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August 29, 2001

Mr. Timothy S. Lucas
Director of Research
Financial Accounting Standards Board
401 Merritt 7
Norwalk, CT 06856-5116

Dear Tim:

Re: Proposed Agenda Project on Disclosure of Information About Intangible Assets Not Recognized in Financial Statements

It won't come as a surprise to you that I strongly support the proposed intangibles' disclosure agenda item. I sincerely hope the FASB will incorporate this item into the top of its agenda. Following are brief supporting arguments, organized according to your four questions.

1. Is there a need for the FASB to comprehensively address the reporting of information about intangibles...?

Dr. Leonard Nakamura, a senior economist with the Federal Reserve Bank of Philadelphia, has recently estimated, using three independent approaches, that the corporate sector's investment in intangible assets in 2000 was about \$1 trillion.¹ This staggering amount, which almost matches the total corporate sector's investment in property, plant and equipment—about \$1.1 trillion—was comprised of roughly \$250 billion each in R&D and software, and the rest in other intangibles, such as brands, human resources, and organizational process (e.g., on-line supply and distribution channels).

The S& P 500 average market-to-book ratio, which at the end of July 2001 stood at about 5.5, attests to the fact that investors perceived the corporate value missing from the

¹ Leonard Nakamura, "What is the U.S. gross Investment in Intangibles? (At Least) One Trillion Dollars a Year!" paper presented at the 4th Conference on Intangibles, New York University, May 2001.

balance sheet to be several orders of magnitude larger than book value (balance sheet value of net assets).

Except for the R&D expensed in the income statement, there is no systematic information disclosed on intangible investments and their consequences. Even with respect to R&D, there is considerable uncertainty regarding the content of this item, given no guidelines as to what constitutes R&D. I have seen cases where expenditures on quality control, consulting with customers, and maintenance of production facilities were included in R&D expenses.

To be sure, a strong case for a reporting change should be based on documented harms (damages) caused by the current reporting environment. Indeed, I have elsewhere elaborated on the substantial research documenting such harms, including the deterioration of the informativeness of financial information; manipulation of financial data by managers using intangibles; systematic capital market undervaluation of certain intangibles-intensive enterprises—leading to excessive cost of capital; abnormal insider gains to officers in intangibles-intensive enterprises; and large volatility and bid-ask spreads (again leading to excessive cost of capital) associated with intangible investments.²

These widespread harms could be substantially mitigated by improved disclosure about intangible investments. Hence, the importance and urgency of the proposed agenda item.

The FASB is the natural host for a project on improved disclosure on intangibles. It's the major standard-setting body in charge of corporate reporting, and its recent activities—Statements 141 and 142 in particular—pave the way for a serious examination of disclosure on intangibles.

As you know, an experts committee appointed by the SEC has recently recommended that the SEC should move to improve disclosure about intangibles. I believe this task should be taken up by the FASB.

2. Is the proposed scope of project insufficient, appropriate, or too ambitious?

I believe the proposed scope is very appropriate. At this early stage of examination by a public institution (i.e., the FASB), it is appropriate to focus on disclosure issues, leaving questions of recognition for future study. I will not, however, lump related issues (e.g., nonfinancial indicators, management goals) with the intangibles project, since this project is sufficiently broad and economically consequential to deserve a unique and focused examination.

3. Should specific issues identified above be excluded from the scope of the proposed project?

The proposed project mentions on page 5 “Values of those assets.” Valuation of intangibles, in contrast with the provision of data on investments, and information on consequences (e.g., the product pipeline) is a thorny issue. It is not even clear to what extent managers know the value

² Baruch Lev, *Intangibles: Management, Measurement and Reporting*, The Brookings Institution Press, 2001, Chapter 4.

of individual intangibles. I believe that application of FASB Statement 142 will initiate an intangibles valuation process for acquired intangibles, but it will take time to evaluate this process.

I would, therefore, consider at this stage the valuation of intangibles issue as a secondary one for the FASB. This will also allay managers' and auditors' concerns with litigation exposure.

4. Should specific issues not identified above be addressed?

I believe that the final objective, or vision of the project should be a comprehensive report on intangible investments, rather than just a list of information items. Such a report should, in my opinion, track the value-chain (business model) of the enterprise, linking inputs (e.g., R&D, customer acquisition costs, employee training) to attributable outputs (new products, revenues from new customers, employee productivity).³ Such a comprehensive report will address the major concerns of financial analysts and institutional investors, as reflected, for example, by the most frequent questions raised in conference calls.

Summarizing, I strongly support the incorporation of the intangibles disclosure project into the top of the FASB agenda. It is hard to find today a more timely, economically consequential, and intellectually stimulating accounting/reporting issue than intangibles.

Best wishes,

Baruch Lev

BL/aa

A handwritten signature in black ink, appearing to read "Baruch Lev", is written over a horizontal line. The signature is slanted and includes a long horizontal stroke at the end.

³ An example and extended discussion of such a report can be found in my book, op cit, chapter 5.