Point of View

The Importance of Intangible Assets in Corporate Reporting

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"What is essential is invisible to the eye" (from *The Little Prince, A. de Saint-Exupéry*)

Intangible assets certainly represent a major topic in the lively debate on modern company analysis. There is no doubt that brands, employee and management skills, IT systems, R&D activities, corporate processes, and stakeholder relations are crucial to a company's success. Product and service quality, customer satisfaction, innovation, as well as profitability and the ability to leverage market opportunities – in short, a company's capacity for growth and sustainability – depend on these.

While, on the one hand, the traditional Financial Report can be considered as a picture of decisions taken by a company's management in previous years, on the other hand, the Intellectual Capital Report plays a symmetric function: in fact, it allows the reader to anticipate possible developments to the company's balance sheet in future years, as it describes a company's competitive advantages, which should generate future earnings streams.

This awareness is a reflection of the huge changes which have taken place in the last 15-20 years: the change from an economic system where competitive advantages mainly depended on tangible assets ***owned*** by the company, towards the so-called *"knowledge economy"*, where the production of goods and services increasingly depends on intangible resources, to which organisations have ***access***, but not legally guaranteed property rights.

This clearly accounts for the growing interest of the financial community, since the late 1990s, in such issues as the measurement, communication, and appraisal of company intangibles. In this respect financial analysts, who draw the main raw material for their valuations from company information, are becoming increasingly aware of the crucial added value that information on intangible resources provides to their job.

However, while the importance of the new phase of the economic system, based on knowledge, innovation, and, more generally, on intangibles as crucial sources of competitive advantage, is often asserted and enhanced, on the other hand, a severe shortage of organised information – both to markets and, often, within the same organisations – on such critical resources is observed.

Information on intangible resources should, in our opinion, be more regularly integrated into the investors' decision-making process. Corporate valuation is not a determinist process: there are no "black boxes" into which numbers are "thrown" and the correct company value is "extracted". Valuation is rather based on qualitative and quantitative elements, combined with a great deal of subjective judgement, experience, and common sense.

In this respect, a more systematic and better organised disclosure of company intangible resources greatly helps financial analysts develop their judgement: for example, information on the quality, seniority of resources, and output of an R&D department can provide support to forecasts on new products that, in turn, translate into forecasts of future revenues.

Similarly, information on the historical trend of customer satisfaction about a firm's products and services improves the analyst's ability to predict customer retention rates and, subsequently, the firm's profitability.

Finally, information on intangible resources can improve visibility over a new business plan announced by the company: this is even more true for so-called "research-intensive" business segments, as well as for smaller companies approaching the debt market.

Higher visibility over company's perspectives can lead analysts to apply a more appropriate cost of capital in their valuation, i.e. can help the company obtain a more profitable funding cost and smoother access to credit.

For those capable of valuing intangible assets this would result in an important competitive advantage in their profession. However, this raises, in turn at least three crucial issues: 1) the extension and the quality of corporate disclosure on intangible assets; 2) the training and the specific expertise of investment professionals; 3) last, but not least, the need of a gradual harmonisation in the Intellectual Capital reports, so that, sometimes in future, we will all talk the same language when discussing about customer satisfaction or brand loyalty.

Conclusions

The quick development of the debate on company intangible assets in the last few years generated competition among different valuation approaches and measurement procedures adopted by different stakeholders.

In this effort, the rush to come up with responses that, in the proponents' expectations, can "hit first" the target of that race, tends to increase the risk that different proposals may only provide fragmented, partial, or even wrong solutions.

We would therefore welcome initiatives from regulators, aimed at gradually defining shared rules and a common language: we believe that this could bring company best practices to the surface, prevent an harmful proliferation of guidelines, and ensure a smooth convergence towards common standards.

The professional financial analysts associations can play a crucial role in helping define the level of information on intangible resources required to carry out an effective analysis and, more generally, to increase the awareness of this issue in the financial community.

In this respect EFFAS (the European Federation of Financial Analysts Societies), through a dedicated commission known as EFFAS CIC (Commission on Intellectual Capital), is promoting initiatives aimed at disseminating knowledge on company intangible assets and draw the attention of companies and supranational decision-makers on the needs of financial markets in this field.

Since 2007, EFFAS also joined forces with some key world players (including the EBRC in the US; the Japanese METI; the Society for Knowledge Economics in Australia; the OECD; the Universities of Ferrara and Waseda) to create WICI, the World Intellectual Capital Initiative, a private/public sector partnership for improving the reporting of intellectual assets and key performance indicators, aiming at improving capital allocation through better corporate reporting information.

In summary, we believe that progress in communication on company intangible resources can only be achieved through a clear alignment of the interests of companies, required to provide more and better information to the outside (with the relevant costs), and of investment professionals, who will use such information within their valuation frameworks.