

Baruch Lev on Intangible Assets

KMM's Alan Kay talks with Baruch Lev, the Philip Bardes Professor of Accounting and Finance at New York University, about instigating change in accounting standards.

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This Q&A with Baruch Levis an extension of the "Movers & Shakers" article from the July 2001 edition of Knowledge Management magazine.

Q: Do people tend to listen to you about measuring intangible assets to a different extent if you're within a commercial context like a consulting firm versus being an academic?

A: Being in academia but also deeply routed in practice like I am, with lots of consulting initiatives, and working very closely with regulators, with the FASB [Financial Accounting Standards Board], with the European Union to some extent, provides some incremental credibility. Maybe not justifiably so, but it gives me credibility over consultants, who are usually viewed as selling something. I appear as someone who does not immediately, at least, want to sell something.

I think what gives me credibility is the amount of research that I'm doing. When I come with an issue, I don't speak about conjectures. I don't speak about a recent case that I have seen or a survey that I did. I speak about solid empirical research. When I started talking six or seven years ago about the terrible impact that intangibles have on the accounting for intangibles has on the usefulness of financial information for investors, I came with empirical evidence based on a sample of 5,000 companies showing the association between earnings and stock returns.

I'm constantly surprised by how open people are to really good empirical evidence, not something that you massage. I have a recent paper, for example, in the Journal of Finance that looks at a sample of 300,000 transactions by insiders-company officers in companies with intensive R&D when R&D is just a measure of an intangible. By trading the stocks of their own companies they earned three to four times more than insiders in companies without R&D. This immediately got coverage in the New York Times and got the SEC looking into these issues. But it comes with the weight of the evidence.

Q: There is sort of a positivistic implication in what you just said. Would you contend that the weight of that evidence is what will move the Securities and Exchange Commission or some other regulating body to change accounting and related standards that apply to intangibles?

A: No doubt about that.

Q: So you think that it is actually the evidence that will make the difference?

A: Yes, and very specific evidence. I will give you what I call the Joe Lieberman case. About three years ago, I got a telephone call from someone who identified himself as the main assistant to Joe Lieberman [the senator from Connecticut]: "The senator heard about your activities in intellectual capital and he wants to know what's going on in this area." Since I wasn't prepared for this phone call, the first things that came to mind were issues of financial reporting and information. The assistant wrote down a few things, then a day later, he called back and said, "The senator asks, where is the damage? Where is the harm?" At first, I didn't even understand the question. Then he explained it to me it and it really had a tremendous effort on what I've done since then.

Basically he was saying that talking about information problems really isn't worth much unless there's a tangible negative impact. To get public policy moved you have to show that there is some kind of damage to people, the economy or the stock market, for instance, if firms cannot raise money. It became clear to me that demonstrating harm is exactly what is needed to move people.

If you can link, for example, information problems to volatility of stock prices, people get excited. Wow, now you're talking business in this case, because we know that volatility is extremely harmful and due to the incredible volatility that we have had in recent months, companies cannot raise funds anymore. Stock capital is very high. People are losing money, losing confidence. To get movement in the public arena--and this is not necessarily to get new regulations--you have to show some kind of an impact, hopefully an adverse impact.

As this guy from Lieberman's office said, this at most should concern accountants, but why should we be concerned about it? Now, every piece of research I do ends with the consequences.

Q: So this is the return of the productivity question that so bedeviled us about ten years ago?

A: Yes. That's the time to pause and start imposing some reasonable measurement.

I want to talk about valuation of intangibles because it's a very important issue and many people really don't understand it. Valuation of intangibles, individual intangibles, is incredibly difficult and may even be impossible. The reason is that intangibles to a large extent are determined by the context. A patent that IBM has can be extremely valuable, but if I owned this patent it's completely useless. The context determines to a large extent the value. Also, most intangibles interact very strongly with other efforts. So to somehow break this interaction is very, very difficult. Value of R&D depends a lot on the training of employees, for example, and on the value of your salespeople.

But here comes my point. Most people either intentionally or unintentionally use these difficulties to knock the whole structure. Some people do it intentionally, maliciously saying, for example, that it's impossible to value intangibles or nothing can be done about it, which is nonsense. Even if it's impossible to value intangibles, you can provide lots of very valuable information about them. You see, the inability to value does not preclude you from providing important measures and good measures that can guide both insiders and outsiders.

Q: Measures meaning quantified metrics?

A: Exactly. Take the measure that we just discussed a few minutes ago, which I call innovation revenues. Okay, how much of your revenues come from recently introduced products? Incredibly important measure. Those studies have shown that it is highly correlated with market values of companies. But this measure has absolutely nothing to do with valuation, absolutely nothing. It doesn't value the ability of the firm to innovate. It doesn't value the ability of firms to bring products to the market, but it's an important measure.

Take information about employee training. I would like to know how much the firm spends on employee training because I would like to benchmark it against other companies. I would like to benchmark it against the past. I would like to see, for example, what happens to employee training in difficult periods. Do they cut it immediately and significantly or do they recognize that it is a very important long-term investment and not cut it significantly? So this is incredibly valuable information both to insiders and outsiders but it has absolutely nothing to do with valuation.

My point is that you really miss the issue when you just focus on valuation. It's really not the objective of the information system to provide you with value.

Q: Give me your definition of an intangible.

A: An intangible is a source of future benefits that doesn't have a physical embodiment. A source of future benefits is basically the definition of an asset. If there are no future benefits, it's not an asset, it's an expense. The thing that differentiates intangibles from physical assets is the lack of a physical embodiment. This is a clean, short definition. People have all kinds of examples but many years ago in a law course, I remember the professor saying that if you need examples, you have a bad definition. A good definition should stand on its own. Examples are always coming because the definition is weak and you have to support it. I think this definition stands on its own. Of course you can speak about specifications. I have my own specification for different classes of intangibles.

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