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Book review

Intangibles: Management, Measurement, and Reporting
by Baruch Lev, Washington, DC, Brookings Institution Press, 2001, pp. viii+216

The intangibles of the modern business — intellectual property and knowledge assets, brands, alliances, human and organizational capital — are frequently its most valuable assets. There is evidence of the growing importance of intangibles in the soaring price-to-book ratio, which has risen almost without interruption from its nadir of below one in the 1970s to in excess of six by early 2000. So long as you believe that stocks are sensibly valued, and assuming the economy is not getting less competitive, the price-to-book ratio reflects the proportion of off-balance sheet (essentially intangible) assets to on-balance sheet (essentially tangible) assets in the economy.

Baruch Lev is perhaps the leading accounting academic who is writing and researching on intangibles. In this timely monograph, Lev explains what we mean by intangibles, presents some explanations for their growing importance in the modern economy, and tackles the difficult question of how intangibles should be accounted for.

Intangibles are clearly not a new phenomenon — the 19th century had plenty of brands, patents, human capital. So why now? Lev attributes the growth in importance of intangibles since the 1980s to two factors: the greatly intensified competitive environment that has followed deregulation and globalization, and the facilitation provided by information technology.

Corporations have now largely exhausted the potential for manufacturing economies of scale, and excellence in manufacturing has been widely mimicked. So production has become commoditized. Increasingly, the corporation must look to innovation rather than manufacturing for competitive advantage. Lev describes how companies such as Ford are busy "deverticalizing" and pushing manufacturing and the ownership of manufacturing assets out to third parties (pp. 10–14). Intensive use of IT permits Ford to manage these new relationships efficiently. Of course, this leaves a nagging question in the mind of someone still trying to figure out why the price-to-book has risen *quite* so high. Where are these manufacturing assets going?

Lev notes the value-creating potential of the scalability of many intangibles — unlike tangibles or financial assets, the use of an intangible at one place or time does not preclude its use elsewhere — and of network effects: "... network effects are a hallmark of advanced technology, information-based industries ... [and] are increasingly characterized by product-related intangibles (unique products and services protected by intellectual property) at the core and alliance-related intangibles at the periphery" (p. 31). The downside is that

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investments in intangibles are often far more risky than investments in tangibles, partly because of the very winner-take-all nature of network economics. Also, intangibles are bedeviled by fuzzy property rights and the difficulty of excluding outsiders from enjoyment of the intangibles.

People are clearly the key to innovation, and CEOs unceasingly remind us that its people are the corporation's most important asset. However, "human capital" raises in stark form a central difficulty of the intangibles economy. Employees are making it increasingly clear that they are not, in any meaningful sense, assets. They can walk. Lev quotes a striking finding: that over 70% of young, fast-growing companies were created by people simply replicating or developing innovations from their previous employer (p. 35). In such a world it remains an open question how much of the value created by the new economy will be left with stockholders in public markets, and how much will be captured by key employees.

The growth of intangibles has exposed the limitations of the existing accounting model. The question that is constantly asked by the innocent nonaccountant is: if intangibles are so important, why aren't they on the balance sheet? This debate surfaced energetically over a decade ago when a small number of leading branded goods firms in the UK and elsewhere started to include a valuation of their brand equity in the balance sheet. The practice did not become widespread, and recent accounting standards reflect the current consensus, which is that internally generated intangibles cannot be usefully included in the balance sheet.

Intangibles do not meet accountants' tests for balance sheet recognition for several reasons. Intangibles are frequently diffuse in nature and not readily separable from other assets or from the business as a whole. The fuzzy property rights surrounding many intangibles mean that the company may not exercise the "effective control" required of an asset. The paradox is that it is the uniqueness of its intangibles that enables the firm to differentiate itself and helps it to sustain competitive advantage. But, being unique, there is no active secondary market in similar assets to which accountants can refer to get a market price. So the valuation of intangibles necessarily involves subjective evaluations of future cash flows.

The debate about whether the firm should value its intangibles in the balance sheet is over. The new challenge is disclosure. At present, firms have very little guidance on what information they should usefully disclose to enable outsiders to evaluate their intangibles.

Throughout the book, Lev associates the creation of intangibles with the process of innovation, and the "innovation value chain" provides the framework for Lev's template for a new set of corporate disclosures (Chapter 5). Lev proposes a detailed series of disclosures under three broad headings: learning activities and the discovery of new ideas, implementation, and commercialization. His proposals jibe with those of other writers who have been calling for systematic disclosure of the way in which management targets and measures the creation of shareholder value. A key element in this work will be the increasing alignment of internal and external reporting.

There is a long way to go in developing an accounting model for the world of intangibles. While templates such as Lev's are well articulated, there is a lot of research still needed before we can define a parsimonious and robust set of metrics for, say, brand equity or human capital. Observation of companies' current *internal* reporting systems suggests that they are using a wide variety of metrics to measure the performance of these assets. If the appropriate metrics for intangibles is quite context-specific, it will be challenging to develop accounting rules that bring forth more useful disclosure. The supply of information on intangibles will need to be matched by demand. At present, both supply and demand are very weak. Unless equity analysts and other outsiders can use the data that companies are producing, attempts to improve disclosure will be frustrated. It is going to be fascinating to watch the debate proceed.

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