Towards Valuation,
Measurement
and Disclosure

EFFAS CIC

EFFAS COMMISSION ON INTELLECTUAL CAPITAL

Principles for Effective Communication of Intellectual Capital

EFFAS THE EUROPEAN FEDERATION OF FINANCIAL ANALYSTS SOCIETIES

High time for the financial community to tackle intangibles

In developed economies today the most important factors associated with corporate competitiveness and growth are invisible. These intangible assets – collectively called intellectual capital – range from staff and management skills, software, R&D, brands and patents all the way to strategies, processes, and relationships with suppliers and customers. Yet despite its paramount importance, intellectual capital is still neither reported by companies nor valued by capital markets systematically and broadly. The current state of accounting for a company's assets, developed over centuries according to evolving economic needs, is not synchronised with today's economic reality.

If this less than full treatment of intellectual capital is continued, the associated adverse effects could be far-reaching: the cost of capital could remain inadequately high for many companies (particularly for those innovative, highly knowledge-intensive ones), investors and lenders might risk missing out on potential opportunities, and the economy on potential growth.

This is why EFFAS, the European Federation of Financial Analysts Societies, has taken action. In this paper, we (a) provide a brief overview of the status quo in the valuation, measurement and disclosure of intellectual capital, (b) briefly summarise EFFAS CIC's aims and roadmap regarding intellectual capital, and (c) condense the needs of analysts and investors regarding the communication of a company's intellectual capital into a set of disclosure principles. We hope this helps to initiate further steps towards a meaningful recognition of the most valuable assets of today's companies.

Substantial benefits for companies

Companies that do not systematically analyse their intellectual capital have an insufficient understanding of what really drives their value creation. Companies that do, benefit twofold:

- Firstly, they improve internal investment and resource allocation, as they increase internal transparency and get a better understanding of the returns on investments in intangible assets. Systematically analysing intellectual capital harmonises with other management tools while putting stronger emphasis on measuring the potential for future growth.

- Secondly, these companies can far better communicate their true strengths to various stakeholders, including customers, partners, the talent market, and providers of capital. That is, they can stand out from the crowd. An efficient way to do so is to publish an "Intellectual Capital Report". Such a report provides an overview of a company's intellectual capital using indicators and narrative amendments.

Action needed on many fronts

In order to make the analysis, reporting, and valuation of intellectual capital standard procedure, action is needed on many fronts. Not only must companies learn to analyse and report their intangible assets more systematically, but also financial analysts and investors have to be able to interpret this additional information and to efficiently integrate it with their existing valuation procedures.

In the pursuit of these goals, all relevant stakeholders have started pushing ahead in recent years. Academia has developed and tested various valuation methods. Governments – especially in Europe and Japan – and supranational organisations like the European Commission and the OECD have developed guidelines on IC-reporting, promoted the development of valuation tool kits and the realisation of pilot studies. Many companies took part in these pilot studies, evaluating and publishing Intellectual Capital Reports (currently some 150 to 200 companies in the Scandinavian countries, Austria, Australia, Germany, Italy, Japan etc.). Accounting standard setters are considering if and how to integrate more information on intangibles into traditional company reporting.

Capital market actors are strongly committed, too: as owners of a company's shares, investors (and their agents) increasingly demand more relevant information on its future prospects. For instance, the Enhanced Analytics Initiative, an influential group of investors and asset managers, now offers prizes for more in-depth information on "material extra-financial issues" in financial analysts' reports. And in 2006, based on previous work within national analysts associations and elsewhere, the European community of financial analysts established the Commission on Intellectual Capital (CIC) under the aegis of EFFAS.

European financial analysts on the move – CIC's road map

The aims of EFFAS CIC are (a) to promote the measurement and disclosure of intellectual capital by companies, highlighting financial professionals' needs and expectations regarding the reported information, (b) to promote standardisation of the disclosure format to keep additional costs to a minimum and facilitate inter-company benchmarking, and (c) to foster the valuation of the information on intangibles by financial analysts, boosting the required expansion of their valuation competencies.

To do so, the CIC is aggregating existing intangibles expertise among European analysts and is building a world-wide network of experts. Based on this unique pool of knowledge, the CIC:

– spreads the word within its European community of analysts,

– provides input outside of this community on financial analysts' and the wider capital market's role and requirements in the disclosure and valuation of intangibles (e.g. through active participation in national and international workshops and conferences),

– cooperates and coordinates its activities with supranational organisations such as the OECD,

– develops principles for the disclosure of intellectual capital that ensure that the reported information is in line with capital market demands and, based on these principles,

– aims to develop sets of sector-specific indicators of crucial intangibles as the financial communities' initial contribution to collaborative further development by all relevant stakeholders (including, among others, disclosing companies and standard setters).

We regard input from the financial professionals side as crucial, as broader reporting of intangibles will benefit company valuations (and thus help reduce overall information asymmetry) only if such reporting is regarded as useful by the financial community. In the following sections, we thus provide a brief overview of how intellectual capital should be disclosed in order that it is truly meaningful to analysts and investors.

Ten principles for the disclosure of intangibles – our perspective

In order to provide a guide for the development of sector-specific sets of indicators of intellectual capital, we developed ten principles. For indicators to be useful for the financial community they should comply as closely as possible with these principles. They condense the needs that analysts and investors should have if they are to integrate information on intangibles into their company ratings. The principles are based on the already substantial body of research on intangibles, our own experience as practitioners, and general criteria for meaningful indicators.

1. Clear link to future value creation

The indicators should enhance the basis for decisions of both internal and external parties. Only those indicators that are also used for internal management are relevant for investors. To that end, indicators should exhibit a clear link to the company's future value creation.

More specifically, analysts and investors are interested in indicators directly related to a company's operating and/or financial market performance. It might be necessary to further clarify this link in a narrative way. In addition, an ideal indicator would be one that could be "modelled", i.e. included in quantitative valuation frameworks.

2. Transparency of methodology

Companies should explain how they have built up the indicators disclosed. "Easy to measure" often means "easy to understand" and thus effective in communication. The calculation method should be derived from the internal management system. This helps to ensure that the benefit attributable to the use of the indicator exceeds the cost for obtaining the information.

3. Standardisation

A transparent methodology facilitates a more fertile discussion with analysts about the company's potential and performance. The resulting deeper understanding in turn enables analysts to compare different indicator approaches. Eventually, market forces would then lead to the emergence of a "market best practice" in the calculation and disclosure of intellectual capital indicators. This is a crucial step: only standardised intangibles indicators can be benchmarked between companies, and only benchmarked indicators are truly useful.

For the time being, we would prefer the market-driven approach to the imposition of mandatory standards at a detailed level, as flexibility is still needed for collaborative experimentation including both companies and analysts/investors. Ultimately, we believe indicator standardisation should exhibit three levels of specificity: indicators on the low level should be generally applicable, i.e. they should be relevant for most or all sectors and companies; indicators on the middle level should be those specific to a certain sector (using a sector taxonomy already broadly used in the financial community); indicators on the top level should be those specific to the individual company.

4. Consistency over time

The second possible dimension of benchmarking is to compare today's indicator values to historical ones for the same company. To enable this to be achieved, the set of indicators chosen has to be as consistent over time as possible. When a company decides to replace an indicator, a rationale should be given (for instance, to align it to a change in the company's strategy).

As long as standardisation has not progressed sufficiently, there is a risk of "indicator moral hazard". We should strive to help companies counter the obvious temptation to replace indicators with new ones that currently seem to portray them more favourably.

5. Balanced trade-off between disclosure and privacy

Indiscriminate disclosure of information on intellectual capital could, in some cases, result in competitive disadvantages. It is thus indispensable to search for the right balance between the disclosure of intellectual capital and privacy issues. The publication of such information should always be preceded by a careful internal management decision process.

6. Alignment of interests between company and investors

Progress in the disclosure of intellectual capital may only be achieved by aligning the interests of the company asked to provide a higher quantity of better quality information to the outside world, and the investor who will use this information within his or her valuation framework. Where complete alignment proves difficult, an adequate compromise should be aimed for.

One important issue to be covered is the disclosure/privacy balance discussed above. Another relates to cost/benefit considerations, on the sides of both the disclosing company and analysts/investors.

7. Prevention of information overflow

Analysts and investors are already confronted with a substantial stream of information today. Thus, while there is a clear lack of information on companies' intellectual capital, this information should be focused on the most crucial indicators. Only then will analysts and investors be able to work with the additional information on a day-to-day basis and closely integrate it into their valuation frameworks. Corporates should also favour relevance rather than quantity when publishing a separate Intellectual Capital Report.

8. Reliability and responsibility

As with any reported piece of company information, information on intellectual capital should, of course, reflect the "true" corporate situation. Both the choice of indicators and the calculation of their values should be objective in portraying the company's potential. Moreover, the indicator values should be verifiable: it should be possible to track the sources of information in order to check the accuracy of the disclosures (which also implies the need for transparent indicator calculation methods; see principle 2).

On a more practical note, information on a company's intellectual capital should be a true and fair expression of its existing internal measurement system or the result of a custom-made, transparent assessment process. The latter could be conducted either internally or by third parties. In addition to external assurance, the assignment of internal management responsibility (at board or senior management level) for the information disclosed will be necessary.

9. Risk assessment

Where feasible, disclosed information on a company's intellectual capital should be accompanied by an assessment of the risks inherent in each indicator. This should include those possible future events and their associated probability that might endanger a company's operating performance. For instance, with reference to human capital, this refers to the risk of key employees leaving the firm. Risks are obviously higher when such key personnel have confidential and/or strategic knowledge. Another important example would be the risks to a company's reputation.

10. Effective disclosure placement and timing

Finally, information on a company's intellectual capital should be communicated through both efficient and effective channels, and with an adequate frequency. In our view, an appropriate place for broader information on a company's intellectual capital, as discussed in this paper, would be the "Management Commentary" (or "Management Discussion and Analysis") within the annual report. Here, intellectual capital indicators can and should be embedded in the narrative where necessary to clarify their meaning and form a link to the company's future value creation. The publication of a separate Intellectual Capital Report in the context of the company's whole reporting system is another possibility to be considered.

Both of the ways outlined above would suggest a publication frequency synchronised with the annual report. External stakeholders might, however, ask to be provided with information on some particularly important indicators of intellectual capital (or the associated risk assessments) on a more frequent basis.

We would not rule out the notion of integrating broad information on intellectual capital into either the balance sheet, the profit and loss or the cashflow statements, this being subject to valuation from accounting standard setters and the broader stakeholder community.

Our future plans

Creating a virtuous circle

By fostering the measurement, disclosure and valuation of companies' intellectual capital, we hope to trigger a virtuous circle, as follows:

– A company gets used to efficiently measuring and managing its intangible value drivers (thereby boosting the efficiency of internal resource allocation),

– by subsequently disclosing such drivers to the market, the company raises its external visibility,

– which yields a more adequate external recognition of its true potential for (future) value creation,

– if the company is rich in intellectual capital compared to its peers (and similarly positioned otherwise), this enhances the company's overall external valuation and reduces its cost of capital relative to its competitors,

– this in turn (1) creates further incentives for the company to invest in the analysis and disclosure of its intellectual capital, (2) serves as a role model for other companies similarly well equipped with intellectual capital, and (3) incentivises those companies less well positioned regarding intangibles and/or their management to catch up.

Towards an ambitious – but rewarding – goal

Spreading the word, disseminating disclosure principles and triggering the collaborative development of sector-specific sets of indicators for intellectual capital constitute only the first step on the CIC's agenda. Building on this, we plan, amongst other things, to foster the development of education modules focusing on new valuation techniques for financial analysts in coming years. In addition, we aim to closely collaborate with accounting standard setters on the integration of intellectual capital in (non-mandatory) disclosure guidelines or (mandatory) standards.

Reporting and valuation of intellectual capital will not be standard procedure within a couple of months, however committed the efforts. But we have to start tackling this pivotal challenge now if we want our businesses and capital markets to stay competitive in the knowledge economy – which is around us already.

About EFFAS CIC

EFFAS CIC was founded in 2006 (EFFAS CIC is the Commission on Intellectual Capital of the European Federation of Financial Analysts Societies). It is a standing commission of experts under the aegis of EFFAS.

As of January 2008, CIC members are: Giampaolo Trasi (CIC Chairman, and Deputy Chairman of the Executive Management Committee of EFFAS), Alexander G. Welzl (CIC European Coordinator), Antoine Colonna (Merrill Lynch), Ralf Frank (Deutsche Vereinigung für Finanzanalyse und Asset Management), Andrea Gasperini (Associazione Italiana degli Analisti Finanziari), Teresa Gil (Instituto Español de Analistas Financieros), Jan Hofmann (Deutsche Bank), and Erwin Houbrechts (PricewaterhouseCoopers).

About EFFAS

EFFAS, the European Federation of Financial Analysts Societies, was set up in 1962 as a professional association for nationally-based investment professional associations in Europe. Today, the umbrella organisation comprises 25 member organisations, representing more than 14,000 investment professionals. EFFAS maintains its Head Office in the European financial centre of Frankfurt am Main. The Federation represents the interests of the profession in Europe and is an authoritative counterpart for politicians and EU representatives/ legislative bodies in the fields of professional ethics as well as standards and qualification in investment research, asset and portfolio management, investment advice, etc. As a founding member of the Association of Certified International Investment Analysts (ACIIA®) EFFAS offers the Certified International Investment Analyst (CIIA®) designation. ACIIA® represents over 30,000 investment professionals world-wide.

The opinions offered in this paper represent those of the authors (i.e. CIC members), and not necessarily those of their respective institutions.

Imprint

EFFAS
Einsteinstrasse 5
63303 Dreieich/Frankfurt am Main
Germany
Tel.: +49 (0)6103 - 58 33-48
Fax: +49 (0)6103 - 58 33-35
Mail: info@effas.com
Web: www.effas.com

EFFAS
THE EUROPEAN FEDERATION
OF FINANCIAL ANALYSTS SOCIETIES
Frankfurt am Main

Operational Office:
Einsteinstrasse 5
63303 Dreieich
Germany

Telephone: +49 (0)61 03-58 33-48
Telefax: +49 (0)61 03-58 33-35
Email: info@effas.com
Internet: www.effas.com

www.effas.com