

Intangibles Reporting – The Financial Communication Challenge in Response to Corporate Responsibility Requirements

In Search for a Common Language

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Remarks on the article of Alexander Bassen and Ana Maria Kovács

1. The Research Object and its Importance

The theory of efficient capital markets postulates that stock prices always correctly reflect all available information. Consequently, as far as immaterial firm specifics include value implications, those also need to be considered in the determination of a firm's fundamental value or financial perspectives.

Bassen and Kovács document that despite the increasing importance and attention attached to a firm's intangibles, present-time research fails to provide a unanimous, applicable measurement methodology that would allow translating all intangible assets into quantified value determinants. Thus, the authors concentrate on measurement instruments capturing three main facets of intangible value determinants – the environmental, social and government (ESG) issues. Institutional investors are more and more interested in these issues and use information about ESG issues for their portfolio decisions. In reaction to this information demand corporates look for adequate standards to offer capital markets a supply of information on ESG issues. However, communication on this topic deserves a common language – clear definitions of critical terms and even before that a common sense on important content factors.

The newly established standard which the German Society of Investment Professionals (DVFA) recently issued through its Committee on Extra-Financials (190) is an attempt to provide the needed language. Consequently, Bassen and Kovács provide a contextual assessment by comparing the standard to international institutional attempts of developing or advancing measurement standards for intangibles. Is the DVFA approach the adequate standard for financial communication on ESG issues?

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The DVFA approach includes the effort of deducing appraising conclusions on existing valuation frameworks designed for the value impacts of extra-financials. Both value-increasing assets and value-hazarding risks are referred to as intangible firm-value-relevant factors (185). Corporate reputation, for instance, is a critical issue representing both facets of the fundamental value implications of an intangible. Immaculate and strong, it preserves the credibility of a company – which finally becomes manifest in the financial performance of a firm. Damaged and poor, it will automatically impose negative monetary effects.

2. The Value Added by Bassen and Kovács

ESG issues experienced a gain in interest in the recent past, particularly in the context of risk valuation, socially responsible investment or corporate responsibility assessment and are frequently understood as a proxy of management quality (186). However, up to present time, prior research lacks a consistent definition of these attributes. ESG analysis is supposed to deliver additional insight into the future performance of a company – also in terms of financials. Approaches towards holistic capital-market relevant reporting particularly make an attempt of incorporating ESG issues.

For instance the most comprehensive method of evaluating intangibles – the newly founded World Intellectual Capital Initiative (WICI) is intended to harmonize global intangibles' reporting attempts. The concept is based on a multitude of input factors such as reporting frameworks, guidelines and indicators developed, advanced and approved by several international institutions and committees. In contrast, the Japanese Ministry of Economy, Trade and Industry centres past-future relationships to be captured in 38 standardized indicators in its “Guidelines for Disclosure of Intellectual Assets Based Management”. The European Federation of Financial Analysts' Societies Commission on Intellectual Capital issued the “Principles for Effective Communication of Intellectual Capital” that are intended to provide guidelines for sector specific indicators of intangibles. Furthermore, the US SEC encouraged the private sector to develop Key Performance Indicators (KPIs) that comprise and reflect crucial aspects of the company's activities which cannot be captured by its financial statements (189).

Against the background of several more or less comparable immaterial values reporting approaches, the focused method is detailed: The standard of the German Society of Investment Professionals (DVFA) – a “comprehensive framework for environmental, social and governance reporting and key performance indicators”, an addition to the EU Accounts Modernisation Directive. Bassen and Kovács offer convincing arguments in favour of this DVFA standard. For instance, as opposed to other standards, the KPI released by the DVFA also include long-term viability as an aspect besides environmental, social and governmental issues in order to account for possible trade-offs between immediate profits and the perseverance of skills, assets or resources. Moreover, this standard is associated with the advantage of being compatible with traditional reporting standards and formats and of not conflicting with other existing reporting schemes despite its clear distinction. The selection of the KPIs (out of an original list of 600 items) has been effected by an inter-disciplinary commission in charge composed of investors, financial analysts and corporate representatives.

By their comparison Bassen and Kovács provide a long time desired recommendatory approach towards a standardization of intangibles' valuation by means of a thorough and critical comparison of existing methods. The DVFA approach indeed seems to be the best of all immaterial values reporting concepts and therefore an appropriate standard for financial communication on ESG issues. Thereby, it includes urgently required recommendations on tools and frameworks for managers whose everyday business deals with this kind of issues.

Tobias Weller, the analyst of Reputational Risk Management and Sustainability of Dresdner Bank, is perhaps a typical demander of such a concept. He is mainly concerned with the legitimacy of a financial project and its implications for the bank's reputation when deciding on investment activities. In this context, especially corporate governance or corporate social responsibility issues are of utmost importance. Particular financial engagements in critical sectors such as nuclear power or defence may bear immense risk potentials for the reputation of a bank. The application of the ESG KPI might simplify and standardize the decision process on whether the bank could risk getting engaged in a specific investment project or not.¹ General KPIs allow ranking a risky project in the overall track record of projects undertaken – and make it consequently more comparable in an overall context of the bank's total activities. And the application of sector specific KPI provide additional insight into the riskiness of a project controlled for its industry specifics and might thereby reveal helpful information on the risks and opportunities implied.

3. The Unaddressed Risk

Besides providing academically and practically useful information on existing intangibles reporting standard, likewise, Bassen and Kovács take a high overall economic risk: What happens if the suggested standard does not correctly incorporate all the ESG issues that might be part of an overall social welfare function? Obviously, this risk must be rather high in a still early stage of discussion on ESG issues.

For following or favouring one recommended methodology of evaluating immaterial factors, managers might hazard to become oblivious of non-involved, possibly crucial factors. Furthermore, vice versa the consideration of the suggested selected factors might result in a overweighting of their importance in the case that they are already overrated in the recommended proposition. Though, besides clearly emphasizing the advantages the DFVA standards of intangibles' reporting imply, Bassen and Kovács do not miss to keep some critical distance and to point out some shortcomings and weaknesses of the concept (192-193). However, what is missing is a remark on the consequences of a biased measurement concept of ESG issues. To overcome this threat it would be necessary to collect information on a complete consensus of ESG characteristics. Bassen and Kovács were only in the position of comparing and evaluating existing standards from a distance. The likewise practical, overall economic importance of the issue of intangibles' valuation will require a final decision-making process by a broad consensus involving firms, investors, and financial analysts.

¹ Cf. Auler, A. (2008): Reputationswächter: Tobias Weller sorgt bei der Dresdner Bank dafür, dass das Geldhaus seinen guten Ruf bei Kunden und Investoren nicht verspielt, in: Frankfurter Allgemeine Sonntagszeitung, 22nd August, 2008, No. 163, 3.