



Intellectual Assets and Innovation: Value Creation in the Knowledge Economy

Ferrara, 20-22 October 2005

Excerpt statement Fritz H Rau

“Corporate valuation is a process that requires both quantitative and qualitative elements, combined with a large degree of knowledge and judgement. As such, information on Intellectual Capital plays an important role in shaping analysts’ conclusions. There is a growing demand for Intellectual Capital disclosure on the corporate side. Investment professionals and their associations as users support this approach and may play an important role in defining the information needed for an effective analysis, thus raising the awareness of the importance of Intellectual Capital Reporting in the financial community. EFFAS supports the growing attention and commitment of its member societies towards Intellectual Capital reporting, which is an issue of the greatest importance for investment professionals”.

“Intellectual Capital and Investment Professionals: The View of the Users”

Introduction

Good morning Ladies and Gentlemen,

Before commencing my speech I would like to do two things:

First, to thank the University of Ferrara and the OECD for inviting EFFAS to express the views of investment professionals on such an important issue as Intellectual Capital reporting; of course, I also congratulate you for the outstanding organisation of this conference.

Secondly, to briefly introduce EFFAS, the European Federation of Financial Analysts Societies. EFFAS is the European umbrella organisation of 23 national analysts societies. It represents more than 14,000 investment professionals in the areas of Equity and Bond Research, Asset and Portfolio management, and Investment Advice.

Our overall aim is to set the standards for investment professionals in the fields of communications, ethics, and qualifications, to actively bring our influence to bear on relevant EU guidelines, and to recognise and respect regional market characteristics.

One of the greatest challenges of the 21st century is protecting the overall prosperity of the population. Europe needs a common financial market to guarantee the competitiveness of its economy and human capital. A smoothly functioning financial market and a high degree of investor confidence are preconditions for this to be achieved.

“Knowledge without integrity is dangerous and dreadful” said Samuel Johnson, the English author and man of letters in the 18th century. EFFAS encourages its member societies to set globally accepted benchmarks for professional behaviour in the codes of ethics. To quote Samuel Johnson again, “Integrity without knowledge is weak and useless”, therefore, we offer qualifications for investment professionals. The global Certified International Investment Analysts designation (CIIA), equips professionals to be able to act competently and with integrity in all areas relevant to their activities.

In the field of accounting, EFFAS’ members, as users, are best positioned to act in developing standards. They are represented in the various national and supranational bodies.

Despite the fact that the quantitative approach to investment evaluation is much more developed than any qualitative approach, EFFAS members are also proactive in these fields. Apart from corporate governance, sustainable investments or corporate responsibility, Intellectual Capital reporting is a topic which is gaining in importance.

I know transparency counts in every form, but not exaggerated up to the point of irrelevance, therefore, time has come to move to the main subject:

Intellectual Capital Reporting

Background: Why investment professionals are interested in IC reporting

The speculative bubble seen at the end of the 1990s and the subsequent crisis suffered by equity markets emphasised, in our view, the limits of the traditional analysis and valuation tools, as well as the shortcomings in standard accounting reporting methods, often incomplete with regard to some fundamental value drivers. We investment professionals believe that these are two sides of the same issue and that, as a result, solving one side (analyses and valuations that are more in keeping with the underlying business operation) leads to the solution for the other side (improving the quality and quantity of information regarding intellectual capital within a business).

The efforts of several professional member associations of EFFAS in recent years were therefore directed towards identifying the most innovative and evolved measurement and valuation methods applied to intangible assets, depending on their suitability to be used either by a company as a tool to manage and control performance, or by an analyst as tools with which to evaluate an enterprise.

These methods enable financial analysts, when they receive an adequate set of information, to value a business more effectively, with reference to both a company's track record in terms of results achieved in the past, and its future growth potential. Consequently, this makes the process by which the value created internally by management is acknowledged and disclosed outside of the company more straightforward.

We thus end up with what we define as a win-win situation: a higher level of disclosure on intellectual capital by management means that the financial analyst is in a position to select the method that is most suitable for his own objectives. Greater ability on the part of analysts to make the company's "Equity Story" more clear-cut (from both a corporate perspective and individual investment perspective) translates into increases in market value for the company (*effectively achieved as a result of the strategic and operating strategies implemented*).

We must not believe that this benefit only concerns listed companies either. Indeed, there are several situations in which the correct valuation of intellectual capital becomes necessary: for example, mergers and acquisitions, stock option plans for management, the measurement of the results attained by individual business units.

Encouraging the use of intellectual capital reporting

The information on IC reporting should, in our view, be regularly integrated into an investor's decision making process. Valuation is not a deterministic process, there is no "black box", where we throw in "numbers" and get out "value". It is, instead, a process that requires quantitative and qualitative elements, combined with a large degree of judgement. Therefore, the information on Intellectual capital may play an important role in shaping the analyst's judgement: for instance, knowing the quality, the seniority and output of R&D personnel may provide support to new product forecasts that, in turn, become revenue forecasts.

Knowing the historical trend of a company's customer satisfaction may help analysts to better forecast retention rates and, again, revenues and profit forecasts. Moreover, reports on Intellectual Capital, may enhance the visibility of a company's business plan: this in

turn would help an investor to make a better assessment of a company's prospects and risk profiles and apply a more appropriate beta and cost of capital in the valuation process.

In short, we feel that more information on a company's intellectual capital may translate into a more appropriate calculation of a company's cost of capital, improving the company's valuation vis-à-vis its peers. This would certainly be a strong incentive to adopt the use of IC reporting. Secondly, professional associations may act in order to develop a higher awareness of the IC reporting issues and to pay close attention to these issues in the investment community.

Towards an harmonisation in the IC reporting and the role of the institutions

The fast development in the debate about Intangible assets in recent years, both in the professional and academic world, has led to a situation where a number of private and public bodies have created different standards and measurement tools.

Some professionals believe that there is a growing need for harmonisation. In our view, however, the utilisation of the Intellectual Capital report among corporates is still at too early a stage to require a "complete standardisation": let's remember, for instance, that it has taken decades for IFRS to be introduced in traditional accounting. Indeed, we should wait for this matter to grow and develop; the implication of it is that we should accept at this stage some discrepancies among different intellectual capital reports. On the other hand, we feel it is more important, at this stage, that corporates should get accustomed to reporting on intellectual capital and start using it as a management tool.

In a second step, they should consider making some of these indicators known to the market: only at that point, would we need a more detailed standardisation. If we try to impose some "stringent rules" now, we would risk jeopardising the development of the instrument. In other words, at this stage, we should favour the "awareness" of the importance of reporting Intellectual Capital in the corporate world, rather than the creation of a detailed "top-down" standard. That should come later in the process.

At present, there are indeed several industry-based guidelines, often developed by consulting firms and research institutes. We feel it is appropriate to start discussing and elaborating some harmonised guidelines; in practical terms, we should assist in:

- 1) sharing guidelines;
- 2) standardisation of contents/indicators (bearing in mind that several of them are "firm specific").

In the future, we would also encourage a gradual convergence with other forms of reporting (e.g. Sustainability report; Social and Environmental report), that sometimes tend to overlap with one another.

We believe that, at this stage, harmonisation could take the form of defining the key areas that should be included into an intellectual capital statement: for instance

1. Strategy
2. Clients and markets
3. Human Resources
4. Process and Innovation
5. Organisation

and other dimensions could well be taken as a benchmark.

The EU may then take a clear leadership in this process. EFFAS approves and fully supports the growing attention and commitment of the European Commission to Intellectual Capital reporting, which is an issue of the greatest importance for investment professionals.

Work done by professional associations

A number of national associations of financial analysts that are members of EFFAS, are paying great attention to issues such as Intangible Assets and Intellectual Capital reporting and have already developed proposals and reporting models. I would like to mention some of the work done by some of the EFFAS member societies in this field, such as the “Recommended Guidelines for additional Information on Value Creation” released by NFF, the Norwegian Society of Financial Analysts and two papers released by AIAF, the Italian Association of Financial Analysts: Reporting Intellectual Capital and Intangibles assets: Measurement and Valorisation methods, followed by several update reports and articles.

Professional associations of financial analysts may play an important role in defining the information needed for an effective analysis, thus raising the awareness of the importance of Intellectual Capital reporting in the financial community. As such, we are ready to bundle our forces and organise an EFFAS working group to take part in the efforts of the European Commission, or other international organisations, such as the OECD, in this field.

Specific issues and requests

In particular, we would like to highlight two points of special relevance for financial analysts, who have the difficult task of valuing a company “as outsiders”, ie. using only publicly available information.

- A. It should be recommended that companies producing Intellectual capital reports are “consistent” over time:** in other words, an investor needs to have consistent historical series, in order to follow the development of certain relevant issues over time. If some indicators are brought into the picture just to be deleted the following year and replaced by other indicators (often, more favourable to the company), this provides very little informative help to an external investor.
- B. Secondly, it should be recommended that companies explain the meaning of the indicators they use, and how they have built those indicators.** Again, rather than “imposing” how to build, e.g. a customer satisfaction index, it should be required that a company explain how certain ratios and indicators are calculated. This allows an analyst to ask better questions, and to make comparisons among different approaches. As a result, market forces would lead eventually to the emergence of a “market best practice” in the calculation and reporting of Intellectual Capital.

Conclusions

To summarise, we are convinced that progress in the disclosure of intellectual capital may only be achieved by clearly aligning interests between the company, asked to provide a higher quantity of better quality information to the outside world (with associated costs), and the investor, who will use this information within his valuation framework.

The virtuous circle that we hope to see is one whereby the company

- first of all becomes used to managing and measuring its intangible value drivers;
- it subsequently raises their visibility by reporting such drivers to the market,
- thereby triggering a greater valuation in respect of competitors;
- this will reduce the cost of capital,
- forcing out and justifying further efforts in terms of communication and transparency in respect of this fundamental component of enterprise value.

Fritz H Rau

Chairman of EFFAS