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# VALUATION OF TRADENAME

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*This thought leadership paper provides insights on valuation of tradename acquired in a business combination*

## INTRODUCTION TO TRADENAME

Tradenames are words, names, symbols, or other devices used in trade to indicate the source of a product and to distinguish it from the products of others. At its essence, a trademark is an economic tool to help consumers to assess the quality of goods and services in making a purchase decision based on the reputation of the manufacturer or seller. Indeed, it's oftentimes hard to imagine a McDonald's without the golden arches, a Nike without the "swoosh," or Apple without, well, an apple. Tradenames can have far-reaching effects and can be a determining factor of income to one's business. Thus the tradename associated with companies is one of the most important intangible assets that the company possesses.

Whether it's the name of an entire business or a single product, tradenames can represent substantial value in business combinations and are recognized as a marketing-related intangible asset under IFRS 3: Business combination<sup>1</sup>.

## HOW FREQUENTLY IS A TRADENAME RECOGNISED AS AN INTANGIBLE IN A PURCHASE PRICE ALLOCATION?

According to the 2019 and 2020 Houlihan Lokey PPA Study, approximately 58% of the transactions allocated purchase consideration ('PC') to tradenames. The median allocation of the purchase consideration to tradename was around 3% through 2018 to in 2020.

Also, per the study, tradenames are the most common intangibles to be considered as indefinite-lived assets.

## SHOULD YOU RECOGNIZE TRADENAME AS A PART OF YOUR PURCHASE PRICE ALLOCATION EXERCISE AS PER IFRS 3?

In determining whether a tradename should be recognized separately from goodwill, the acquirer should evaluate whether the asset meets either of the following criteria:

- **Contractual-legal criterion**

*Tradenames are legally protected through registration with governmental agencies or other means. Registered or unregistered, if it is legally protected, then a tradename acquired in business combination meets the contractual-legal criterion.*

- **Separability criterion**

*If tradenames are not protected legally, but there is an evidence of similar sale or exchange, the tradenames would meet the separability criterion.*

<sup>1</sup> International financial reporting standards - IFRS 3: Business combinations

**Initial recognition**

Tradename acquired in a business combination is capitalized (separately from goodwill) at fair value as per guidance laid down in IFRS 3.

**Useful life**

The estimation of useful lives of tradename is generally based on the following factors:

- contractual or other legal terms
- plans for use of the assets and
- cost of renewing the lives of the assets.

The useful life may change or terminate before the end of their contractual lives due to changes in operating plans, brand strategy, acquisition or disposition of businesses and legal action, among other circumstances.

Legally, no restrictions exist as to the limitation of the registration of a trademark over time and its continual renewals. Therefore, tradenames are typically considered to have an indefinite life unless the company has an intention to discontinue the use of tradename in near future.

**Impairment test**

If a tradename is classified as an indefinite-life intangible then it is not amortised but annually tested for impairment per guidance given in International Accounting Standard ("IAS") 36<sup>2</sup>.

**VALUATION GUIDANCE**

The value of tradename acquired in the course of business combination is a function of many factors. Typically, the revenue associated with such tradename right, as well as the relevant discount rate, useful life assumptions, applicable royalty rate, profit margins, risks, and market conditions together determine tradename values.

Tradenames are valued using a range of methods. These methods can be broadly classified into three general approaches: the Income, Market, and Cost based approaches

APPROACH	VALUE INDICATION	INFORMATION
Income approach	Present value of future economic benefits from use of the tradename rights.	<ul style="list-style-type: none"> <li>• Earnings forecast</li> <li>• Reasonable royalty rates</li> <li>• Contributory assets</li> </ul>
Market approach	Observable transactions of similar tradename rights.	<ul style="list-style-type: none"> <li>• Transactions of similar tradename right</li> </ul>
Cost approach	Cost a market participant would incur if they were to create the utility of the asset themselves.	<ul style="list-style-type: none"> <li>• Historical costs</li> <li>• Costs to replicate utility</li> <li>• Price Index</li> <li>• Obsolescence assumption</li> </ul>

One of the most prevalent methodologies for valuing trademarks is the relief from royalty method, a variant of the income approach. It estimates the expected royalty savings attributable to the ownership of the intangible asset. It is a modified application of the income approach which takes into account probabilities of continuing or discontinuing the use of the tradename.

<sup>2</sup> IAS 36: Impairment of assets

## APPLICATION OF RELIEF FROM ROYALTY ('RFR')

The basic tenet of the RFR is that without ownership of the subject intangible asset, the user of that intangible asset would have to make a stream of payments to the owner of the asset in return for the rights to use that asset. By acquiring the intangible asset, the user avoids these payments. The fair value of the asset is the present value of license fees avoided by owning it (i.e., the royalty savings).

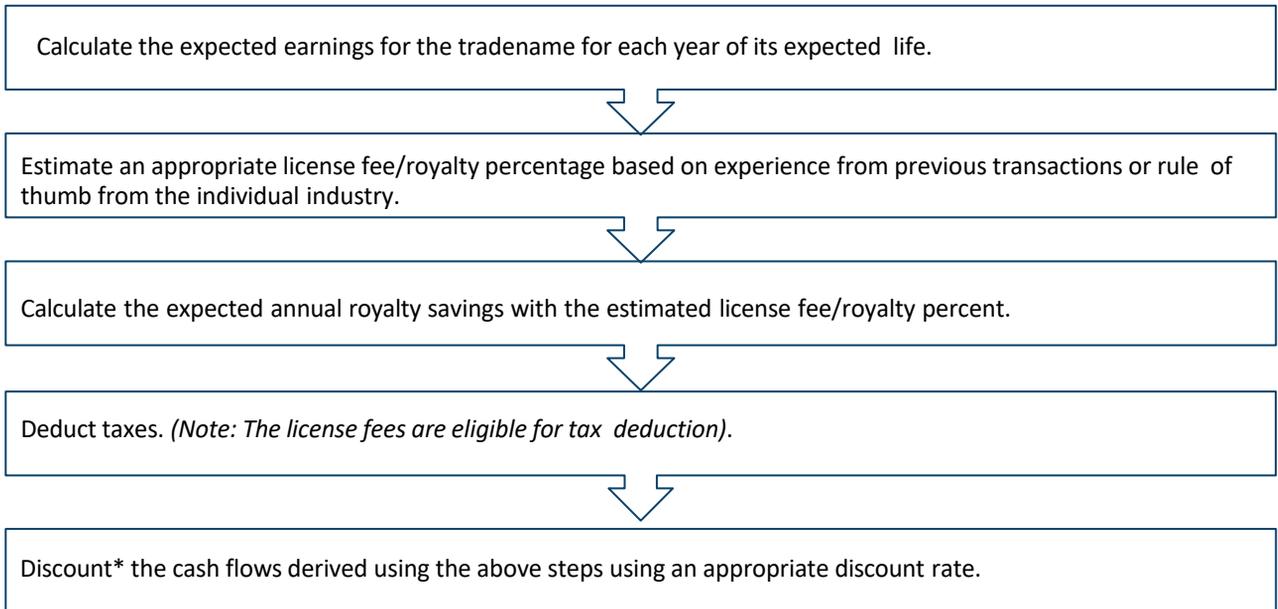
To summarize:



*The royalty savings are the expected cash flows for the subject intangible assets.*

To appropriately apply this method, it is critical to develop a hypothetical royalty rate that reflects comparable comprehensive rights of use for comparable intangible assets. The use of observed market data, such as observed royalty rates in actual arm's length negotiated licenses, is preferable to more subjective unobservable inputs. Market royalty rates can be obtained from various third-party data vendors and publications.

## STEPS FOR RFR METHODS



\*Formula for calculating the value:

$$\text{Current value} = \sum_{t=1}^T \text{Royalties} \div 1 + (\text{Discount rate})^t$$

"T" is the expected lifespan of the tradename (in years), and "t" is a single year.

## ILLUSTRATION

ASSUMPTIONS	
Royalty rate	1%
Discount rate	15%
Tax	19%
Remaining useful life	5 years

DESCRIPTION	2022	2023	2024	2025	2026
Revenue	20,000	22,000	23,650	24,833	25,577
<i>Growth</i>		<i>10.00%</i>	<i>7.50%</i>	<i>5.00%</i>	<i>3.00%</i>
Pre-tax royalty savings	200	220	237	248	256
Less: Taxes	(38)	(42)	(45)	(47)	(49)
After-tax royalty savings	162	178	192	201	207
Present value factor	0.87	0.76	0.66	0.57	0.50
Present value of after-tax royalty savings	141	135	126	115	103
Sum of PV of after-tax royalty saving					620

## CONCLUSION

In general, the value of a tradename is based on earning power of the company, the perception of customers, and the company's industry. While the above discussion is a good base for tradename valuation, there are no generally accepted rules of thumb. As is often the case with intangibles, experience, common sense and reasoned judgment may be the best guides.

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