

## **Beyond the Divining Rod – Making Intangibles Tangible**

Keynote Speech  
Conference on the Financial Impact of Extra-Financial Information  
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Thank you for your warm welcome. I would also particularly like to thank Ken Jarboe for the invitation to speak here today. The name of one of today's host organizations — "Athena Alliance"— is intriguing, so I looked up some background on Athena and learned, among other things, that Athena is clearly associated with invention and academic principles. That fact, along with the topic of today's conference and that I was already going to be in New York at another program that ended at 2 PM today, were all signs from the gods that I should accept this invitation! I am glad to have this opportunity to share my perspectives with you.

Let me begin by telling you a little bit about myself, which will no doubt explain my interest in extra-financial information. As noted, I currently serve as Under Secretary for Economic Affairs at the U.S. Department of Commerce. In this role, I advise the Secretary of Commerce, Carlos Gutierrez, on economic matters and oversee two key U.S. Government statistical agencies—the Bureau of Economic Analysis (BEA) and the Bureau of the Census. Part of my daily work is turning data into useable information. I have also tried to advance efforts to improve the quality of existing statistics and to ensure that statistical data collection keeps pace with the demands of a rapidly changing global economy.

Prior to taking this position, I served as a Commissioner at the Securities and Exchange Commission. At the SEC, I developed a deep appreciation for the interplay between financial reporting and investor decision making.

What perhaps I should have mentioned first is that I am an economist by training. As you likely know, this is a field that is largely, if not entirely, about finding factual evidence and making decisions based on that evidence.

Given my background, the statistics about how much non-financial and non-balance sheet information count in investment decisions cited in the letter inviting me to speak here today could only spark my interest. I am not surprised by these statistics. One only has to remember the phrase "animal spirits" to know that hard facts are not the only basis for investment decision making. But, what we are talking about here is neither mood swing

nor rumor, but the cutting edge information that we are learning investors need to understand better in order to make sound decisions.

I am naturally inclined to be concerned about the types and quality of information that investors are using. I have seen the results when individuals, business leaders, and policy makers make decisions based on poor or inadequate information. As I am sure you know, investors, creditors, regulators, and other market participants rely on getting accurate, timely and comparable financial information from public companies. This is the “regular” financial information that we use as something of a baseline. The efficient allocation of capital depends on financial reports and accompanying discussions that provide a realistic picture of firms' past performance and future prospects.

While I was a Commissioner at the SEC, a series of corporate reporting scandals highlighted how important accurate financial reporting is to our capital markets. The misleading information reported by those companies resulted both directly and indirectly in a serious misallocation of resources.

- Investors in those companies paid a huge opportunity cost by investing in companies with unrealistic, inflated values;
- Competitors made business decisions on a distorted playing field;
- Creditors did not price credit appropriately for the real risk taken; and
- Employees tragically made career and retirement investment decisions based on a false picture of their employer's financial prospects.

The impact did not end there. The misleading information reported by those companies also led to confusion about the rate of growth of the economy as a whole. The inflated profits contributed to a difference in the growth rates of two key economic measures that theoretically should grow at the same rate. Gross Domestic Income grew faster than its theoretical equivalent the Gross Domestic Product. The difference between those two statistics—which are both calculated by the Bureau of Economic Analysis—raised questions about the rate of GDP growth at a time of business uncertainty. Not knowing the answer led to challenges in determining monetary and fiscal policy at the time. In retrospect, we now know that the discrepancy was due, in part, to the same misleading financial information.

If indeed investors are relying a great deal on non-financial information, it is critical that the data users carefully scrutinize the information and data they are using. I am in the lucky position of being able to contribute to a solution. As the head of two major U.S. economic statistics agencies, I think about the role government statistical agencies can play. As a matter of course, we regularly ask the question: are there things that we should be counting or could count better, but are not?

The answer is...yes, of course there are. And, given that the United States is fully engaged in the rapidly changing global economy, the list is long. The trick is to understand what we should measure. And, once we know what it is we are trying to measure, we need to figure out how to do it ... in the most down-in-the-weeds technical sense you can imagine.

During this past year, I have been engaged in an effort to explore these questions—what should we be measuring and how should we do it—with respect to innovation. In late 2006, Secretary Gutierrez convened an Advisory Committee on Measuring Innovation in the 21st Century Economy—a group of 15 top-tier CEOs and academics—to develop recommendations with respect to what we should be measuring. As it turns out, the Advisory Committee’s examination of innovation metrics dovetails neatly with today’s conference. Much of what we have learned about measuring innovation in the U.S. economy comes down to doing a better job of measuring and understanding various intangibles. And, intangibles, almost by definition, are very hard to measure.

The Committee’s recommendations are in the final stages of development and will not be formally presented to Secretary Gutierrez until early next year. I can, however, give you a sense of what we have learned. This is the high-level version of what you would glean if you read the meeting transcripts and public comments on the Committee’s website: [innovationmetrics.gov](http://innovationmetrics.gov).

One of the lessons that I’ve taken away from this process is the value of putting new measures within a framework that enables data users to understand the entire process—from input to impact. If you have a solid analytical framework, you can always make it stronger and better by adding more detail and better data, but it is important to have the framework first.

One of the ways that BEA is already doing this is by using what are known as satellite accounts to the GDP Accounts. Satellite accounts are supplementary estimates that do not change the official national accounts. However, by remaining consistent with the broader economic accounts, while adding new information and formats better suited to answering particular analytical questions, these accounts provide a laboratory for economic accounting research into specific industries and markets. In 2006, BEA, with support from the National Science Foundation, created and published a satellite account on investment in research and development to explore the effect of investment in R&D on U.S. economic growth. This is a good model of progress built on an established framework.

What we have learned from this exercise has also demonstrated how important it is to continue to improve our statistical picture of the economy. If R&D spending were treated as an investment in the GDP accounts rather than as an expense, R&D would have accounted for 5 percent of real GDP growth between 1959 and 2004, and 7 percent between 1995 and 2004. This ramp-up in R&D’s contribution helps explain the pick-up in economic growth and productivity since 1995. To put the contribution of R&D in perspective, the business sector’s investment in commercial and other types of structures accounted for just over 2 percent of real GDP growth between 1995 and 2004.<sup>1</sup>

The focus on R&D in relation to *economic growth* illustrates another key principle that the advisory committee process highlighted, that is, the importance of looking at outcome measures and not just focusing on inputs. Ken Jarboe rightly stated in a recent paper that R&D spending is an input that is

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<sup>1</sup> Bureau of Economic Analysis, “Research and Development Satellite Account: 2007 Satellite Account Underscores Importance of R&D,” News Release, September 28, 2007 (<http://www.bea.gov/industry/index.htm#satellite>).

often used as a surrogate for an outcome—such as knowledge creation.<sup>2</sup> We need to find a way to really look at those outcomes, rather than trying to make input measures carry more weight than they should. It is what you are doing here today by focusing on the *impact* of extra-financial information.

One of the constraints faced by statistical agencies is that we can only collect data about activities that have enough history and structure that they have already been codified and measured by the businesses themselves. For example, BusinessWeek, in its survey of the most innovative companies, has regularly highlighted the importance to innovation of business collaboration. Not surprisingly, our discussions with the Advisory Committee members invariably included some discussion of measuring collaboration. However, businesses themselves don't systematically measure their own collaboration activities. It is not a concept that lends itself easily to quantitative measures. How does a firm, much less the government, capture a numerical value for something that ranges from formal joint projects among companies to professional networks that enable employees in one company to tap into the guidance or expertise of people at another company? Nonetheless, collaboration is likely an important intangible for investors to watch even though the measures are *at best* qualitative and noisy. Indeed, we can not measure prices or quantities of many intangibles the way we do for other assets or investments, yet somehow we need to factor them into our assessments. As we explore what new information we need to navigate our changing economy, we must have a tolerance for qualitative and subjective measures, as well as for the iterative process from which we learn what these measures mean.

Obviously, there is also plenty of scope for further research. Furthermore, there is a real need for us—and I mean both the public sector and the private sector—to persist in the effort to understand and, when possible, measure intangibles. Business leaders need more than instincts to understand their risks and manage assets such as reputation, brand, and corporate culture. And, investors should have more than a divining rod for finding companies that truly understand their risks and the value of these assets and manage them accordingly.

I applaud the organizers and sponsors of today's conference for working to advance our knowledge of intangibles and the financial impact that they can have. Thank you for the opportunity to share my perspective with you.

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<sup>2</sup> Kenan Patrick Jarboe, "Measuring Intangibles: A Summary of Recent Activities," Athena Alliance Working Paper #02, April 2007 (<http://www.athenaalliance.org/apapers/athenapapers.html>).