Providing Better Information to Capital Markets to Improve Valuation Decisions: A Discussion on the Reporting of Intellectual Capital Assets

Comments by
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Thank you Rob. I appreciate the invitation to be here today and to have the opportunity to comment on the remarks of the distinguished panelists, Stefano Zambon and Bob Laux.

Our topic today is one about which I have been interested for some time. Early in my tenure at the SEC, I was introduced to a book by Peter Wallison and Bob Litan called *The GAAP Gap: Corporate Disclosure in the Internet Age.* That piqued my interest as an economist – and in my new role as SEC Commissioner – in what corporate reports tell us, and what they should tell us. As a result, I was happy to meet with the organizers in the early stages of developing the Enhanced Business Reporting Consortium.

During my close to five years at the SEC, as we developed regulations and voted on enforcement actions, the relevance of the information in corporate reports was always on my mind. I saw what happened in the extreme when the reports were fraudulent or misleading. As I said five years ago[1] in the aftermath of the corporate accounting scandals:

- Investors 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.

But the issues we need to address are more than about ensuring that corporate reports are accurate in the current framework. It is really about how to improve the current framework – as the title of our session says, it is about "providing better information to capital markets to improve valuation decisions: A discussion on the reporting of intellectual capital assets."

[1] Glassman, Cynthia A. "Financial Reform: Relevance and Reality in Financial Reporting." Speech delivered to the National Association for Business Economics, Atlanta, Georgia, September 16, 2003 (http://www.sec.gov/news/speech/spch091603cag.htm).

My interest in the issue has not waned since I arrived at the Department of Commerce, but I now come at it from a different perspective. As Under Secretary of Commerce for Economic Affairs, I oversee the Bureau of Economic Analysis (BEA) which is in the process of extending the National Income and Product Accounts to include investments in R&D and other intellectual capital assets. BEA has found that Gross Domestic Product (GDP) would have been 2.9 percent higher between 1959 and 2004 if R&D spending was treated as investment rather than expensed in the U.S. National Income and Product Accounts. In 2004, GDP would have been $284 billion higher.[2] You will be hearing from BEA Director Steve Landefeld later today. I also oversee the Census Bureau, which is working with the National Science Foundation to expand its firm level R&D data collection efforts to include investments by firms in intellectual capital assets. In addition, my policy staff and I provided support to Secretary of Commerce Gutierrez's Advisory Committee on Measuring Innovation in the 21st Century Economy. We are now working on implementing the recommendations of the Committee, which was made up of five leading academics and ten CEOs of innovative companies. For more information on the work of the Committee and its report, please go to the website: www.innovationmetrics.gov.

The two speakers on this panel are part of a growing movement to reform financial reporting to make it more relevant to investors, rating agencies, policymakers, and, in fact, to the companies themselves. In a market economy, efficient allocation of resources requires good information. Companies, their investors, and their creditors need to know which projects will yield the highest return for a given level of risk. The information must be accurate, complete, and relevant.

An important part of increasing the relevance is understanding the value derived not just from physical assets but from what I think of as mental assets. You can't see them or touch them the way you can physical assets, but they matter to the viability of the company, especially as we continue to transition from a manufacturing to a service economy. They can affect both return and risk. As Stefano mentioned, they include such things as brand, reputation, organizational structures, employee training, supply chain management, innovativeness, and beta testing of software. They include patents, used either offensively or defensively. Overall, they include factors that enable a company to premium price or grow market share. Some researchers have found that gaps between managers and investors in information about such mental assets may give insiders an edge, increase bid-ask spreads, and ultimately increase the cost of capital. It can also provide opportunities for fraud.[3]

If such information is so important to the capital markets, one would think that companies would want to provide it. Ideally, companies with strong intangibles that aren't reflected in their market value should have an incentive to credibly report such information because the market will reward it with higher ratings and stock prices. Competitors who don't report similar information would get penalized with lower stock prices. As stock values of non-disclosers fall,

[2] U.S. Bureau of Economic Analysis. "Research and Development Satellite Account: 2007 Satellite Account Underscores Importance of R&D." Press release of September 28, 2007. (http://www.bea.gov/newsreleases/general/rd/2007/rdspend07.htm).

[3] Lev, Baruch. *Intangibles: Management, Measurement, and Reporting.* Brookings, Washington, DC, 2001, pp. 93-95.

the ones who believe they are undervalued would report the information. Ultimately, then, everyone would report.[4]

This does seem to happen in some cases. "Page views" (that is, the number of times a web page is viewed per month) as an internet traffic metric, customer churn in wireless phones, and same store sales in retailing have emerged as indicators of companies' health. But these developments are not systematic and their occurrence is ad hoc. There are many reasons for this. It is costly to collect such information. It may be proprietary. It may help competitors. It may become less relevant over time. For example, new web-traffic measures, such as time spent visiting a website, or the number of times people return to visit a website per month, have superseded page views.[5] As gift card and internet sales grow relative to conventional store sales, retailers have begun to abandon reporting monthly same store sales, although this trend has come under criticism by analysts.[6]

Given the importance of this issue, and the challenges it entails, I applaud the efforts of our two panelists.

Stefano described the measurement challenges that intellectual capital assets pose to financial reporting. He also highlighted the role that key performance indicators (KPIs) can play in complementing financial reporting by including information on intellectual capital assets, and he emphasized the importance of standardization in promoting wider use of KPIs. Focusing on the global perspective, he pointed out the problems, the challenges, and some solutions. As he noted, his work with others to create bridges between European, Japanese, and U.S. enhanced business reporting efforts has culminated in the founding of the World Intellectual Capital Initiative (WICI), which will work to develop internationally compatible standards for KPI's for intellectual capital assets.

Bob has provided the US domestic perspective on the work of the EBRC as well as the practical implications from a company perspective. He described Microsoft's leadership role in developing, promoting, and implementing enhanced business reporting initiatives, including providing tools for consumers of financial reports to use data provided in XBRL format. Microsoft has set an example by reporting its own quarterly SEC earnings filings in XBRL format.

While supporting efforts to improve the reporting of intellectual capital assets, I want to offer both caution and encouragement.

In my view, it is important that any enhanced measures reflect reality, and are not unduly burdensome on companies. We should learn from past experience and think about developing principles-based (rather than bright-line rules-based) standards. We should avoid getting ahead of what companies are already doing as part of their internal management and control processes.

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[4] Lev, pp. 86-91.
[5] Ovide, Shira. "Rethinking Web-Traffic Gauges." *The Wall Street Journal*. April 18, 2007, p. B3A.
[6] O'Connell, Vanessa. "Macy's Joins Trend of Retailers Ending Monthly Reports." *The Wall Street Journal*. March 6, 2008; p. B1.

We should keep in mind the costs and benefits of increased measurement and disclosure. We should focus only on measures and disclosures that are really relevant to the value of the company. Further, we should recognize that the measures should be dynamic, and accept that they will need to change as the businesses, industries, and economies change.

The good news is that there are some areas that can be built upon. Companies' internal KPIs are obviously important to them in how they evaluate their own business, so they should be looked at as potential metrics for disclosure. As Bob noted, the information in the management discussion and analysis (MD&A) in companies' reports can indicate sources of value that are not directly reported, especially with the SEC's focus on improved MD&A. In 2003, the SEC issued an interpretative release that provided principles-based guidance to help make MD&A more useful. More recently, the SEC staff reviewed several thousand filings and found that in many instances, companies were better explaining their financial statements, providing and clarifying context, and using MD&A to fill in some of those gaps in GAAP.[7] Further, the use of XBRL – or data tagging – being promoted by the SEC provides a vehicle for enhanced data and easier analysis of it.

Finally, as sessions like today's indicate, the issue is being taken seriously across the globe. My hope is that best practices will emerge and lead to globally consistent approaches to reporting intellectual capital assets that are not unduly burdensome, are dynamic, and – most important of all – truly reflect the economic reality of companies.

[7] Glassman, Cynthia A. "Priorities and Concerns at the SEC." Remarks before the Tenth Annual Corporate Counsel InstituteWashington, DC, March 9, 2006 (http://www.sec.gov/news/speech/spch030906cag.htm).