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Capitalising on Income Approach as Trademark Valuation for Entrepreneurs

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ABSTRACT

The various valuation approaches that have been developed are meant for tangible assets valuation and are carried out by expert valuers. For intangible assets including trademarks, the international standards propose three main valuation approaches with the aim, among others, of better transparency and wider interest groups. These are the cost, market and income approaches. This paper suggests that the valuation of trademarks helps to reassure entrepreneurs that their trademarks are valuable assets. The entrepreneurs' competitiveness in the market is reassured when the trademarks are disclosed at fair value in the financial statements. This paper highlights the benefits of adopting the income approach for entrepreneurs, particularly the profit split method, by referring to several calculation methodologies as guidance for entrepreneurs in the valuation of trademarks.

Keywords: valuation, trademark, intellectual property, entrepreneur, financial statement

INTRODUCTION

The number of intellectual property valuation experts in Malaysia is still small and the fees charged for their expert services may be burdensome to entrepreneurs. Trademark valuation is actually more complex than the valuation of tangible assets because of the intangible nature of the trademark itself (Allen & Rigby, 2003). The valuation of trademarks also requires a different set of information from other intellectual property rights such as patents, industrial designs and copyrights.

There are various valuation approaches and interestingly, there is no single approach that can come out with a correct answer for the valuation

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of intangible assets. For trademarks, the international valuation standards propose three main valuation approaches with the aim, among others, of better transparency and wider interest groups. The three main valuation approaches are the cost, market and income approaches. In 2013, the Malaysian Government supported the Intellectual Property Corporation of Malaysia (MyIPO) for intellectual property valuation training programmes. One of the outcomes of the programme would be an IP Valuation Model. Nonetheless, there can still be a suitable valuation approach, which can assist entrepreneurs to know the value of their trademarks after they have created successful branding and trademark strategies. Knowledge of the trademark valuation is an important extension to knowledge for exploiting a trademark.

IMPORTANCE OF TRADEMARK VALUATION TO ENTREPRENEURS

A strong trademark is a promise of quality and satisfaction, and these are linked to the good image that consumers want to be associated with. Entrepreneurs use trademarks as tools to enhance their marketing strategy (Goodman *et al*., 2008) and to build their reputations (Menapace & Moschini, 2011). In the 21st century, entrepreneurs are becoming increasingly dependent on their trademarks (Mard *et al.,* 2000) compared to other intellectual properties (WIPO, 2013; MyIPO, 2013). The dependence of entrepreneurs on trademarks in business is evident from the number of trademark applications for registration. In 2012, global trademark applications totalled 6.58 million compared to 2.35 million patent applications and 1.22 million industrial design applications (WIPO, 2013). The total Malaysian trademark applications in 2013 was 14,705, of which 9,777 were registered (MyIPO, 2013).

According to Smith and Richey (2013), the value of a trademark depends on its exploitation in the market. When the trademark gains a reputation in the market, as long as it does not become a generic trademark, it could be as valuable as, or more valuable than, the entrepreneur's tangible assets. Trademark valuation can benefit the entrepreneur in his business strategy planning when the focus is on trademark exploitation. For example, the entrepreneur can forecast the worth of a new venture and decide on the cost of licensing the use of the trademark or the licensing strategy or use it as security for loans. The intellectual property monetisation strategy means a greater importance is given to its valuation aspect.

The trademark becomes a prospective investment when its rate of return is greater than the weighted average cost of the capital used to finance it (Hagelin, 2002). Once the trademark is successful and strong, it will help the entrepreneur to build strong commercialisation, in addition to its potential use with other goods or in other industries (Cohen, 1986; Carter, 1990; Smith, 1997; Flignor & Orozco, 2006). Flignor and Orozco (2006) stated that commercialisation strategies for

trademarks include acquisitions, sales, licensing, franchising or merchandising. A trademark, like other intellectual property rights, could also become a collateral, either as part of other existing assets or as a standalone asset for a specific duration. The growing role of the trademark as a commercialised asset has given rise to significant challenges, even for the estimation of the trademark value (Pro Inno Europe, 2008).

Previous studies in the area of trademark valuation covered the importance, methods and purpose of valuation (Smith, 1997; Pavri, 1999; Anson, 2002; Flignor & Orozco, 2006; Zapata, 2009), but were lacking with regard to the unique worth of trademark valuation for entrepreneurs.

Gream (2004) noted that trademarks need to be correctly valued. According to Ernst & Young (2000), trademark valuation first rose to prominence in the late 1980s. Trademark valuations gradually developed based on fair value (Ashley, 1909; Mill, 1909; Moore, 2004; Fishman *et al.,* 2007), which consists of five different features, namely loyalty, awareness, perceived quality, associations and other proprietary assets that underlie trademarks (Tuominen, 1999). Entrepreneurs used these fair values to simplify the decision-making process for the exploitation of trademarks (Anson, 2002; Reilly, 2010), which can be in a variety of ways such as licensing and franchising (Martensen, 2007); taxation and transfer (Basset *et al.,* 2010); raising funds and securing financing (*The Clorox Company v Chemical Bank,* 1996; *Haymaker Sports Inc. v Tunan,*1978); profit sharing for multiple trademark owners (Bryer & Asbel, 2008); financial reporting (Whitwell, 2005); transfer pricing (McClure, 2009); restructuring or liquidation procedures (Torres, 2007); driving the market value of shares (Greenhalgh & Rogers, 2005); and damages for infringement (Ross, 2006).

DETERMINING SUITABLE TRADEMARK VALUATION METHODS

Although several valuation methods were developed in the 1980s (Chaplinsky & Payne, 2002; Keller, 2008), all these methods yield significantly different results (Prashar & Aggarwal, 2009) and have been categorised into three main approaches *viz.* cost approach, market approach, and income approach (Catty, 2010; Salinas, 2011). The three approaches are mentioned in the ISO 10668 (2010) and the Guidance on the Valuation of Intangible Assets - IVS 210, 2011. The ISO 10668 is the first international standard that deals exclusively with brands and is targeted at a broader audience than the valuation community. The IVS 210, 2011, with an effective date of 1 January 2012, is a standard specifically developed by the International Valuation Standards Council (IVSC) for intangible assets valuation.[1]

The cost method is a value indication of an individual asset by quantifying the

[1]Malaysia is yet to adopt the ISO 10668 and IVS 210. Currently Malaysia, via the Malaysian Intellectual Property Office (MyIPO), is guided by the IP Valuation Model launched in 2013.

amount of money required to replace or produce it in future. The market approach indicates the value of a trademark in comparison to a similar trademark, which has been sold. The income approach indicates a trademark value that converts anticipated economic benefits into a present single amount.

Each valuation method has strengths and weaknesses that depend on the available data in relation to market factors such as historical results, industry trends, and the competitive environment, as well as the specific characteristics of the trademark being valued and the degree to which the trademark is being exploited. The income approach is the most common approach compared to the other two valuation approaches (Smith & Parr, 2005; Hagelin, 2002; Brauner, 2008; Zapata, 2009; Catty, 2010; Rachael, 2011). For that reason, this paper discusses only the income approach.

The Income Approach

Generally, scholars agree that the income approach is the most accurate approach for valuing trademarks (Razgaitis, 1999; Smith & Parr, 2000; Anson, 2002; Hagelin, 2002; Anson *et al.,* 2005; Smith & Richey, 2013). The income approach measures future economic benefits or net future cash flows discounted to a present value that is based on the determination of future cash flows (Smith & Parr, 2000; Sharma, 2007; Prashar & Aggarwal, 2009; Mard, 2011). When an entrepreneur effectively uses the trademark, a value is created and reflected in the entrepreneur's cash flow (Hagelin, 2002).

The income approach is the most widely used approach because the information is usually relatively accurate and is often readily available within the entrepreneur's control (Flignor & Orozco, 2006). The information required for the income approach includes an expected increase or decrease in the entrepreneur's income, the duration of the income, the income associated with the use of the trademark, the returns for other assets, the discounted factor, and the risks associated with the generation of the estimates of income (Mard *et al*., 2000; Smith & Parr*,* 2005; Zapata, 2009; Catty, 2010). This information is based on observations of relevant markets, including size, growth trends, market share dynamics among participants, overall market risk characteristics, duration and the growth rate of cash flow increases.

The income approach depends heavily on economic income, which relies on prospective financial information that includes the forecast of revenue, gross profit, operating profit and net profit, profit before and after tax, cash flow before and after tax, and the estimated remaining useful life (Pareja & Tham, 2009). An understanding of compound interest is at the core of the income approach, which involves estimating a reasonable amount of future economic benefit from the trademark.

There are various methods under the income approach; these include reasonable relief from royalty method, price premium method, volume premium method, incremental cash flow method, and profit split methods (excess earning method and residual earnings method). These methods may be grouped into two main categories of income approach to calculate the future economic benefit, namely, the direct capitalisation and discounted future economic benefits. Various methods under the income approach may

be grouped into two categories, namely, the direct capitalisation and discounted future economic benefits. Direct capitalisation analysis estimates the appropriate trademark revenue for one period based on the valuation date and divides that revenue by an appropriate investment rate of return. The capitalisation rate may be derived for a perpetual period of time or for a specified finite period of time, depending upon the expectations for the duration of the income.

In discounted future economic benefits, projections of appropriate future revenue for several discrete time periods are needed. Discounted cash flow is projected. Such a plan must account for trademark strength and its effect upon the competitive environment. Discounted future economic benefits are used to determine the present value of income earned in future years. Future value can be derived by forecasting the revenue and determining the required rate of return to be associated with the trademark.

Among the various methods under the income approach, the profit split methods (residual earning method and excess earning method) are widely used to determine the profits of the different types of assets for entrepreneurs to value their trademarks. Even if the other valuation methods provide an analysis of future benefits in order to estimate the future economic benefits of the trademark, the profit split method is able to differentiate between profits in different markets or business areas, and in this way, it represents the most recent stage in the development of valuation techniques (Vögele *et al.*, 2012).

Profit Split – Residual Earnings Method

In every business enterprise, assets are comprised of monetary assets, tangible assets, intangible assets and intellectual property. Therefore, in order to use the profit split - residual earnings method, all information related to each asset value, returns required and amount of returns are required. This information is needed to calculate the market value of the entrepreneurship. Table 1 gives an example of the estimated returns required by assets, which are usually derived from a company's balance sheet:

TABLE 1
Estimated Returns Required by Assets

	ASSET VALUE	RETURNS REQUIRED	AMOUNT OF RETURNS
ASSET CATEGORY	($ 000's)		($ 000's)
Net working capital	3,830	2.70%	103
Tangible assets	13,600	5.70%	775
Intangible assets	5,000	12.00%	600
Intellectual property	15,080	18.00%	2,714
Total	37,510	11.20%	4,193
Technology IP	5,000	25.00%	1,250
Trade marks	10,800	14.50%	1,462
	15,800	18.00%	2,712

Source: Smith and Richey (2013)

Table 1 shows the asset value, percentage of returns required and amount of returns for each asset. The total amount of returns of $4,193,000 is the result of the asset value multiplied by the percentage of returns required. The lowest percentage of returns required is from the net working capital (2.7%), while the highest percentage of returns required is from the Technology IP (25.0%). The amount of returns from trademarks, which is equivalent to $1,462,000, is obtained by multiplying the trademark value ($10,080 million) by the percentage of returns required (14.5%).

Table 2 provides data on the income after tax for the year 2015 to an indefinite year using the residual earnings valuation method. The calculation of the income after the tax deduction on the total returns required from each asset (except trademark) is based on the percentage given in Table 1. The excess income after deduction is the residual earnings attributed to the trademark. The residual earnings or the amount of returns is the value of the trademark at the time of the valuation.

TABLE 2
Profit Split - Residual Earnings Valuation Method

	2015	2016	2017	2018	2019	Terminal
Income After Tax	5,510	5,675	5,846	6,021	6,202	6,388
Present Value Factor	0.91	0.83	0.75	0.68	0.62	
Terminal Factor						14
Entity Value of Business	5,014	4,710	4,385	4,094	3,845	89,432
Less Return Required on other assets						
Net Working Capital	135	127	118	111	104	2,415
Tangible Assets	286	268	250	233	219	5,098
Intangible Assets	602	565	526	491	461	10,732
Technology IP	1,254	1,178	1,096	1,024	961	22,358
Total	2,276	2,138	1,991	1,859	1,746	40,602
Residual Earnings	2,738	2,572	2,394	2,235	2,100	48,830
Residual Value	60,868					

i. The discounted rate is 10%
ii. TGR = The terminal growth rate is 3% for income and assets

The terminal growth rate is a multiple that is used to derive the terminal value. It is assumed in Table 2 that the discounted rate is no longer necessary after the fifth year (post-2015) as the calculation is then based on the terminal growth rate. Selected multiples commonly use the median multiple of the total invested capital to earnings before interest, tax, depreciation and amortization (EBITDA) of comparable companies selected in a comparable public company analysis. The formula for the terminal value = 1/(r-g), where:

g = growth rate

r = present value rate (WACC rate)

Hence, the same trademark of the same company (shown in Table 1 and Table 2) had different values although it was calculated at the same time using a

different method. Table 1 provides the value of the trademark as $10,800,000, while Table 2, using the residual earnings method, provides the value of the trademark as $60,868,000.

Profit Split - Excess Earnings Method

The excess earnings method is a combination of cost and income approach (Anson *et al*., 2005; Brauner, 2008; Haigh, 2010). A trademark value constitutes the entire excess earnings, depending on the particular facts and circumstances of any inquiry. This method involves allocating cash flows to groups of tangible assets and intangible assets, which contribute to cash flow generation. The excess earnings method may be used as a starting point for determining a royalty rate. The format for the calculation of the excess earnings is as follows:

i. Calculate the earnings attributable to the tangible assets. The calculation is the market value of the net tangible assets multiplied by the rate of return appropriate to these assets;
ii. Add all the earnings attributable to the tangible assets and intangible assets;
iii. Minus the total earnings attributable to the tangible assets from that of the intangible assets. The balance is excess earnings.

Five steps must be followed in order to value the trademark using the return of assets rate. For example, a company has two different trademarks for a product. One is the "DREAM" trademark and the other is a less popular trademark, referred to here as the "company's own trademark." The steps are as follows:

i. Project revenues for both trademarks;
ii. Compute the apportionment of assets employed to the "DREAM" trade mark and the company's own trademark projection**;**
iii. Compute the return (%) on the company's own trademark;
iv. Compute the excess return of the company to the "DREAM" trade mark; and
v. Compute the net present value of the "DREAM" trademark.

i. Step 1 - Project Revenues for Both Trademarks

Table 3 gives the projected revenue for the "DREAM" trademark for the year ended 31 Mac 2013 to 2018. Table 4 gives the projected revenue for the company's own trademark for the year ended 31 Mac 2013 to 2018.

TABLE 3
Projected Revenue for "DREAM" Trademark 2013- 2018

Year ended 31 March	2013 (Actual)	Projection				
		2014	2015	2016	2017	2018
DREAM trade mark (RM000)						
Sales revenue	20,200	21,008	21,638	22,287	22,956	23,645
Production costs	6,060	6,302	6,491	6,686	6,887	7,093
Marketing costs	2,400	2,448	2,497	2,547	2,598	2,650

TABLE 4
Projected Revenue for the Company's Own Trademark 2013-2018

Year ended 31 March		Projection				
	2013 (Actual)	2014	2015	2016	2017	2018
Company's Own mark (RM000)						
Sales revenue	3,565	3,636	3,709	3,783	3,859	3,936
Production costs	3,030	3,091	3,152	3,215	3,280	3,345

ii. Step 2 - Compute the Apportionment of Assets Employed to the "DREAM" Trademark and the Company's Own Trademark Projection

In Table 5, the total for the assets is given as RM 10,000 for the year 2014 and it increased at an annual rate of 2% for the year 2015. The percentages of the total assets attributed to "DREAM" and the company's own trademark are segregated by using the cost of production for each trademark. For the year 2014, the percentage allocated to "DREAM" is 6,302/9,393 (67.1%) and to the company's own trademark is 3,091/9,303 (32.9%). For the year 2010, the apportionment of the asset costs allocated to "DREAM" is RM6,710 and to the company's own trademark is RM3,290. The assets calculation formula is the same as in Table 5 below:

TABLE 5
Apportionment of the Total Assets to the "Dream" Trademark and to the Company's Own Trademark

	2014	2015	2016	2017	2018	Terminal
Cost inccured (RM000)						
Production cost - DREAM	6,302	6,491	6,686	6,887	7,093	7,235
Production cost - company's own mark	3,091	3,153	3,216	3,280	3,346	3,413
Total cost inccured (RM000)	9,393	9,643	9,901	10,167	10,438	10,647
% of asset employed						
% DREAM trade mark	67.10%	67.30%	67.50%	67.70%	68.00%	68.00%
% company's own mark	32.90%	32.70%	32.50%	32.30%	32.00%	32.00%
Total Assets (RM000)	10,000	10,200	10,404	10,612	10,824	11,041
Apportion to DREAM	6,710	6,865	7,023	7,184	7,360	7,508
Apportion to company's own mark	3,290	3,335	3,381	3,428	3,464	3,533

iii. Step 3 - Compute the Return (%) on the Company's Own Trademark

In the year 2014, the company's own trademark sales revenue was RM3,636. The sales revenue minus the production cost (RM 3,091) gave the gross margin (RM 545). Assuming the return of assets was 8% (RM3,290), the charge of the

assets for the company's own trademark was RM263 (RM3,290 X 8%). The return after the asset charge for the company's own trademark is RM157 (4.31%). The computation for the return of the company's own trademark projection for the year 2015 and subsequently is illustrated in Table 6 below:

TABLE 6
Computed % Returns on Company's Own Trademark

Return of company's own mark (RM000)						
	2014	2015	2016	2017	2018	Terminal
Sales revenue	3,636	3,709	3,783	3,859	3,936	4,014
Production costs	3,091	3,152	3,215	3,280	3,345	3,412
Gross margin	545	556	567	579	590	602
Tax	125	128	131	133	136	139
After tax projected cash flow	420	428	437	446	455	464
Charge for use of assets (8%)	263	267	270	274	278	283
Return after asset charge	157	162	167	172	177	181
Company's own mark, % of sales	4.31%	4.36%	4.40%	4.45%	4.50%	4.50%

iv. Step 4 - Compute the Excess Return of the Company's Trademark to the "DREAM" Trademark

In order to compute the excess return of the "DREAM" trademark, use the formula in Table 6. This formula is used for the "DREAM" data on the trademark sales, production costs, marketing costs, and charges for use of the assets. After the return of the assets charge is calculated, the next step is to deduct the return on the company's own trademark (% calculated in Table 6 multiplied with the sales of the "DREAM" trademark). Table 7 provides the computed excess returns of the company's own trademark to the "DREAM" trademark.

TABLE 7
Computed Excess Returns of Company's Own Trademark to "DREAM" Trademark

	2014	2015	2016	2017	2018	Terminal
Sales revenue	21,008	21,638	22,287	22,956	23,645	24,118
Production cost	6,302	6,491	6,686	6,887	7,093	7,235
Gross margin	14,706	15,147	15,601	16,069	16,552	16,883
Marketing	2,448	2,497	2,547	2,598	2,650	2,703
Cash flows (pre-tax)	12,258	12,650	13,054	13,471	13,902	14,180
Tax	3,065	3,163	3,264	3,368	3,476	3,545
After-tax cash flow	9,439	9,741	10,052	10,373	10,705	10,919
Charge for use of assets	537	549	562	575	589	601
Return after asset charge	8,902	9,192	9,490	9,798	10,116	10,318
Return on company's own mark	905	943	982	1,022	1,064	1,085
Excess return on DREAM trade mark	7,997	8,249	8,508	8,776	9,052	9,233

v. Step 5 - Compute the Net Present Value of the "DREAM" Trade Mark

All the excess returns calculated in Table 7 are then calculated by weighted average cost of capital (WACC) to get the present value of the "DREAM" trademark. All the present values are added to get the net present value or the value of the "DREAM" trademark. Table 8 illustrates the computation of the net present value of the "DREAM" trademark. From the computation below, the value of the trademark is RM 159,138,000.

TABLE 8
Computation of the Net Present Value of the "DREAM" Trademark

	2014	2015	2016	2017	2018	Terminal
Excess return on DREAM trade mark (RM'000)	7,997	8,249	8,508	8,776	9,052	9,233
Terminal Multiple						14
Terminal Value						128,154
Discount rate	13.90%	13.90%	13.90%	13.90%	13.90%	
Time	0.5	1.5	2.5	3.5	4.5	
Discounted factor	1.07	1.22	1.38	1.58	1.80	
Discounted returns	7,474	6,761	6,165	5,554	5,029	128,154
DREAM trade value	159,138					

It is worth noting that the assumptions used in the valuation of the "DREAM" trademark (Step 1 to Step 5 above) by using the Profit Split - Excess Earnings Method are as follows:

i. Inflation/Terminal growth rate is 2%;
ii. Tax rate is 25%;
iii. Assets employed in the company is RM 10,000;
iv. Return on assets is 8%;
v. Discount rate is 13.9%;
vi. Valuation date is 1 July 2014.

LIMITATIONS OF THE INCOME APPROACH

The income approach captures the value of relatively stable trademarks by means of a predictable cash flow. Although this method is the most accurate method for the valuation of trademarks, the stability of the earnings is never guaranteed. This method assumes that the cash flow is irreversible and is irrespective of future circumstances. The cash flow of future earnings is developed using the weighted average cost of capital (WACC), which is merely a mechanical valuation tool. All the risks are lumped together and assumed to be appropriately adjusted for the discounted rate and the probability of success. The use of WACC, subject to changes in inputs, would result in large changes in the value of the trademark. Hence, the trademark value may change over time, leading to uncertainty.

The Financial Reporting Standard (Para 63, FRS 138, 2006) does not allow internally generated trademarks to be recognised as intangible assets in financial statements. In a company's financial statement, the trademark is only recognised as the amount of cash or cash equivalents paid or the fair value of other considerations given to acquire an asset at the time of its acquisition or construction (Para 8, FRS 138, 2006). Therefore, the value of the trademark is hidden in the presentation of a statement on the financial position. The valuation done by an entrepreneur cannot be used due to constraints in the standard.

The information needed for valuation comes from an entrepreneur's accounting records and is identified internally. If entrepreneurs do not have internal experts in this area, there are experts available who are highly experienced in analysing financial data including revenues, profits, return on assets, and the apportionment of trademark value among other contributory assets.

CONCLUSION

The valuation of trademarks for entrepreneurs is vital for a number of reasons. First, it greatly strengthens the perception of the importance of trademarks in the business environment. Second, the trademark lends as much credibility to the entrepreneur as any other property. The trademark valuation clearly provides unambiguous signals to a third party of its value and the effects of damaging the entrepreneur's rights. Apart from the above reasons, valuation has become important because it helps entrepreneurs exploit their trademark through licensing and other means of trading, such as issuing securities, increasing asset value, obtaining financing and making informed investment and other business decisions. Entrepreneurs are guided to use the valuation format for the profit split-residual earnings valuation method under the income approach. Nevertheless, the profit split-residual earnings valuation method is not an answer for all valuation problems. Valuers still face difficulties in estimating the income attributable to the trademark, namely its economic life, appropriate discount rate or cost of capital and discount rate. Hence, fair market valuation is only an estimate, and it will not be accurate until the actual transactions occur such as damage decisions, sales and purchases. These transactions occur at specific times and require that certain decisions be made. Furthermore, even the trademark values in financial statements is questionable because they are not challenged.

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