be no need to attempt detailed calculations of net realisable value or economic value, as the current cost of the brand would be its net current replacement cost.

In summary, the alternative accounting rules permit companies to revalue their brands, but that revaluation must be based on current cost principles rather than on market value. As indicated above, the application of current cost principles may sometimes, but not necessarily always, result in a valuation that is equivalent to the market value.

SSAP14 - Group accounts

The ASC developed Statement of Standard Accounting Practice ("SSAP") 14, "Group accounts", in the late 1970s. It was issued by the UK accountancy bodies in September 1978, and was effective for accounting periods starting on or after 1 January 1979.

SSAP 14 did not deal specifically with accounting for brands. However, it indicated how a group should value and record intangible assets that are acquired when a group purchases a subsidiary. Paragraph 29 of SSAP 14 states:
"When subsidiaries are purchased, the purchase consideration should be allocated between the underlying net tangible and intangible assets other than goodwill on the basis of the fair value to the acquiring company. If this is not done by means of adjusting the values in the books of the acquired company, it should be done on consolidation. Any difference between the purchase consideration and the value ascribed to net tangible assets and identifiable intangible assets such as trade marks, patents or development expenditure, will represent premium or discount on acquisition."

So SSAP 14 required a group to account for any intangible assets such as brands that the group acquired when it purchased a subsidiary. In these circumstances, SSAP 14 required the group to value the acquired brands at the fair value to the acquiring company, and to incorporate these fair values into the consolidated balance sheet.

SSAP 14 did not give any guidance on how the group should subsequently account for any increase or decrease in the recorded values of the brands that it had acquired. Nor did SSAP 14 give any guidance on how to interpret "fair value". In fact, SSAP 14 dealt with goodwill and other intangible assets only to a limited extent. Paragraph 4 of SSAP 14 recognised this limitation in the scope of the standard, and commented that the subject of goodwill was better dealt with as a separate accounting standard.

In practice, despite the introduction of SSAP 14 few groups carried out a fair value exercise on each of the assets and liabilities acquired. Many groups fair valued land and property but little else. Some groups took the opportunity to reconsider any provisions carried by the acquired company, for example against stock obsolescence or bad debts, and to incorporate provisions for rationalisation and reorganisation costs. However, few groups fair valued long-term debt to reflect current rather than historical interest rates. Few
groups incorporated the fair values of any brands acquired, or indeed of any other intangible assets.

SSAP 22 - Accounting for goodwill

As indicated above, few groups in the early 1980s followed the strict letter of SSAP 14 in calculating goodwill on the consolidation of a newly-acquired subsidiary. In particular, groups frequently did not allocate fair values to each of the intangible assets acquired. As a result, goodwill on consolidation was often overstated. It was often a mixture of intangible assets such as brands, patents and trade marks, as well as "true" goodwill.

The ASC considered the goodwill issue in the early 1980s. It published a discussion paper (June 1980), an exposure draft (October 1982) and a statement of intent (July 1983). SSAP 22, "Accounting for goodwill", was issued by the UK accountancy bodies in December 1984, and was effective for accounting periods starting on or after 1 January 1985. SSAP 22 was revised in July 1989. The revisions do not affect the comments below, and paragraph references are to the original SSAP 22.

SSAP 22 sought to clarify the distinction between goodwill and other intangible assets. It defined goodwill as "... the difference between the value of a business as a whole and the aggregate of the fair values of its separable net assets" (paragraph 21). Separable net assets were defined in turn as "... those assets (and liabilities) which can be identified and sold (or discharged) separately without necessarily disposing of the business as a whole. They include identifiable intangibles" (paragraph 22).

Paragraph 13 gave further guidance on separable net assets. It indicated that the criterion to be satisfied was whether the asset in question could be identified and sold separately without disposing of
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the business as a whole. Paragraph 13 indicated that separable net assets may include intangibles such as those mentioned in the balance sheet formats in company law, that is concessions, patents, licences, trademarks and similar rights and assets. Paragraph 13 gave other examples of intangible assets, namely publishing titles, franchise rights and customer lists.

SSAP 22 repeated the requirements of SSAP 14 on how a group should measure and record any intangible assets that it acquires when it purchases a subsidiary. That is, it should fair value such intangibles and include these fair values in the consolidated balance sheet (paragraph 19).

SSAP 22 provided some guidance on what was meant by "fair value". It defined fair value as "... the amount for which an asset (or liability) could be exchanged in an arm's length transaction" (paragraph 25). The ASC recognised that further guidance was needed, and it subsequently set up a working party to develop guidance on how to determine fair values in practice. However, the definition in SSAP 22 indicated that fair value was to be interpreted as market value.

SSAP 22 did not deal specifically with accounting for brands. If a particular brand can be identified and sold separately without disposing of the business as a whole, then it seems clear from paragraph 13 that the brand would be a "separable asset". Consequently, if a group acquires brands when it purchases a subsidiary, then it should attribute fair values to those brands that pass the "separability" test and include them in the consolidated balance sheet. The appropriate fair value in these circumstances would be the amount for which the brand could be exchanged in an arm's length transaction.

The brands should be described in the consolidated accounts as being at cost rather than at valuation, even though the amount is calculated
on the basis of fair values. The amount should be described at cost because the fair value exercise is not an end in itself but is the means of estimating the cost to the acquiring group.

As noted above, SSAP 22 indicated in general terms how a group should account for intangible assets such as brands that it acquires when it purchases a subsidiary. It does not deal with how a group should account for subsequent increases or decreases in the value of such intangibles.

SSAP 22 does not deal directly with accounting for internally created brands. However, SSAP 14 and SSAP 22 seem to imply that an acquired company can incorporate into its own balance sheet the market value of any internally created brands. Paragraph 29 of SSAP 14 implies that an acquired company can incorporate the fair value of its separable net assets into its own accounts when it is acquired, as well as these fair values appearing in the consolidated balance sheet. And paragraph 25 of SSAP 22 implies that fair value means market value.

However, this interpretation of the accounting standards conflicts with company law. As noted earlier, the Companies Act 1985 allows companies to include intangible assets at their current cost, but it indicates that market value is not necessarily the same as current cost.

This apparent contradiction between company law and accounting standards arises because the relevant requirements were introduced at different times. The relevant provisions in the Companies Act 1985 were first introduced into UK company law in the Companies Act 1981, which implemented the provisions of the EC Fourth Directive on company law. Consequently, the above provisions of SSAP 14 have in effect been superseded by subsequent legislation. In any event, company law would generally take precedence over an
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accounting standard in determining the appropriate accounting treatment.

So although it appears that accounting standards allow a company to account for an internally created brand at market value in certain circumstances, this treatment is only permitted by company law if the current cost of the brand is market value.

Fair value discussion paper

As noted earlier, the ASC set up a working party to consider fair values soon after SSAP 22 was issued. The working party prepared a discussion paper, "Fair value in the context of acquisition accounting", which was issued by the ASC in June 1988.

The discussion paper provides some guidance on the issues discussed above. The introduction to the discussion paper states that the ASC has tentatively concluded that there is a need for an accounting standard on fair value.

The discussion paper concludes that "... the fair value of an asset is the amount which the acquiring company would have been willing to pay for the asset had it been acquired directly" (paragraph 6.2). In particular, "The fair value of a fixed asset will usually be its net current replacement cost" (paragraph 6.33).

The discussion paper recognises that in practice, market transactions in intangible assets (such as brands) are infrequent and that accordingly it may be difficult to establish fair values.

The working party invited comments on these matters "... to assist in formulating more detailed guidance, if that should be considered necessary, or to gauge the extent to which such rights are elements
of goodwill which should not be evaluated as separable items" (paragraph 6.44).

These last comments seem to reflect a widespread concern that some acquiring groups are being overly imaginative in treating brands as separable assets. Intangibles other than goodwill can be revalued under the alternative accounting rules in the Companies Act 1985, and so they may be able to strengthen the balance sheet almost indefinitely. Goodwill, on the other hand, is not permitted to be revalued under the alternative accounting rules. SSAP 22 requires that goodwill must be eliminated from a group's balance sheet either immediately on acquisition against reserves or by amortisation through the profit and loss account over its useful economic life. Consequently, acquisitive groups may react to perceived commercial pressures for strong balance sheets by attributing values to brands rather than to goodwill.

SSAP 13 - Accounting for research and development

In the absence of an accounting standard on brands, appropriate accounting treatments have to be developed by reference to accepted fundamental accounting concepts. SSAP 13, "Accounting for research and development", is an example of how the ASC applied fundamental accounting concepts to the issue of accounting for another intangible asset, namely development expenditure. Consequently, although brands are clearly outside the scope of SSAP 13, it may provide some analogies for considering how companies should account for brands.

SSAP 13 was issued in December 1977 and was revised in January 1989. SSAP 13 (revised) distinguished between pure research, applied research and development. SSAP 13 (revised) defined development expenditure as:
"use of scientific or technical knowledge in order to produce new or substantially improved materials, devices, products or services, to install new processes or systems prior to the commencement of commercial production or commercial applications, or to improving substantially those already produced or installed" (Paragraph 21).

SSAP 13 (revised) states that:

"Development expenditure should be written off in the year of expenditure except in the following circumstances when it may be deferred to future periods:

(a) there is a clearly defined project, and

(b) the related expenditure is separately identifiable, and

(c) the outcome of such a project has been assessed with reasonable certainty as to:-

(i) its technical feasibility, and

(ii) its ultimate commercial viability considered in the light of factors such as likely market conditions (including competing products), public opinion, consumer and environmental legislation, and

(d) the aggregate of the deferred development costs, any further development costs, and related production, selling and administration costs is reasonably expected to be exceeded by related future sales or other revenues, and

(e) adequate resources exist, or are reasonably expected to be available, to enable the project to be completed and to provide any consequential increases in working capital."
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In the foregoing circumstances development expenditure may be deferred to the extent that its recovery can reasonably be regarded as assured" (paragraphs 25 and 26).

Any deferred development costs should be amortised, in effect over the useful economic life of the product or process. Deferred development costs can be included at their current cost, under the alternative accounting rules in the Companies Act 1985.

The above criteria for deferring development costs are derived largely from the matching concept (matching of expenditure with related revenues) and the prudence concept. Applying these concepts to accounting for brands could result in a set of criteria along the following lines:

"Expenditure on brands should be written off in the year of expenditure except in the following circumstances when it may be deferred to future periods:

(a) there is a clearly defined brand, and

(b) the related expenditure is separately identifiable, and

(c) the development of the brand has been assessed with reasonable certainty as to its commercial viability considered in the light of factors such as likely market conditions (including competing products) and public opinion, and

(d) the aggregate of the deferred expenditure on the brand, any further costs in developing the brand, and related production, selling and administration costs is reasonably expected to be exceeded by related future sales or other revenues, and
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(e) adequate resources exist, or are reasonably expected to be available, to exploit the potential of the brand and to provide any consequential increases in working capital.

In the foregoing circumstances expenditure on brands may be deferred to the extent that its recovery may reasonably be regarded as assured".

In practice, it may be extremely difficult to assess the "commercial viability" of a new brand, in which case the prudence concept should prevail and the expenditure should be written off as incurred.

ASC statement of provisional views on brands

In January 1989 the ASC issued a statement of its "Provisional views on accounting for intangible assets with special reference to brands". The ASC said that a more detailed discussion on the subject would be given in an exposure draft on "Accounting for fixed assets", which it expected to publish in the summer of 1989.

The proposed guidance on accounting for fixed assets has been developed in response to concerns over issues other than accounting for brands. The apparent shift in focus to brands, culminating in the issue of the above interim statement, reflects the pressure that the ASC was under to respond to what companies were doing in practice.

The ASC’s interim statement appears to be relatively cautious regarding accounting for brands, in particular with respect to internally generated brands. In the statement the ASC "... urges companies not to change their existing practice for accounting for intangibles", until it publishes its exposure draft on fixed assets. The key features of the interim statement relevant to brands are as follows:
1. The balance sheet does not purport to be a statement of corporate value.

2. The ASC encourages companies to disclose information about significant brands (and by implication, seems not to encourage companies to incorporate such information in the balance sheet).

3. A group should account for brands that it acquires when it purchases a subsidiary, in accordance with SSAP 22.

4. There may be limited (unspecified) circumstances in which intangibles can be capitalised in accordance with SSAP 13.

5. There is a rebuttable presumption that brands have a limited useful economic life.

6. The ASC discourages companies from incorporating revaluations of brands in the balance sheet.

7. Any revaluations of brands should be part of a consistent policy of revaluation.

It seems reasonable to expect the ASC to provide guidance on emerging accounting issues, while not appearing to discourage experimentation. In this instance, they were criticised for not reacting quickly enough to developments in practice, and then they were criticised for providing guidance that attempted to restrict the range of acceptable alternatives. The latter criticism was perhaps understandable, given that the ASC’s guidance appeared to be along the lines of "don’t change anything until we develop further guidance".
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Stock Exchange requirements

On the same day as the ASC issued its interim statement, the Stock Exchange issued a statement which may encourage companies to include internally generated brands in their balance sheets. The statement provides guidance on the Stock Exchange rules governing acquisitions and disposals. These rules are contained in the Stock Exchange Continuing Obligations, sometimes referred to as the "Listing Agreement" or the "Yellow Book".

Under the Continuing Obligations, listed companies intending to acquire or dispose of businesses are required to seek the approval of their shareholders if the transaction exceeds certain size criteria. One criterion is that the assets acquired or disposed of exceed 25% of the company's own assets.

The Stock Exchange statement said that a company can include the value of its intangible assets when considering these size tests, provided that the intangible assets are incorporated into the balance sheet.

Consequently, some companies may choose to value their brands and other intangible assets, as a means of avoiding the need to seek their shareholders' approval for certain transactions.

London Business School report

The Research Board of The Institute of Chartered Accountants in England and Wales commissioned a report on accounting for brands from four academics based at the London Business School. The report, "Accounting for Brands", was written by P Barwise, C Higson, A Likierman and P Marsh and was published in June 1989. The report does not form part of the "regulatory
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environment", but it is appropriate to refer to it on the grounds that it was commissioned by one of the professional bodies.

The report reaches the following key conclusions:

1. Recent pressures to account for brands would not have arisen if goodwill were to be carried in the balance sheet, either amortised or unamortised.

2. In most cases it is impossible to separate the value of the brand from that of the rest of the business.

3. Any valid assessment of a brand's future profitability involves many inherently subjective judgements about marketing factors.

4. The efficiency of the capital markets indicates that companies are not undervalued if they do not include brands in their balance sheets.

5. There is no general agreement on valuation methods, and the existing methods are methodologically suspect and highly subjective.

6. It would be highly unwise to allow brands to continue to be included in the balance sheet.

Overview

This chapter has shown that at present there are few specific legal or professional requirements in the UK on accounting for brands. However, guidance can be derived from various legal and professional sources dealing with asset valuation and accounting for acquisitions. In particular, it has been shown that both the law and accounting standards permit companies and groups to capitalise brand values in certain circumstances. Furthermore, there is actually
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a requirement for groups to capitalise brands, provided that they are separable assets, which are acquired when the group purchases a subsidiary.
3. RECENT DEVELOPMENTS IN PRACTICE

The recent interest in accounting for brands was largely initiated by Nestle's successful takeover bid for Rowntree in 1988. Rowntree believed that their share price was undervalued in that it did not fully reflect the value of its brands, and consequently that the takeover bid price was too low. A key element of Rowntree's defence was a document titled "Our brands speak for themselves", which sought to convince shareholders of the "enormous value" of the company's brands. Rowntree's balance sheet did not incorporate a value for any of its brands.

Rowntree's experience led other companies to consider how they could strengthen their balance sheets in an attempt to deter would-be predators. Ranks Hovis McDougall ("RHM") took the initiative in this respect, by incorporating brand values of £678 million into its September 1988 balance sheet. RHM had recently been the subject of a hostile takeover bid from Goodman Fielder Wattie, an Australian food group.

RHM placed a value on internally created brands as well as on acquired brands. This approach differed from that used by the few other companies that had previously ventured to account for brands. None of these companies had incorporated a value for internally created brands.

RHM describes its valuation method as being current cost. It has emphasised that the recorded values do not reflect the market value of the brands. RHM considers that its brands have an unlimited useful life, and so it does not intend to amortise its brands. However, it plans to review the carrying value every year and to perform a full revaluation every three years. RHM has indicated that it may be possible to offset any provisions for diminution in value of some brands against revaluation surpluses on other brands. Consequently, RHM seems to be suggesting that it will deal with any increases or decreases in brand values through its reserves.
RECENT DEVELOPMENTS IN PRACTICE

RHM has adopted a high profile in justifying its innovative approach and in explaining its methodology. In January 1989 it published a paper jointly with Interbrand Group plc, the branding consultants who had assisted in RHM’s valuation exercise. The paper lists several benefits of incorporating brands in the balance sheet, including the following:

1. The practice gives a more realistic picture of shareholders’ funds.

2. The goodwill arising from an acquisition can be reduced.

3. The practice allows better comparisons between companies.

4. It may assist capital raising by reducing gearing ratios.

The paper does not comment in detail on RHM’s reasons for capitalising internally created brands. The paper merely states:

"We see no reason why acquired brands should be treated differently from ‘home grown’ brands since both can be equally valuable as assets to the company".

The paper concentrates on appropriate methodologies for valuing brands. These issues are addressed in the next chapter.

Grand Metropolitan ("Grand Met") was another major company to incorporate brand valuation into its 1988 accounts for the first time. It announced its decision to capitalise brands several months before RHM made its decision public. Grand Met’s September 1988 balance sheet included over £500 million in respect of brands. Grand Met included acquired brands only, not internally created brands. Its change in accounting policy was retrospective to some extent, in that it valued those brands that it had acquired during the last three years. Grand Met was in effect catching up with the
RECENT DEVELOPMENTS IN PRACTICE

requirements of SSAP 22, by allocating fair values to brands as separable assets rather than including their value in the goodwill figure.

Rowntree, RHM and Grand Met were the companies that perhaps attracted most attention in the brands debate in 1988. Some other large companies had previously been accounting for intangible assets for some years, but few had accounted for brands. Several publishing companies, including Reed International and United Newspapers, capitalised publishing rights and titles. Reckitt and Colman capitalised trademarks that it acquired.

Since the brands debate began, several companies have considered whether and how to follow the precedents set by RHM and Grand Met ("jumping on the brand wagon", to paraphrase a memorable headline in The Independent).

Guinness announced in February 1989 that it had decided to incorporate brand names acquired in takeovers into its 1988 balance sheet. The change in accounting policy resulted in £1,695 million being added to the group’s stated net assets, giving total net assets of approximately £2,880 million. The main element of the £1,695 million represents the estimated cost of spirit brands acquired during the past four years. Consequently, Guinness seems to have followed Grand Met in catching up with the SSAP 22 requirements to allocate fair values to brands as separable assets.

Guinness considers that the brands in question have an unlimited useful life, and consequently it does not intend to amortise its brands. However, it intends to review the estimated lives and the carrying values of its brands every year. Any amortisation or permanent diminution in value recognised in this review will be charged against profits. This approach seems to contrast with that of RHM, which has indicated that movements in brand valuations would be dealt with in reserves.
RECENT DEVELOPMENTS IN PRACTICE

Guinness echoed RHM in emphasising that the recorded values of its brands were based on estimated cost to the group, and were considerably less than the market value of the brands. These comments may have been intended as a warning to potential predators, indicating that the recorded values were not to be seen as putting a value on the group as a whole.

Lonrho announced in January 1989 that it was capitalising its existing newspaper titles in its 1989 accounts. The change added £117 million to the company’s recorded net assets. Lonrho’s decision was announced on the same day that the ASC issued its interim statement discouraging revaluations of intangible assets.

Lonrho stated that it carried out its revaluation in line with standard practice within the newspaper industry, taking into account factors such as turnover and readership. Lonrho considers that its newspaper titles have an unlimited useful life, and so it does not intend to amortise its titles.

By capitalising its existing titles, Lonrho has followed the approach adopted by United Newspapers and News International. Other publishing groups have capitalised publishing titles only on acquisition.

Saatchi & Saatchi is another company to be affected by the perceived limitations of traditional financial reporting with regard to accounting for intangible assets. Saatchi & Saatchi, being an acquisitive group in the service sector, was paying enormous sums for companies which had relatively few separable net assets. Consequently, Saatchi & Saatchi had to recognise significant amounts of goodwill, which they wrote off immediately to reserves.

Goodwill write-offs left Saatchi & Saatchi’s shareholders’ funds looking extremely low compared to its borrowings, and reduced the company’s borrowing ability as laid down by its articles of
association. Saatchi & Saatchi's solution was to include all previously purchased goodwill when it calculated its borrowing limits. The goodwill was not reinstated into the statutory accounts, but was included in pro forma accounts that were prepared for the purpose of calculating borrowing limits. The reported effect was to increase shareholders' funds from £65 million to over £1,000 million.

Hanson Trust has subsequently adopted a similar approach. Its articles of association restricted its borrowing powers to 2\frac{1}{2} times its shareholders' funds, which have been reduced by the immediate write-offs of goodwill. As with Saatchi & Saatchi, Hanson Trust has decided to add back that goodwill for the purpose of calculating borrowing limits.

Cadbury Schweppes is one of the few companies to have expressed reservations publicly about the present state of accounting for brands. They have announced that they will not capitalise brands until the accounting profession produces an agreed methodology. Instead, they disclose in their accounts the amounts spent on marketing their brands (11.3% of sales in 1988).

This chapter has described how some leading UK companies have accounted for brands. Various press reports have indicated that several other large companies are seriously considering whether and how to capitalise their brands. This brief overview of current practice suggests that despite the recent controversy over accounting for brands, few UK groups are complying with the requirements of SSAP 14 and SSAP 22 to attribute fair values to separable intangibles such as brands when they purchase a subsidiary.
4. VALUATION METHODS

There are as yet no definitive rules on how brands should be valued for accounting purposes. This chapter describes some key factors that may affect the value of a brand, and then describes and comments on some of the valuation methods that have been suggested to date.

Key factors affecting brand values

The following factors may affect the value of a brand.

Market sector

A brand in a market sector which generates high profit margins is likely to have a higher value than a brand in a market sector with restricted profit margins. If the market sector in which the brand exists is expanding, then the prospects for exploiting the brand name may be higher than otherwise and so its value is likely to be relatively high.

International markets

A brand that has international recognition is likely to have a higher value than one that is recognised only in the domestic market.

Market position

A brand which is a market leader is likely to have a higher value than a brand which is not. This comment may apply particularly to those brands which are almost synonymous with the product (for
example, "Hoover" for vacuum cleaner, or "Walkman" for personal stereo).

Durability

If a brand has existed for many years in reasonably stable market conditions, then its value may be relatively high. In contrast, if a brand is in a volatile market sector where technologies or fashions change quickly and often, then the brand is likely to be less durable and so its value may be relatively low.

Advertising support

This factor may have a negative influence or a positive influence on the value of a brand. If a brand is receiving substantial advertising support, this may indicate that the position of the brand in the marketplace is weakening and hence that its value is declining. Conversely, advertising expenditure may lead to enhanced profit margins and so may increase the value of the brand.

Existing licences or franchises

If a company has recently granted licences or franchises to use one of its brand names, the transaction price may provide some evidence of the value of the brand.

The relative significance of the above factors will depend on the nature of the brand. Their relative significance will also depend on the valuation method used. For example, a valuation method based on past expenditure may place greater weight on factors such as amounts spent on advertising. However, a valuation method based
on future cash flows may place greater weight on likely future changes in market demand.

The following paragraphs deal with some of the valuation methods that have been suggested to date. They concentrate mainly on the method used by RHM, because to date that method appears to have attracted most publicity and debate.

**Earnings method**

Under the earnings method the earnings attributable to a brand are multiplied by a factor that takes into account considerations such as those listed above. There are several variations of this approach. The earnings might be historical earnings or future maintainable earnings. The earnings might be the total earnings attributable to the branded product, or they might be restricted to the marginal earnings attributable to the brand itself.

RHM used a variation of the earnings method. They identified the post tax profits attributable to each of the brands to be valued, thus excluding those elements of profitability that do not result from the brand's identity. They then calculated a three-year weighted average profit figure, in order to reduce any distortion caused by variations in profitability over time.

Having arrived at an earnings figure for each of its brands, RHM then calculated a figure to represent the "brand strength" of each brand. That calculation took into account factors such as market leadership, stability, type of market, internationality, long-term trend, support and legal protection. The figure was expressed as a "brand strength score", which was given as a percentage.

The earnings multiplier was derived from that brand strength score as follows. A brand with a zero brand strength score was assumed
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to have a zero multiplier, on the basis that such a brand would have zero value. A notional "perfect" brand with a 100% brand strength score was assumed to generate a return slightly lower than that available from a risk free investment. As the brand strength score increased from 0 to 100%, the multiplier increased in an S-curve pattern. The S-curve indicates that in RHM’s view the value of a brand increases slowly as the brand moves from being unknown to being number 3 or 4 in the market. The value of a brand then accelerates rapidly as the brand moves into the number 2 position, and particularly if it becomes market leader. The rate of increase of the brand's value then slows down as it consolidates its number one position. RHM indicated that the multiples at the high end of the scale are probably higher than the average price earnings ratio of the sector in which the company operates.

RHM applied the appropriate multiple to the relevant attributable earnings in order to arrive at a value for each brand.

RHM have attempted to establish a constructive and rigorous framework for establishing brand valuations. In the author's view, they are to be congratulated for experimenting with an innovative accounting practice, and for disclosing extensive details of their methodology.

However, their approach seems to have two key limitations. The first limitation is that it is not clear how their approach corresponds to the valuation rules laid down in the Companies Act 1985. It is not historical cost, as a brand with little historical expenditure but high earnings could attract a high value. Indeed, the RHM/Interbrand paper specifically rejects the historical cost approach, stating that such an approach "ignores the current financial position of the brand". The paper rejects market value, noting that market values are prohibited by the Companies Act 1985.
VALUATION METHODS

The RHM/Interbrand paper does not refer to current cost. However, to comply with the statutory requirements, it would seem that if the valuation method is not historical cost then it must be current cost.

Chapter 2 notes that according to the latest professional guidance, the measurement of current cost generally involves an assessment of net current replacement cost, net realisable value and economic value. The paper implicitly rejects the concept of economic value, stating that any method that relies on predicting future cash flow patterns cannot meet the fundamental accounting concepts of prudence and consistency. The method is clearly not based on net realisable value, and in any case as noted above the paper rejects the concept of market value. By a process of elimination, the only remaining option is net current replacement cost. It may be that RHM would argue that their approach provides the best available estimate of net current replacement cost. That argument would have some merit in considering brands that would be replaced by purchased brands, where a similar methodology might be used to form the basis of the purchase price. (Similarly, the RHM approach may be appropriate for calculating the historical cost of a brand to a group when it acquires a brand on the purchase of a subsidiary.) However, it is difficult to argue that the RHM approach provides the net current replacement cost of brands which would be replaced by internally generated brands. In these circumstances, the cost of replacing the brand would not be directly affected by its earnings.

The RHM/Interbrand paper does not address the issue of how their methodology relates to the statutory requirements.

The second limitation concerns the high degree of subjectivity involved, which may raise concerns as to the reliability of the figures produced by the methodology. There appears to be scope for considerable subjectivity in determining the marginal earnings attributable to each brand, in assessing the brand strengths-and in
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estimating the multiplier. Subjectivity in itself is an accepted part of the financial environment. All published accounts incorporate elements of subjectivity, for example, with respect to estimates of fixed asset lives and estimates of bad debt provisions and stock provisions. However, it is perhaps unusual to have a high degree of subjectivity in using a novel accounting approach to arrive at such material figures in a company’s balance sheet.

If the RHM approach becomes widely adopted, then the high degree of subjectivity involved may lead to inconsistencies between companies valuing similar brands. Consequently, it may be difficult for a user of accounts to make meaningful comparisons between similar companies. There are of course already many other potential difficulties in comparing the accounts of similar companies, given the range of accounting choices available to companies.

Historical cost

Under this method, a company would capitalise all of the costs attributable to developing its brands. This approach appears to be simpler and less subjective than the RHM approach. However, it may involve a considerable degree of judgement in assessing which costs were attributable to developing the brand. Even if the costs of a newly-developed brand can be readily determined, in many cases the prudence concept may dictate that these costs should be written off as incurred. The historical cost approach also has limitations in its application to determining fair values on consolidation of a newly-acquired subsidiary, as it is of little help in allocating a proportion of the fair value of the purchase consideration to the brands acquired.
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Net current replacement cost

Under this method, a company would consider how it would replace each of its existing brands. For those brands that it would replace by purchasing another brand, the company would assess the likely purchase price of the replacement. A method such as that used by RHM might give an appropriate estimate of this figure. For those brands that it would replace by developing another brand internally, the company would assess the current costs of that development expenditure. This method is subject to limitations in view of the element of subjectivity involved, with respect to the RHM type of estimates and with respect to allocating specific development costs to each brand.

Economic value

This method is based on discounted cash flows attributable to each brand. This method has some theoretical attractions, in that it may provide relevant information to an investor who is attempting to calculate the likely returns from an investment in the company's shares. However, the subjectivity problem is magnified here, in view of the difficulties in assessing future marginal cash flows attributable to the brand and in determining an appropriate discount rate. In any case, the latest professional guidance on current cost indicates that economic value is not always the appropriate way of determining current cost. As noted earlier, the Companies Act 1985 requires that brands must be valued either at historical cost or current cost.

Royalty method

Under this method, a company would estimate the capitalised value that it could obtain if it licensed the brand to a third party. The
company would estimate the likely royalty stream, either based on recent similar transactions or based on a typical industry royalty applied to likely sales. The company would then apply an appropriate multiple to that royalty stream to arrive at a capitalised value. It could be argued that the royalty method provides a current cost figure, in that it indicates what it would cost to license the brand from a third party. The limitation of this approach is that it involves considerable subjectivity in assessing royalty streams and appropriate multiples.

Summary

There are considerable limitations in each of the valuation methods outlined above. The key limitations are firstly, the difficulties in reconciling some of the methods with the valuation rules of the Companies Act 1985 and secondly, the high degree of subjectivity involved in the calculations.

Whichever of the above methods a company may choose, it seems clear that the Companies Act 1985 generally requires a company to amortise the value of a brand over its useful economic life. The only exception would be where the life of the brand is unlimited. The general amortisation rule applies even where the company values its brands at their current cost. It also seems clear that the Act requires a company to provide for any permanent diminution in the recorded value of its brands.

This chapter has addressed measurement issues rather than disclosure issues. However, it should be said that the Companies Act 1985 requires disclosure of the accounting policies that a company has adopted. Given that accounting for brands is a relatively novel and controversial issue, it would seem appropriate for a company that capitalises brand values to provide detailed information in its accounts on the valuation method it has adopted.
5. A PERSONAL VIEW

This chapter provides a personal view on the two key issues in accounting for brands. The first issue concerns whether or not companies should incorporate brand values into their balance sheets. The second issue concerns how companies should value their brands. The following comments are made in the context of the current regulatory environment for financial reporting in this country.

Capitalisation

There is some merit in considering acquired brands and internally generated brands separately. It seems clear from SSAP 14, supported by SSAP 22, that a group is required to capitalise any brands that it acquires when it purchases a subsidiary, provided that the brand is considered to be a separable asset. The requirement applies whether or not the brands were previously recorded in the balance sheet of the acquired company. Few groups have complied with this requirement to date. The reluctance of the majority is perhaps understandable in view of the considerable practical difficulties involved. Nevertheless, under existing accounting standards, groups must capitalise acquired brands if they are considered to be separable assets.

The separability issue is fundamentally important in the brands debate. Under the present regulatory framework, it is clear that if a brand cannot be identified as a separable asset then it should not be capitalised. In practice, brands are rarely bought and sold separately from the related business. The absence of a ready market in brands may indicate the practical difficulties in identifying brands as separable assets. In the author’s view, a company that capitalises brands should disclose how it has resolved these practical difficulties, and should disclose its justification for treating brands as separable assets.
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In the author's view, under the present reporting framework, a balance sheet is generally considered to include the cost (or subsequent revaluations), less depreciation, of all assets acquired or purchased by the business. Consequently, in the present reporting environment it seems appropriate that groups should be required to capitalise acquired brands, provided that they pass the separability test.

With regard to internally generated brands, current legislation and accounting standards permit, but do not require, a company to capitalise such brands. There is an argument that in order to achieve consistency, companies should be required to treat all brands in the same manner. That argument would lead to companies being required to capitalise internally generated brands. However, this application of the consistency argument was rejected by the ASC when it considered how to deal with internally generated goodwill. SSAP 22 does not allow companies to capitalise such goodwill.

In the author's view, if a company has incurred expenditure in creating a brand, if that expenditure is likely to generate revenues in future years, and if the brand can be considered to be a separable asset, then in principle the expenditure should be capitalised as an asset in the company's balance sheet. However, a company should seriously consider how the prudence concept applies to such capitalised expenditure. The uncertainties involved in calculating the relevant costs and in particular the future revenues, which are of course dependent on the uncertain success of the brand, may lead to a company deciding to write off the capitalised expenditure immediately.

The above comments deal with recording the historical cost of the brand, either when it is acquired or when it is created. The next question is whether or not companies should subsequently revalue their brands.
A PERSONAL VIEW

Current legislation permits companies to revalue their brands to their current cost. In the author's view, in the present reporting environment it seems sensible that companies should be allowed to revalue their brands, given that companies are allowed to revalue other fixed assets. There does not seem to be any great demand to require companies to revalue brands.

Valuation methods

The previous chapter noted some limitations of the various valuation methods that have been suggested. At the present time, few companies have valued their brands and so there is limited practical experience from which to draw conclusions as to which methods are feasible or acceptable. If accounting for brands increases in popularity, it is to be hoped that companies are encouraged to experiment with their valuation methods, so that the accounting profession and the standard-setters can develop a wider base of knowledge and understanding than currently exists. In that context, the ASC's interim statement in January 1989 may be seen as somewhat unhelpful, in that it strongly discouraged experimentation.

In view of the limited practical experience to date, the following comments on valuation methods are intended to represent provisional views only. If and when more companies experiment with valuation methods, the conceptual issues are likely to come into sharper focus.

As with the capitalisation issue, there is some merit in considering acquired brands and internally generated brands separately.

In the author's view, the appropriate valuation method for acquired brands is the historical cost to the acquiring group. When a group acquires brands on the purchase of a subsidiary, it must attribute fair values to these brands in order to arrive at their historical cost
to the group. It may be possible for the group to estimate what it would have paid for the subsidiary without the brand in question. If so, than the difference between that notional price and the actual price paid could be taken to represent the fair value of the brand. Alternatively, it may be that the acquiring group attributed specific values to specific brands when it was considering how much to offer for the target company. If so, then these brand values would seem to be an appropriate indication of the historical cost to the group. If neither of the above alternatives is feasible, then a valuation based on an approach such as that used by RHM would seem the most appropriate. Such a figure could indicate what the group might have to pay if it were to purchase the brand in the open market, and consequently the figure could represent the fair value of the brand to the group.

In the author's view, the appropriate valuation method for internally generated brands is their historical cost, to be interpreted as the total expenditure incurred in creating the brand (reduced where appropriate by the application of the prudence concept). That approach may involve considerable judgement in allocating shared overheads and other expenditure. However, the degree of subjectivity involved is likely to be substantially less than in any of the current cost approaches.

This expressed preference for historical cost is not to be seen as inconsistent with the earlier comments regarding experimentation. The author remains to be convinced that methods other than historical cost can produce reliable and supportable valuations. However, this concern may diminish if and when current practice develops a widely-accepted methodology.

Whichever valuation method is used, current legislation requires that the capitalised value is amortised over the useful economic life of the brand, unless that life is unlimited. In the author's view, there are relatively few brands that have an unlimited life. There are
considerable practical difficulties in estimating the useful economic life of a brand. There does not appear to be a generally accepted methodology for assessing brand lives, and there are few examples in published accounts for use as precedents. In view of the uncertainties and subjectivities involved, companies should be encouraged to adopt a prudent approach in estimating useful lives.

The objectives of financial reporting

The debate over accounting for brands centres on the two key issues discussed above, namely whether, and if so how, companies should value brands. However, underlying the debate is a fundamental issue concerning the objectives of financial reporting. In particular, this issue concerns whether at one extreme the balance sheet should record the historical costs of a company's assets, suitably depreciated, or whether at the other extreme it should record some form of current values of the company's assets. In practice, a company's balance sheet is often a mixture of the two extremes, showing land and property at revalued amounts (though not necessarily current values) and other assets at historical cost.

There is at present no generally accepted framework of objectives for financial reporting in this country. There has been a growing interest in recent years in how to develop and agree on such a framework. That interest has been stimulated by the recent publication of "Making Corporate Reports Valuable" by the Research Committee of The Institute of Chartered Accountants of Scotland, and of Professor David Solomons' study on "Guidelines for Financial Reporting Standards" for The Institute of Chartered Accountants in England and Wales.

It seems clear that emerging issues such as accounting for brands cannot be addressed in isolation, but must be considered in the context of what financial reporting is intended to achieve. Unless
and until agreement is reached on that fundamental point, it is likely that emerging issues will be dealt with piecemeal and will add to the inconsistencies that abound in the present financial reporting environment. At the very least, it is to be hoped that the debate over accounting for brands will increase the likelihood of arriving at an agreed set of objectives for financial reporting.