Capitalising intangibles such as brand-names can be a useful balance-sheet tool for companies looking to borrow. Paul Mather and Ken Peasnell examine the effect on share prices.

The late 1980s saw an increasing number of Australian and UK companies valuing identifiable intangible assets such as brand-names and mastheads and placing them on their balance sheets. A report on brand-name valuations by Ernst & Young in 1989 indicated that 30 of Australia's top 150 companies capitalised some amount for brand-names, mastheads or other intellectual property in their balance sheets. The report suggested that this was an increasing trend.

News Corporation Ltd provides an illustration of the substantial impact that the capitalisation of identifiable intangibles can have on the balance sheet of a reporting entity. Mastheads were valued in the company's 1991 balance sheet at $13 billion — almost three times its market capitalisation! Including mastheads on the balance sheet improved News Corporation's gearing (debt-to-total-assets) ratio from 90 per cent to a more respectable 43 per cent.

The Australian Accounting Research Foundation (AARF) issued ED49 Accounting for Identifiable Intangible Assets in August 1989. ED49 covered not just brand-names but other identifiable intangibles such as mastheads, licences, patents, intellectual property and trademarks, and allowed companies to capitalise the value of acquired and internally generated identifiable intangible assets (such as brand-names) but required amortisation over their economic useful life. However, ED49 was withdrawn in March 1992 because of a lack of consensus on the national and international fronts.

There has been little, if any, empirical research in this area. This article provides evidence about the impact of the disclosure of brand values on share prices of UK companies, and about some of the motives for capitalising brands. An evaluation of the share-price effects is particularly relevant in the light of the claim frequently made by companies that omission of brand-names from the balance sheet has led to undervaluation by the market and consequent increased vulnerability to hostile takeover bids. (A fuller, more technical account of this study can be found in the British Journal of Management, Vol. 2, 1991.)

The hypotheses

Many reasons are given by companies for recognising brand-names as an asset in the balance sheet. Two of the more common assertions are that recognition will result in:

- recording otherwise "hidden" ass-
sets on the balance sheet so as to provide information which may be of benefit to users of financial reports; and deterring possible takeover bids, on the premise that investors would otherwise undervalue the company.

These assertions assume that users of financial reports will ignore, or at least not take full account of, the value of brand-names unless they are recognised in the balance sheet.

This assumption implies a degree of investor irrationality contrary to the Efficient Market Hypothesis, which proposes that share prices accurately reflect available information and respond rapidly and appropriately to new information. While this is difficult to establish at an individual security level, studies fairly consistently support the existence of a broadly efficient and competitive stockmarket, where a wide range of information (accounting and other data) is taken into account in setting share prices.

The key question that therefore needs to be asked is whether valuing and placing brand-names in the balance sheet gives the market any information additional to what has already been factored into share prices.

Few people would dispute that the market will attribute some value to brand-names such as Fosters and Castlemaine XXXX whether or not they appear in the balance sheet. It seems unlikely, however, that there would be new information of any significance, given the limited information disclosed in support of brand-name valuations. Typically, this amounts to a single valuation figure and a brief outline of the broad methodology used without any details of the relevant earnings or cashflows used in the valuation or the capitalisation rate. Accordingly, it is hypothesised that there is no positive association between brand valuation announcements and share-price revisions.

Accounting numbers also serve a contracting function. Some examples of contracts where accounting numbers are frequently used are debt contracts, management bonus plans, articles of association and stock-exchange listing rules.

Debt covenants and the process of negotiating debt finance provide a motive for brand capitalisation. Loan agreements (or articles of association) often contain restrictive covenants — for example, by placing a ceiling on the company's gearing ratio computed from its annual accounts. This could make life difficult for an enterprise which is increasing borrowings to finance internal expansion or the acquisition of firms with high growth potential.

The company could, of course, attempt to renegotiate the restrictive covenants, but this may incur costs (eg, increased interest rates on existing loans and new restrictive covenants). For example, in early 1989 a minority shareholder resisted Cadbury Schweppes PLC's attempt to increase borrowing limits set out in its articles of association. It took three general meetings and several months (not to mention considerable adverse publicity) before the necessary resolution was finally approved.

Capitalisation of brands might be a cost-effective means of circumventing such restrictions. It is worth noting that Cadbury Schweppes, which had not capitalised the value of its brands at the time of that incident, now does so.

Ideally, research would try to determine the extent to which debt covenants of the kind discussed above exist, whether or not they exclude intangibles in the calculation of the ratios, the likelihood of their being breached and the costs of both breaching and renegotiating them. This is extremely difficult to do.

We follow the conventional approach of assuming the existence of costly debt covenants and postulating that breach is more likely the higher the company's level of debt. Accordingly, we hypothesise that companies capitalising their brands have higher gearing ratios than similar non-capitalising companies.

Stock-exchange regulations provide an additional contracting motive for brand capitalisation. Section 6 of the International (London) Stock Exchange's Yellow Book states that where the fair value of the assets being acquired (or disposed of) exceeds the book value of the net assets of the acquiring (disposing) company by 15 per cent or more, the transaction is deemed a Class I transaction and the company will be required to send a Class I circular to its shareholders.

Apart from its direct costs, the process of compilation and obtaining stock-exchange approval can occupy a considerable amount of senior management time. It is therefore reasonable to assume that companies will try to ensure that transactions do not fall into the Class I category.

This is by no means unique to the UK. For example, Listing Rule 3(3) of the Australian Stock Exchange imposes various requirements on companies engaging in related-party transactions where the consideration is more than 5 per cent of shareholders' equity.

Whether a transaction will cross the threshold depends on the circumstances. But, clearly, the greater the ratio of unrecorded intangible assets to tangible ones, the more this is likely to occur.

One way of measuring the existence of intangibles is to compare the market value of the company's shares with the book equity. This method can be used to test what might be called the Shareholder Approval Hypothesis that companies which capitalise brands have lower book-equity-to-market ratios than similar non-capitalising companies.

The study

Thirteen listed companies in the UK were identified as having capitalised brands some time during the period 1986-89. Most of these companies offered as a main reason for capitalisation their opinion that the capital market placed insufficient weight on their brands and mastheads.

The following procedure was adopted to allow for the non-random occurrence of brand capitalisation. A "control" company which did not capitalise brands was selected for comparison with each "treatment" company which did so. The aim was to pair companies which were as alike as possible with respect to extraneous variables (industry membership, size and accounting policies) which might influence the comparisons.

Although risk was not explicitly used as a matching criterion, it should be noted that mean "beta" for the
capitalising firms (1.01) was almost the same as that of the controls (0.94).

Results

The share price reaction during the four weeks surrounding the announcement of brand capitalisation (two weeks before and two after) was determined by comparing the actual return (dividend and capital gain) of each company with its expected return in the week in question. These weekly abnormal returns were summed week by week to form a picture of the cumulative "abnormal" return an investor would have obtained during this period.

Expected returns were computed in two different ways to check the sensitivity of the results: first, by reference to the Capital Asset Pricing (CAPM) model, where beta is used to allow for differences in systematic risk between companies; and, second, a simplified version of the CAPM where beta is assumed to be equal to one—which is equivalent to treating the return on the stockmarket in general as the expected return for each company.

The patterns of cumulative abnormal returns (CARs) for brand-capitalising companies over the four-week period can be summarised as follows: allowing for differences in risk makes virtually no difference to the results. In both cases, positive excess returns of about 2 per cent are observed in the week of announcements. The CARs are positive throughout the four-week period, a result which seems to suggest that either the market had previously been under-valuing the treatment companies or that brand capitalisation is viewed by the market as a value-enhancing event. (As the CAPM refinements add very little, we report only the results for the simplified version in the remainder of this article.)

One possible reason for the observed differences in share price reactions across firms could be that they are a positive function of the increase in reported assets caused by capitalising brands. To examine this possibility, the percentage increase in net assets resulting from putting brands on the balance sheet was computed for each company and the companies were grouped on this basis into four equal-sized "impact" portfolios.

Although the grouping technique results in very small portfolios, results lend some support to the hypothesis that the greater the valuation increase, the larger is the price reaction. For example, the portfolio where brand capitalisation had the smallest impact on net assets (13 per cent increase) had the lowest abnormal return in the announcement week (0.5 per cent), whereas at the opposite end of the spectrum the portfolio where brand capitalisation had the greatest impact (299 per cent increase in net assets) had the largest price impact (2 per cent increase).

There is a possibility, of course, that the price reactions (such as they are) stem not from the brand capitalisations but from other information released at the same time. The results were therefore partitioned according to (a) unexpected earnings (calculated by comparing reported earnings with the latest IBES consensus analysts' forecasts) and (b) other contemporaneous news.

Again, the samples are too small for the results to be anything but suggestive, but they paint a somewhat different picture. The price reaction was stronger, for example, for the portfolio with particularly good earnings results, notwithstanding the fact that brand capitalisation had a much smaller proportionate effect on net assets than was the case for the portfolio with less-favourable earnings news. The price reactions in two other cases were much more strongly associated with the publicity associated with cash acquisitions in process at the time than with brand capitalisation.

This analysis suggests that price gains occur only when the brand capitalisations are accompanied by some other favourable signal about the company's prospects.

Data for the "contracting" tests were computed as follows:

Gearing ratios were computed for all "treatment" and control companies using the numbers reported in their annual accounts. The treatment companies' gearing was also computed on an "adjusted equity" basis, by eliminating the portion of reserves attributable to the valuation of brands. Debt is defined as short and long-term borrowings, including financial leases, less cash and bank balances. Equity includes minority interests. Gearing is expressed as the ratio of debt to debt-plus-equity. Book equity/market ratios were calculated for all treatment and sample companies, with book equity again being measured on an "adjusted" basis.

The gearing ratio results can be summarised as follows:

The effect of capitalising brands is to reduce reported gearing ratios: median ratios with and without capitalisation are 33.9 per cent and 21.0 per cent respectively.

The more interesting question is whether the treatment companies' gearing ratios without brand capitalisation tend to exceed those of the non-capitalising controls. The median
ratio of the former is 33.9 per cent and the latter's is 23.5 per cent. The effect of brand capitalisation is generally to eliminate the gap between the treatment and control samples, although the median ratio of the capitalisers remains slightly smaller than that for the non-capitalising controls — 21.0 per cent compared with 23.5 per cent.

These results provide strong support for the debt covenant hypothesis. Brand capitalisation is an accounting technique which appears to be effective in eliminating the difference between the gearing levels of capitalising and non-capitalising firms.

The book-to-market valuation results can be summarised as follows:
- The effects of brand capitalisation on the valuation ratios are very marked: the median ratio increased threefold. Moreover, the median valuation ratio without brands is 21 per cent for the treatment companies and 35 per cent for the controls, indicating very clearly that the capital market is very well aware that companies have substantial intangible assets. Intangibles and growth prospects (together with unrecorded valuation gains on tangible assets) typically amounted to more than twice the book value of net tangible assets. Brand capitalisation removed about half of this discrepancy.
- The results provide some support for the shareholder approval hypothesis. Nine of the treatment companies had lower ratios than their controls and (as noted above) both the mean and median is smaller for the treatment group than for the control one.

One possibility which needs to be considered is that early adopters of the brand capitalisation technique are systematically different from late adopters. To explore this possibility, we split the treatment sample into two sub-samples, according to whether capitalisation occurred before or after the controversy over brand capitalisation became public in August 1988.

The median gearing ratios of the early adopters, computed without brands, are not much higher than those of their controls (30 per cent compared with 26 per cent) but late adopters are more heavily geared (34 per cent compared with 22 per cent).

The picture is the same with the valuation ratios, late adopters having substantially lower ratios than their controls (32 per cent compared with 61 per cent) where early adopters are not (both 26 per cent).

These results suggest that whereas the early adopters capitalised brands for a variety of reasons not necessarily connected with the contracting hypotheses, the publicity surrounding the capitalisation debate alerted corporate managements to the usefulness of the technique as a means of avoiding covenant restrictions or stock-exchange requirements.

Finally, if the contracting costs avoided by brand capitalisation are real, we would expect such avoiding actions to be reflected in share prices. Evidence of this was discovered: abnormal share returns were positively (albeit weakly) correlated with the capitalisation-induced changes in gearing and book-to-market ratios.

The results of this study do not support the common assertion that the stockmarket systematically undervalues companies with large investments in intangible assets. There is some indication that share-price gains were marginally related to the size of the change in book values brought about by capitalising brands, but there is reason to believe that this relationship is largely spurious and disappears when allowance is made for the simultaneous release of other information.

Brand capitalisation markedly lowered reported gearing ratios and, certainly in the case of late adopters, capitalising firms had noticeably higher gearing levels (before capitalising brands) than did their controls. Brand capitalising firms have lower book-to-market-equity valuation ratios than their controls, again particularly so in the case of late adopters. The results are therefore consistent with the debt covenant and shareholder approval hypotheses.

Despite the lack of support for the suggestion that the market systematically undervalues firms with unrecorded intangibles, it is clear from the pressure placed on the accounting profession, not to mention the costs incurred by the firms concerned, that managers of brand-heavy companies consider the absence of brands from their balance sheets to be a serious matter. The reason for their enthusiasm to capitalise brand values might lie in the contracting role played by corporate financial reports.

New age for ADRs

Another indication of the dramatic increase in ADR activity came with the SEC's decision to seek comments from the industry on regulatory matters affecting ADRs. Issues under examination include qualifications of depositaries; the adequacy of information about issuers of securities underlying ADRs; and, perhaps most significantly, the question of approving both sponsored and unsponsored ADRs in a single stock.

The latter issue was triggered by a filing by Security Pacific seeking to create an unsponsored program for the West Australian mining company Sons of Gwalia, which already had a sponsored program with a US bank. Although not specifically prohibited by any current regulation, the dual-tracking question had not been raised previously because most depositary banks believed the agency would not sanction the arrangement.

Another development encouraging to participants in the ADR market is the increasing interest being shown in dividend reinvestment programs by ADR holders. Like similar programs used in direct share ownership, they have given the market an important boost. Haslingden argues that dividend reinvestment programs are only one example of the potential flexibility and usefulness of sponsored ADR programs.

ADR trading does not constitute the full trading of non-US securities. A Gavin Anderson survey of institutional investors' preferences in trading vehicles showed 51.2 per cent preferred ADRs, 26.4 per cent preferred ordinary shares and 22.4 per cent were happy with either. But all indications are that growth in the ADR market will expand as the rising tide of interest in overseas investment continues.