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European Chair on Intangibles

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Intellectual Capital for Communities In the Knowledge Economy

UNESCO
United Nations Educational, Scientific and Cultural Organization

IFAP
Information for All Programme

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

Feng Gu
University at Buffalo, U.S.A.

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?

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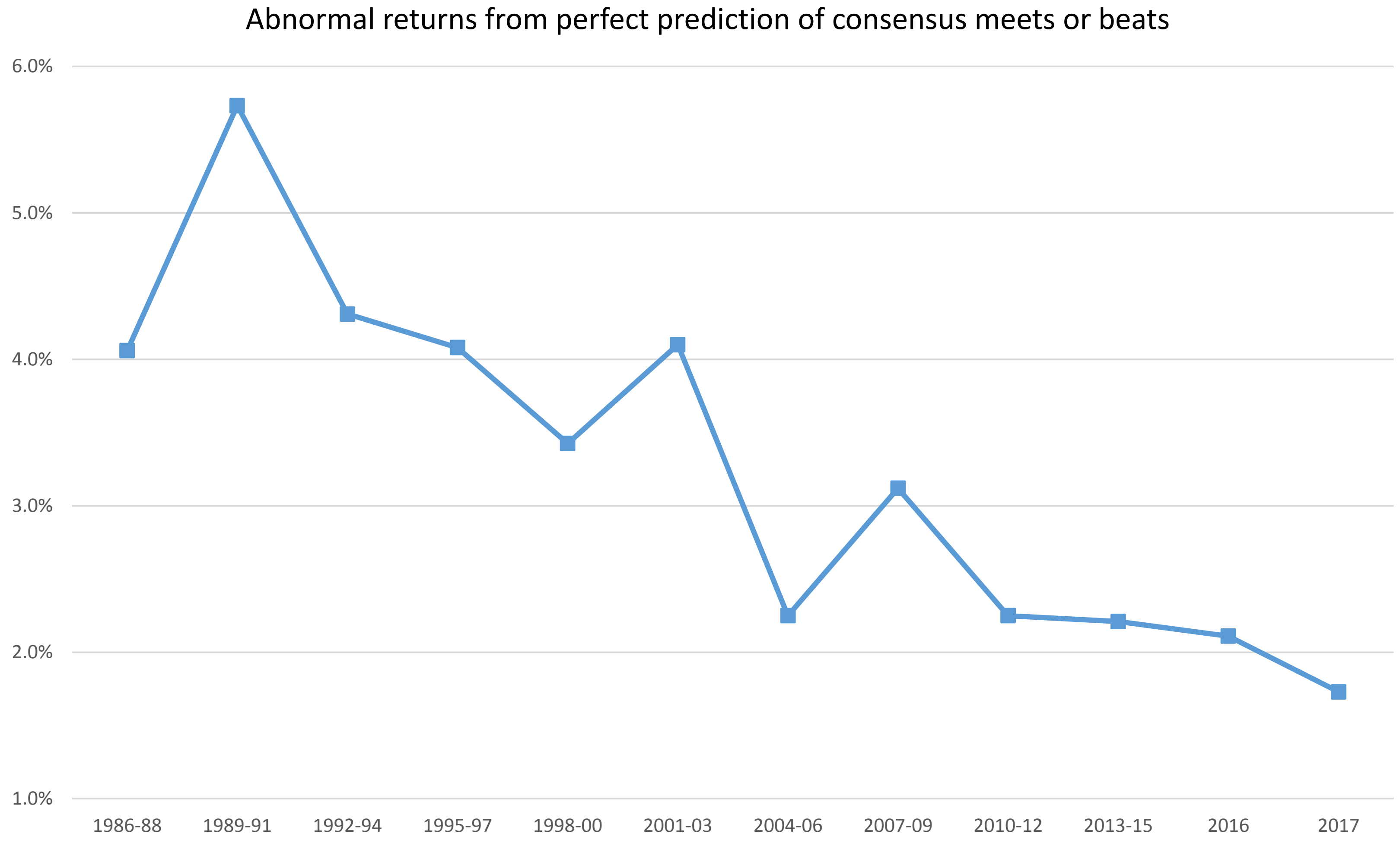

From: Gu and Lev, "Time to Change Your Investment Model," *Financial Analysts Journal*, 2017.

- Decreasing reward of predicting beating or meeting of consensus forecast

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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)

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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

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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

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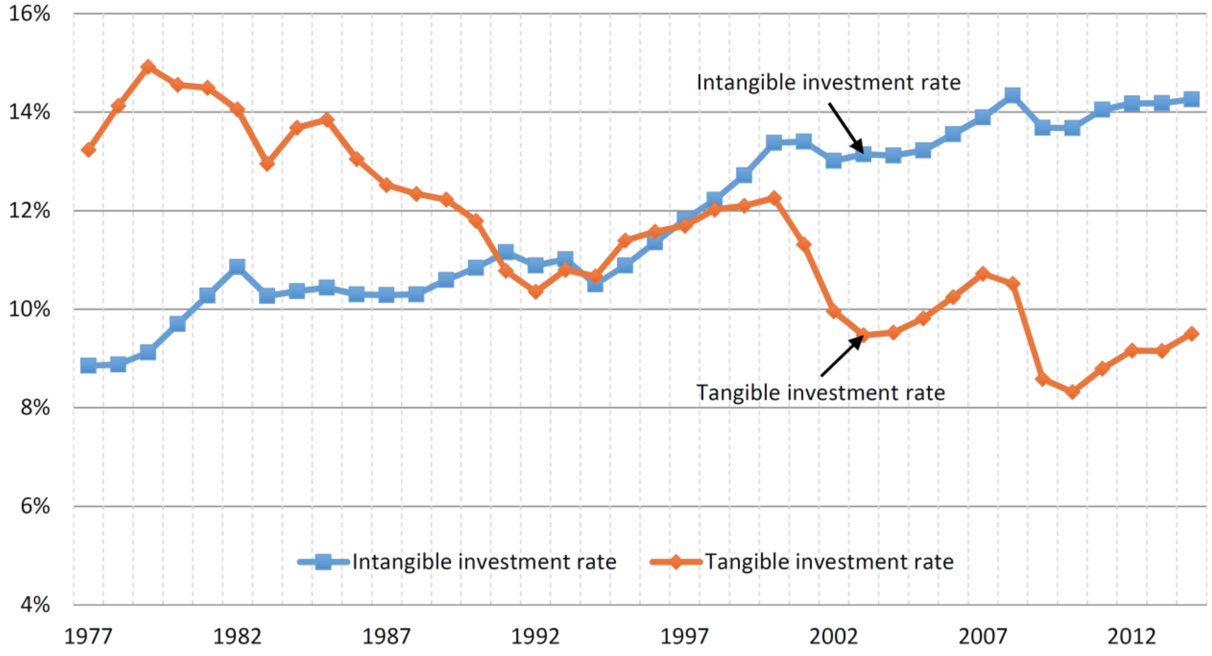
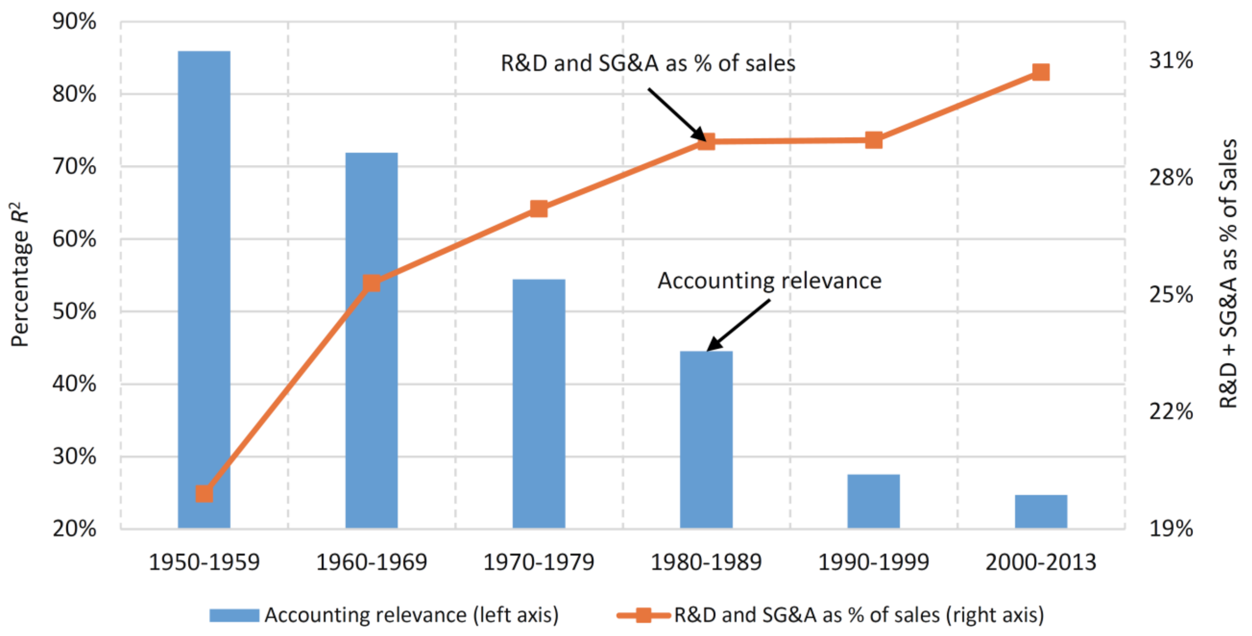
- Accounting for intangibles is inconsistent, opaque, and even misleading

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



R^2s 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

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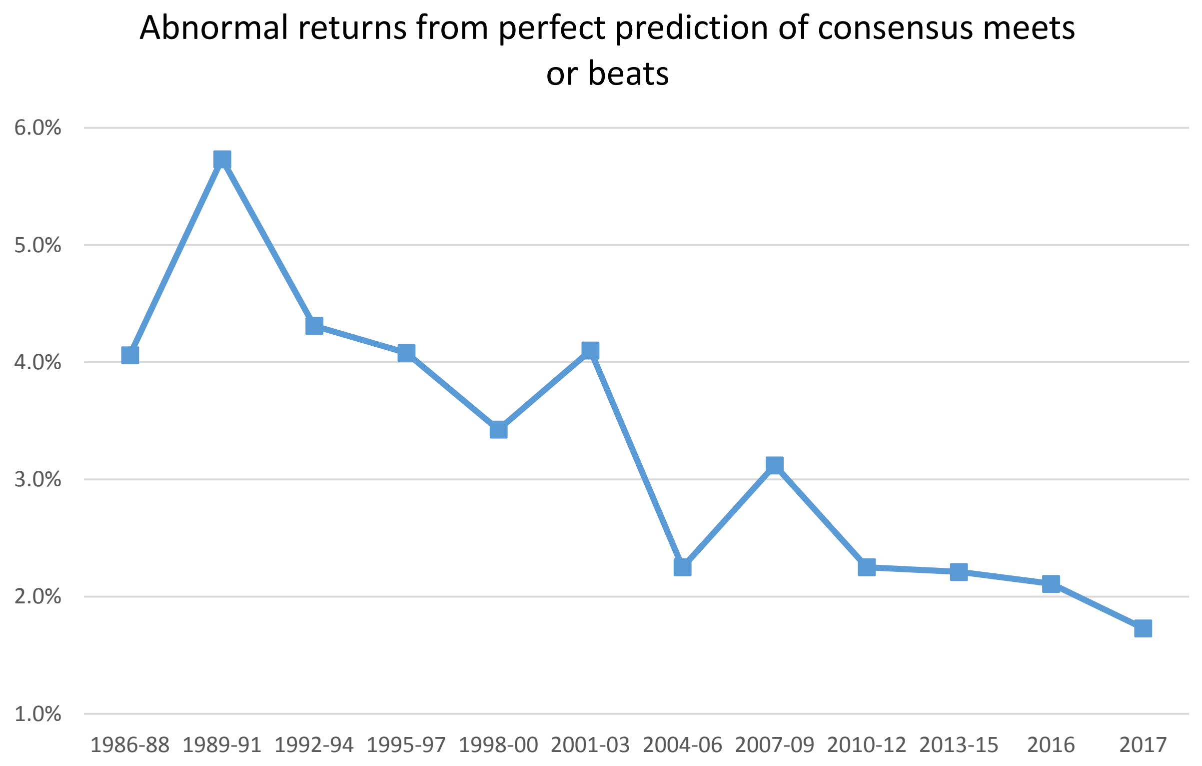
- Earnings for high-intangible firms are irrelevant



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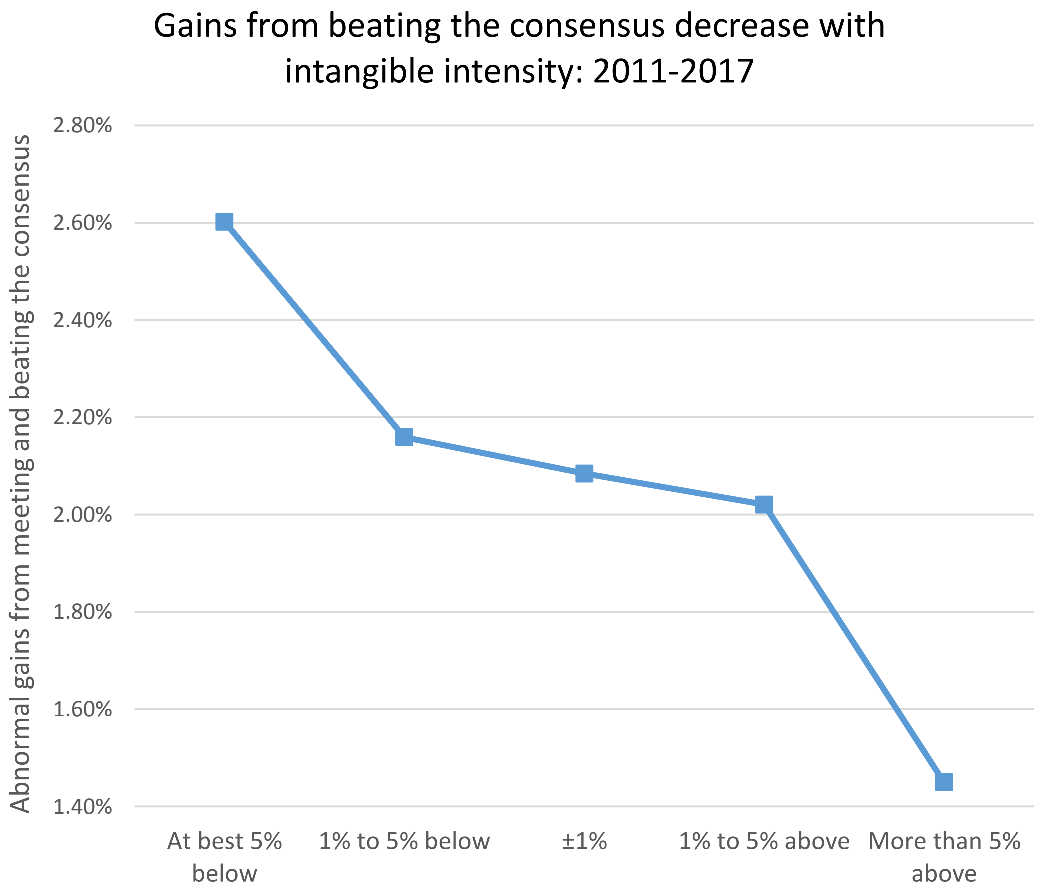

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What is at stake here?

- 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

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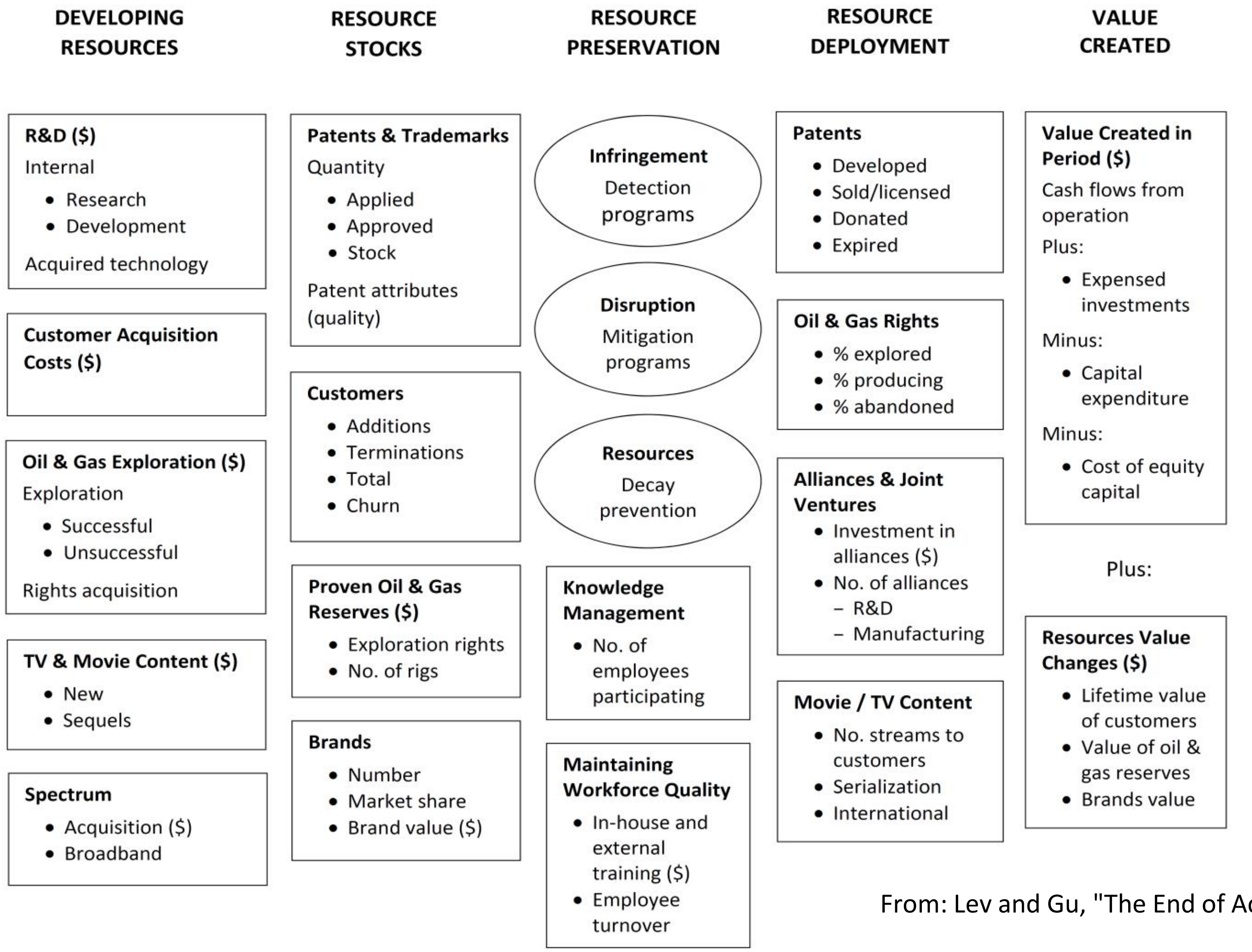
A new report on strategic resources & consequences

Figure 11.1: THE STRATEGIC RESOURCES & CONSQUENCES 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)

RESOURCE DEVELOPMENT

Subscribers
- Subscriber acquisition Costs ($M)
  139; 127; 134
- Cost per new subscriber ($)
  52; 51; 54
- Sales & marketing per sub. ($)
  2.8; 2.7; 2.6

Content Cost
- Per subscriber ($)
  2.9; 3.1; 2.9

Engineering, Design & Development
- Per subscriber ($)
  0.6; 0.6; 0.3

STRATEGIC RESOURCES

Subscribers
- Additions (M)
  2.7; 2.5; 2.5
- Terminations (M)
  1.9; 2.1; 1.9
- Total (paying) (M)
  20.3; 19.9; 18.7
- Churn (monthly)
  1.7%; 2.0%; 1.9%

FCC Licenses & Trademarks ($M)
2,494; 2,500; 2,520

Agreements with Car Manufacturers and Dealers

RESOURCE PRESERVATION

Disruption
- Internet/ Cloud

Competition
- Apple Radio
- Pandora
- Google

RESOURCE DEPLOYMENT

Marketing Initiatives
- New cars
- Used cars
- Telematics

New Products
- SiriusXM 2.0
- MySXM
- Original programs

Marketing Record
- New cars penetration
  69%; 67%; 67%
- New cars conversion
  45%; 44%; 45%
- All cars penetration
  21%; 22%; 20%

VALUE CREATED

Value Created in Period ($)
- Cash from operations ($M)
  273; 169; 254
- Plus expensed investments
  85; 89; 71
- Minus capital expenditures
  37; 26; 24
- Minus cost of equity
  91; 57; 56

Equal: value created ($M)
230; 175; 245

Subscriber Lifetime Value ($B)
8.38; 6.76; 6.52

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.

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Customer Equity Value

Customer Value = (1/Churn) x Customer Contribution x 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).