

# ACCOUNTING AND FINANCIAL REPORTING IN THE INTANGIBLE ECONOMY: CHALLENGE AND SOLUTION

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**Safe and Ethical Cyberspace, digital assets and risks:**  
*How to assess the intangible impacts of a growing phenomenon?*

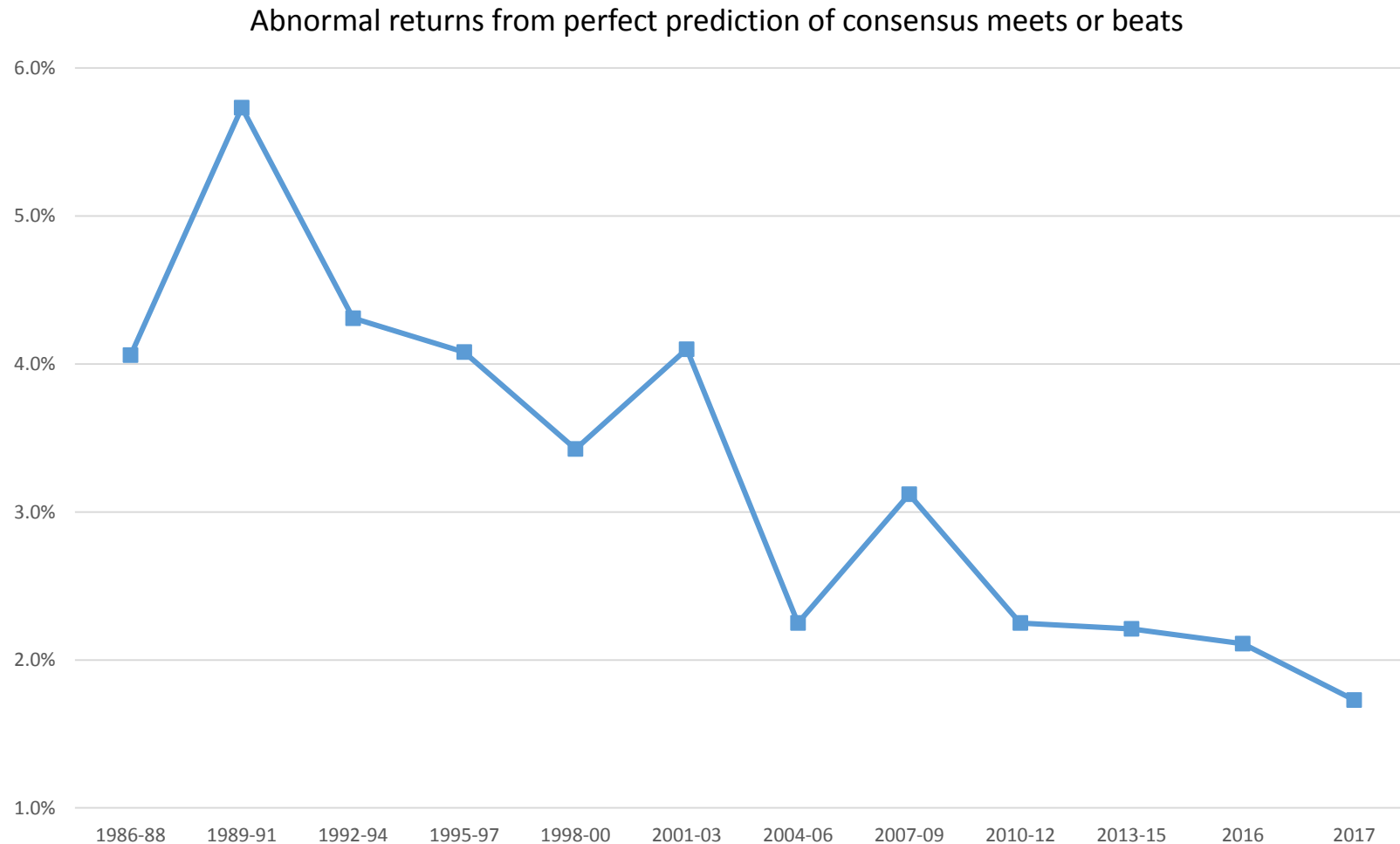
**The World Conference on Intellectual Capital for Communities**

UNESCO, June 14&15 2018

# Accounting relevance in the intangible economy

- Do investors care about accounting numbers?
  - earnings move market, do they?
  - does financial reporting still matter?
- *The End of Accounting and the Path Forward for Investors and Managers* (2016): comprehensive evidence on declining relevance of accounting information, particularly for firms investing in intangibles

# Does the prediction of beating or meeting consensus forecast still matter?



- Decreasing reward of predicting beating or meeting of consensus forecast

From: Gu and Lev, "Time to Change Your Investment Model," *Financial Analysts Journal*, 2017.

# Disappearing relevance of accounting earnings

- *Wall Street Journal* (2018)
  - “Earnings don’t pack much punch after long stock rally” (March 5, 2018)
  - “Strong earnings? Don’t expect the market to rally” (March 17, 2018)
  - “The forgotten earnings season” (April 12, 2018)
  - “Earnings are strong, but rewards are scarce” (April 22, 2018)
  - “Stocks have an earnings problem” (April 30, 2018)

# Do earnings still matter?

- Strong earnings? Don't expect the market to rally (*Wall Street Journal* , March 17, 2018)
  - “U.S. companies have posted great earnings, but investors shouldn't count on that giving their stocks a particular boost. That is the counterintuitive conclusion from the past seven years, when U.S. and European stock markets tend to do worse after a bumper earnings seasons than a disappointing one, according to a Wall Street Journal analysis.”

# Why accounting relevance lost?

- The rise of intangible assets and their absence and distortion in accounting reports
  - with a few exceptions, investment in intangibles is treated as expenses → total assets and firm performance metrics are distorted
- Prevalence of estimates in accounting
- Ignorance and delayed recognition of important business events

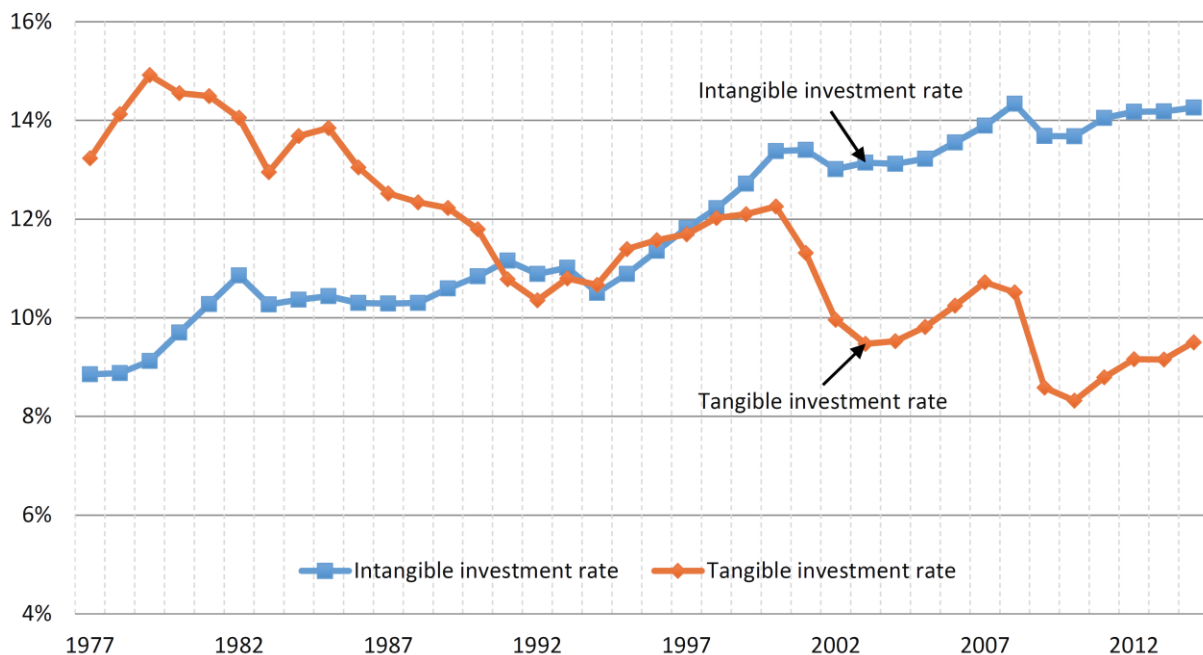
# Where are intangibles?

- Discovery/learning: R&D → patents, software, copyrights, design, database, etc.
- Customers: market research & investment → brands, trademarks, on-line distribution channels, marketing alliances, etc.
- Organization design & development: business process improvement and training → supply chain, integrated production and inventory systems, etc.

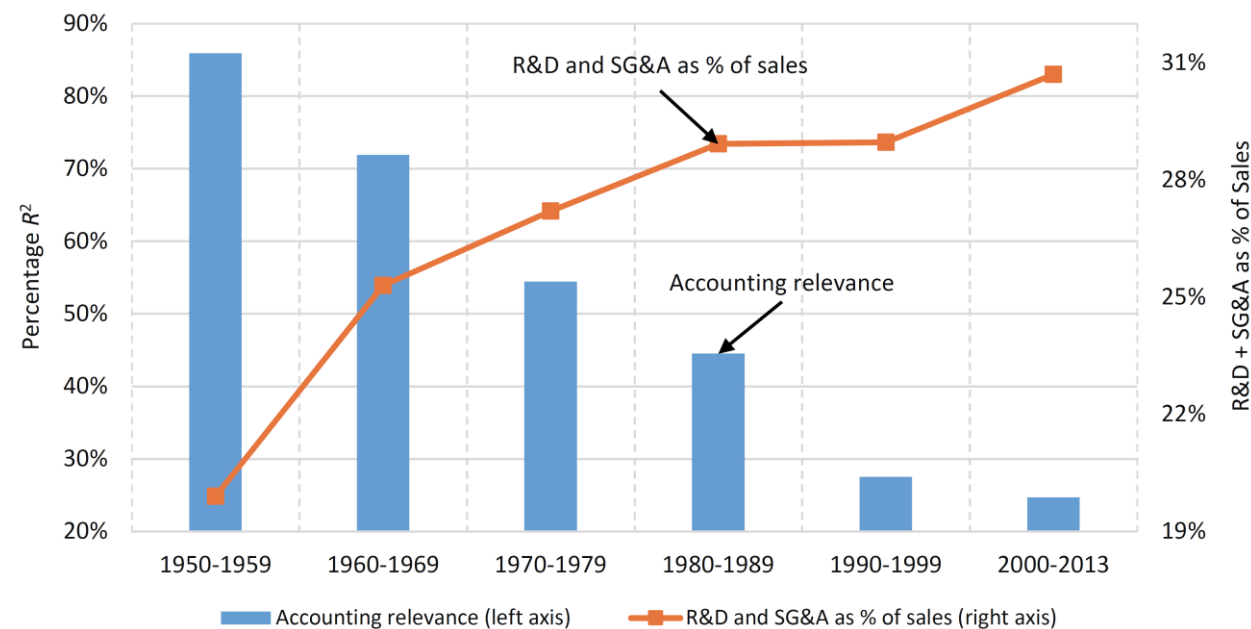
# The rise of intangibles and fall of accounting

- Accounting for intangibles is inconsistent, opaque, and even misleading

US private sector investment in tangible and intangible capital (relative to gross value added), 1977-2014



$R^2$ s of market values regressed on earnings and book values of companies entering the public market in successive decades, 1950-2013



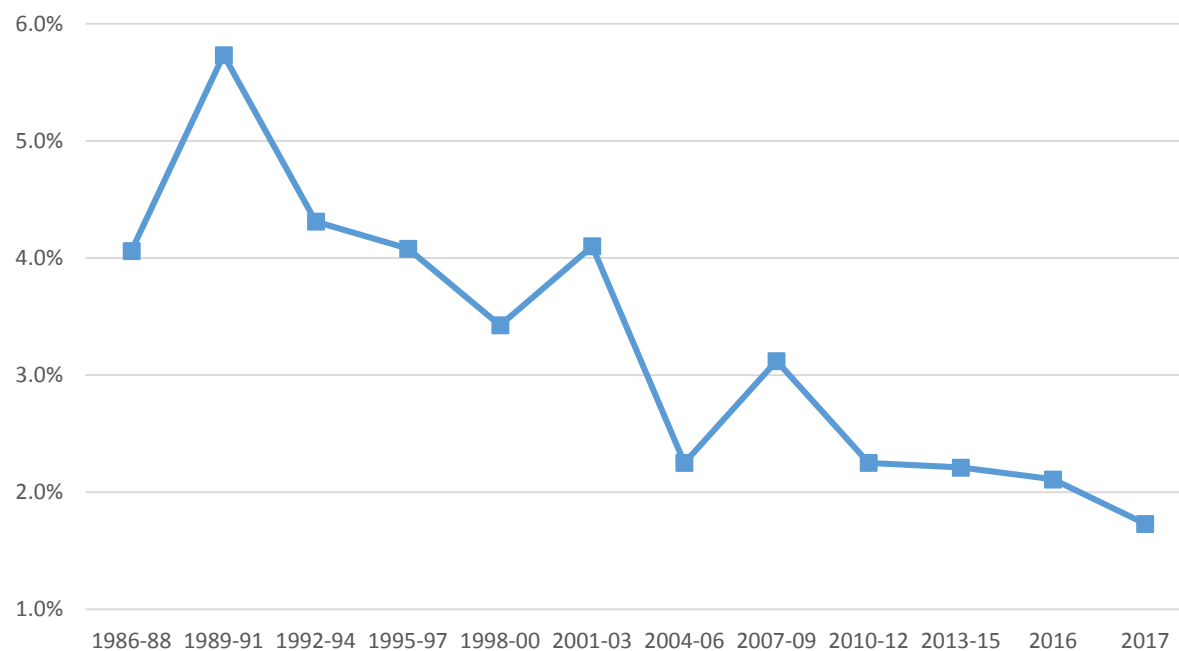
From: Lev and Gu, "The End of Accounting and the Path Forward for Investors and Managers," 2016.



# Earnings are less relevant for firms with more intangibles

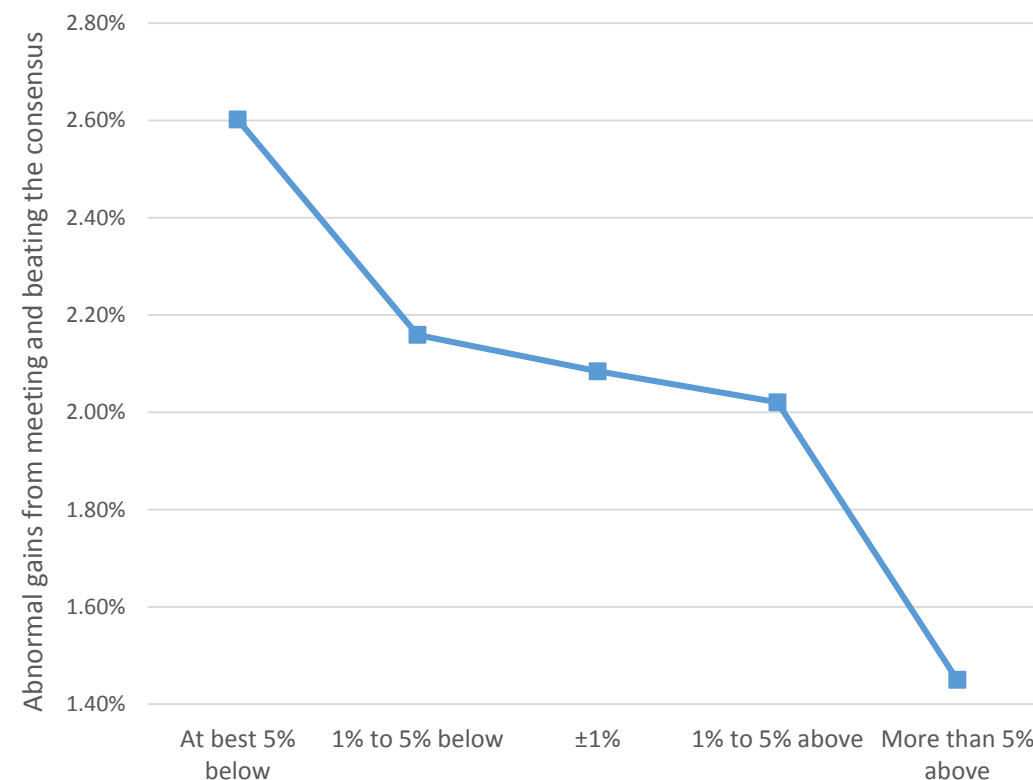
- Earnings for high-intangible firms are irrelevant

Abnormal returns from perfect prediction of consensus meets or beats



From: Gu and Lev, "Time to Change Your Investment Model," *Financial Analysts Journal*, 2017.

Gains from beating the consensus decrease with intangible intensity: 2011-2017



# What is at stake here?

- Companies investing in intangibles
  - U.S. accounting standards (GAAP) produce financial reports that distort the value and performance of these firms
  - Disclosure requirements may have adverse effects, leading to unfavorable valuation
  - Early stage, intangible-intensive firms increasingly shun away from public equity markets (e.g., a sharp decline in new stock listings in the U.S. markets)
  - A growing challenge for investors and policy-makers.

# Our proposal

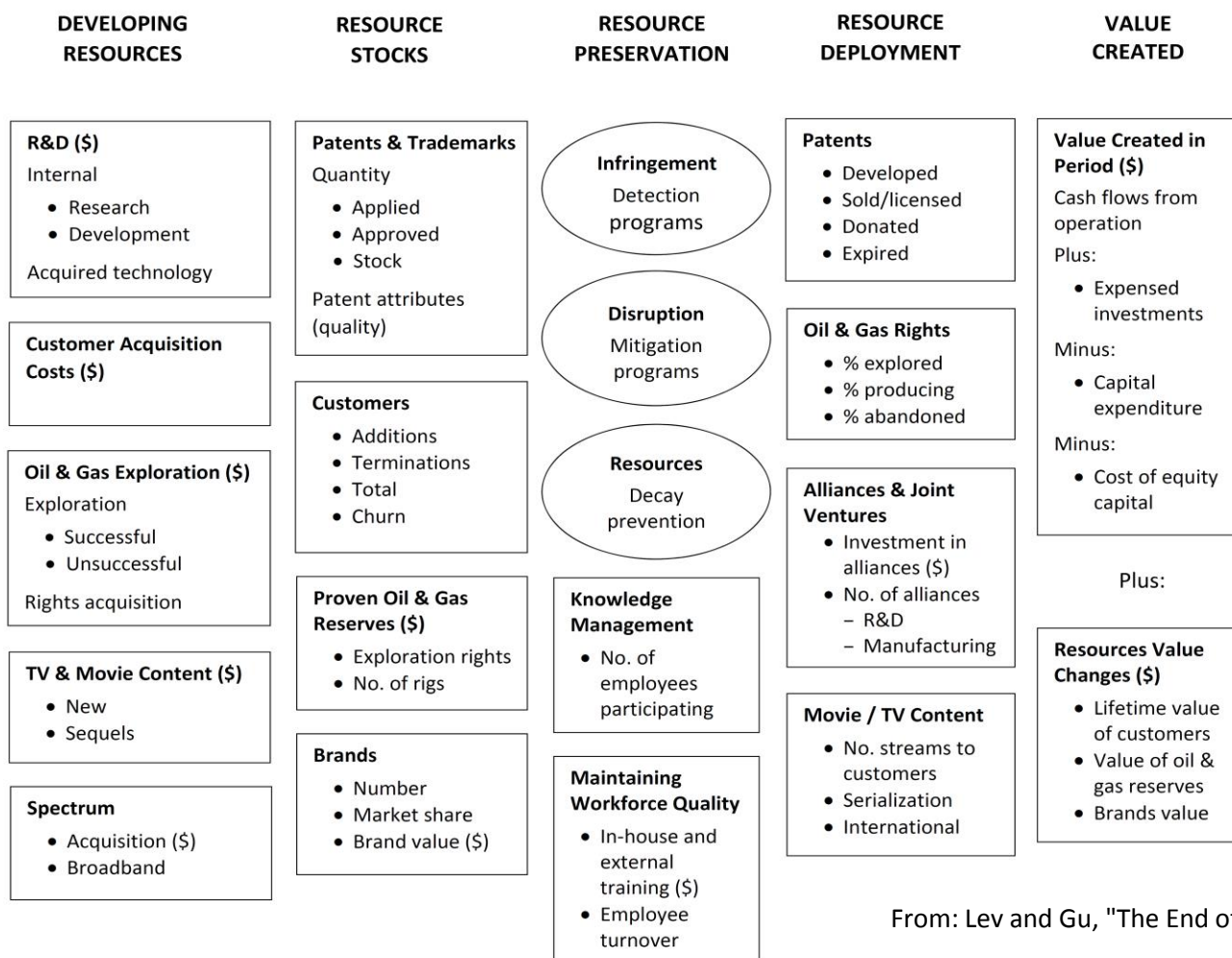
- Treat intangibles as assets in accounting reports
- A new tool: Strategic Resources & Consequences Report
  - a framework for disclosure about strategic resources, most of which are intangibles
  - organizing principles for CEOs, CFOs, and managers who want to provide useful information in a more integrated way
  - based on what really matters to investors and managers

# Strategic resources and consequences report

- Focuses on strategic resources
  - generate net benefits, are rare, difficult to imitate
  - key for achieving and maintaining a sustained competitive advantage
- Mapping investments to resources
- Efforts and success in preserving and renewing strategic resources
- Strategic asset deployment and operation
- Measuring the value created

# A new report on strategic resources & consequences

Figure 11.1: THE STRATEGIC RESOURCES & CONSEQUENCES REPORT

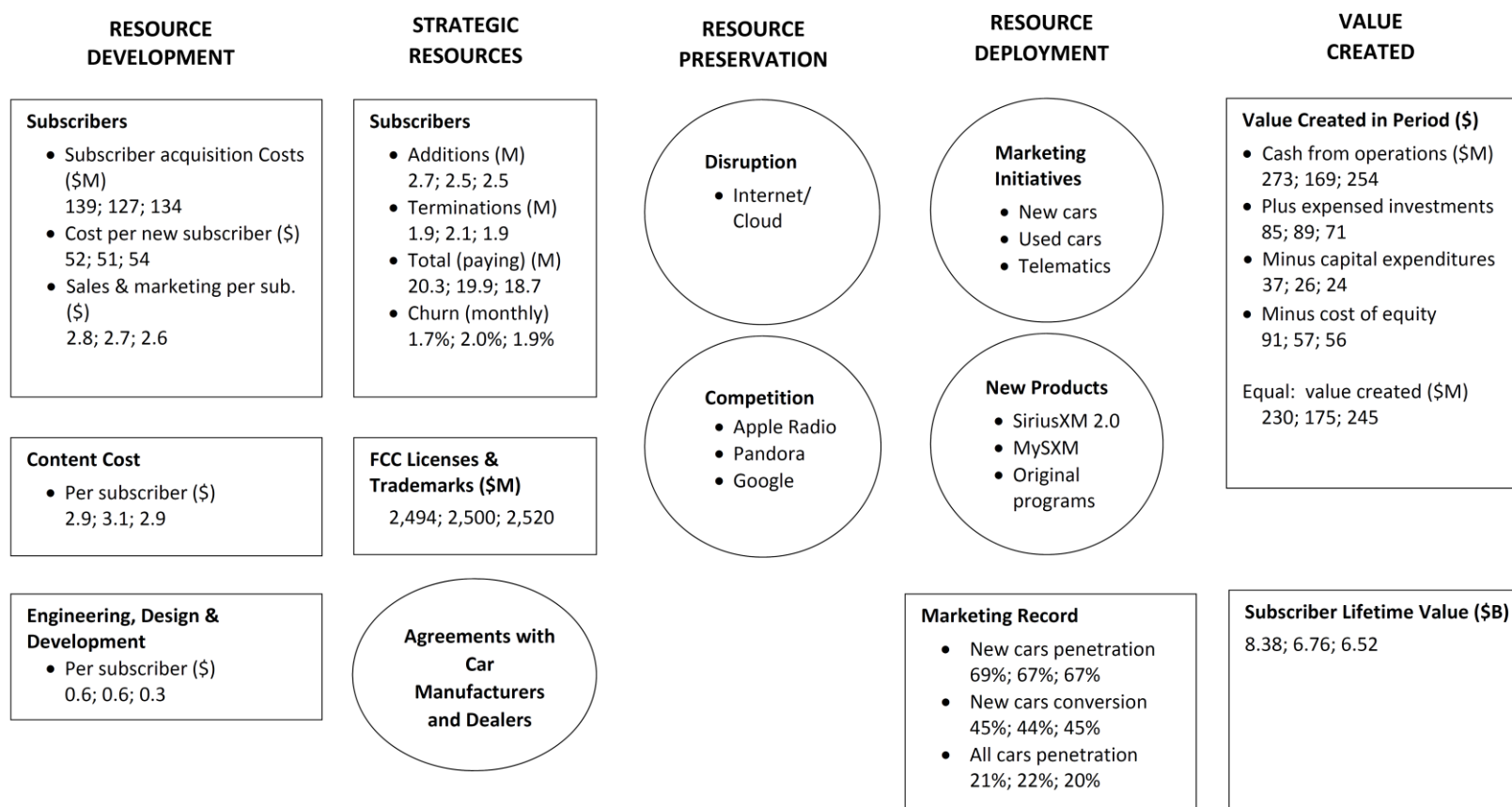


From: Lev and Gu, "The End of Accounting and the Path Forward for Investors and Managers," 2016.

# A demonstration: SiriusXM

Second Quarter 2013

(Numbers in the boxes are, from left: for the current, previous and year-earlier quarters)



Note: boxes provide quantitative data, while circles provide qualitative information

- A new view on investment on strategic resources and its outcome
- Not dependent on complex estimates (it uses cash flows and other factual information)
- A new indicator of subscriber lifetime value

From: Lev and Gu, "The End of Accounting and the Path Forward for Investors and Managers," 2016.

# Customer Equity Value

Customer Value =  $(1/\text{Churn}) \times \text{Customer Contribution} \times \text{Number of Customers}$ ,  
where Customer Contribution = Average Revenue per Subscriber – Adjusted Operating Expenses (= Reported Operating Expenses – Subscriber Acquisition Cost – Cost of Programming & Content – Cost of Engineering, Design, & Development)

	2017 Q3	2017 Q4	% change
Report date	10/25/2017	1/31/2018	
Earnings	\$275 M	(\$37 M)	(113%)
Income from operation	\$434 M	\$397 M	(8.5%)
Customer value	\$10.45 B	\$10.53 B	0.8%
Stock price	\$5.56	\$6.14	10.4%
S&P 500 index	2,557.15	2,823.81	10.4%
NASDAQ index	6,563.89	7,411.48	12.9%

# Focus on strategic resources

- Despite beating analysts' estimate for revenue and earnings for Q2 2016, the stock of Netflix fell by 13% on July 19. The reason: it reported the slowest subscriber growth in three years.



# So, what's to be done

- Reform financial reporting to better serve the intangible economy
  - focus on strategic resources, most of which are intangibles, and consequences
  - provide better information by returning to fundamentals—fact finding and reporting, rather than estimating, forecasting, and valuation of non-traded assets
  - reduce the short-term orientation of current reporting approach (e.g., eliminating quarterly reporting).