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Better Business Reporting for Investors: Help Is on the Way

By Peter J. Wallison

As U.S. companies have come to rely increasingly on intangible assets for the generation of revenue, financial accounting based on Generally Accepted Accounting Principles (GAAP) has become less and less useful as a means of disclosure. A new form of disclosure—relying on key performance indicators—is necessary to provide investors with information about the success of companies in creating value and the likelihood of sustaining profitability in the future. A coalition of businesses, business and investor organizations, and accounting professionals is forming to bring this new version of disclosure into being.

A key reform of the Sarbanes-Oxley Act was the creation of the Public Company Accounting Oversight Board—a five-member nongovernmental organization with authority to make rules for the auditing of financial statements—which would, as Congress believed, render financial statements more accurate and increase the quality of financial information available to investors.

For at least twenty years, GAAP has become less and less useful to investors.¹ In 1990, after three years of deliberation, a special committee sponsored by the American Institute of Certified Public Accountants (AICPA) would declare that “continuing the present course, we believe, will lead to the growing irrelevance of conventional financial reporting in the new age of information.”² It is a remarkable testament to the lack of communication between government and the private sector that, more than ten years later, Congress could plunge ahead with an “improvement” to a system of financial disclosure that was considered out of date a decade earlier.

GAAP accounting is increasingly irrelevant for financial disclosure because it was developed to describe a wholly different economy, with a wholly

different method of value-creation. Developed and systematized during the early-twentieth century, GAAP accounting was designed to reveal important information about the companies—railroads, automobile makers, and manufacturing enterprises of all kinds—that then dominated the U.S. economy. These companies acquired their productive assets in the market, purchasing plant, machinery, equipment, rolling stock, and other units of production from suppliers. The costs of these assets were recorded on balance sheets and depreciated over time as they were used to generate revenues. Balance sheet values thus roughly reflected the cost of replacing the company as a whole, and the company’s earnings reflected the costs of producing the goods and services that were responsible for its revenues.

But change was coming. Economic principles such as comparative advantage, spurred by competition in the U.S. and abroad, began to move the U.S. economy toward higher value activities. The creation of value through muscle and machinery began to give way to the creation of value through intellectual effort and the effective use of knowledge and information—the advent of what has been called the Post-Industrial Age, the Information Age, or the Knowledge Economy, a change as profound as the Industrial Revolution in eighteenth-century Britain.

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For revenue generation, companies began to rely less on tangible productive assets purchased from others and more on internally generated *intangible* assets. These included computer software that was created by their employees, but also such items as pharmaceutical designs, clothing designs, brand names, contractual relationships with suppliers and distributors, employee skills and know-how, and employee and customer loyalty. All of these items became important assets to companies that were either selling knowledge and information itself or selling products that derived substantial portions of their value from intangibles such as knowledge, reputation, and superior design or service.

The increasing importance of intangible assets had a profound effect on both the balance sheet and market values of public companies. Thus, as Professor Baruch Lev has pointed out, the ratio between the balance sheet equity and market value of companies in the S&P 500 Index hovered around 1 to 1 in the 1977–1983 period (when goods manufacturing still dominated the U.S. economy), rose to 3 to 1 in the 1993–1995 period (as the knowledge economy began to take hold), and increased to 6 to 1 by 2001 (as intangible assets and intellectual property came to dominate the economy). Although, as Professor Lev has noted, some of this disparity is attributable to the high stock prices during the late 1990s and early 2000s, clearly during this twenty-year period something happened that broke the connection between the depreciated cost of a company's assets and the company's market value.

America Online provides an illustration of this process. During the mid-1990s, the company sent out vast numbers of computer disks, intended to encourage recipients to try AOL's system and ultimately to become members of its online service. As the company began to grow, its greatest asset was the customer or member list that it developed through its massive disk mailings. Not only did a large number of members increase the company's revenues through the payment of fees for connecting to its servers, but advertisers were willing to pay for the opportunity to contact AOL members through AOL's website. Apart from its members, the rest of the company consisted of its headquarters, a large number of computer servers, and a lot of rented telephone lines. But if AOL's membership or customer list was its most important asset, it was nowhere to be found on AOL's balance sheet. AOL was and is an example of a company that was generating revenues through the exploitation of an intangible asset—its membership list—that was not on its balance sheet at all.

The AOL example also illustrates a defect in GAAP accounting for companies that earn their profits through

the use of intangible assets. AOL of course incurred substantial costs in sending out computer disks. In one sense, this was an investment, since it was creating a productive asset, but under GAAP promotional expenses of this kind must be written off as incurred.³ This is because GAAP accounting is based on cost. The items that are added to the balance sheet as productive assets, like machinery and equipment, have generally been purchased at a defined cost and presumably could be resold for that amount less depreciation. Depreciating these assets places revenues and expenses in the same accounting period and allows the computation of profit. In this conceptual structure, promotional expenses cannot be considered investments because their value is too speculative. If they are treated as investments and capitalized—i.e., not written off as incurred—profits are increased. In addition, even assuming that promotional expenses are capitalized, there is no known way to establish their value for purposes of depreciation. The same is true of salaries for the programmers, designers, and scientists who develop the knowledge-based products that modern companies now sell. As a result, the balance sheets of these companies do not reflect many of the assets that account for their profitability.

Some might argue that this does not matter anyway. It is not the balance sheet value of a company that is important, but its GAAP earnings—and specifically its earnings per share (EPS).⁴ However, as the preceding discussion shows, the value of the EPS computation under GAAP depends heavily on bringing into the same accounting period the revenues and the expenses associated with generating those revenues. The failure of GAAP in this case is again illustrated by the AOL example. If we assume that the promotional costs associated with the generation of AOL's membership list were incurred and written off (as required by GAAP) in 1995, most of the revenues and associated profits that resulted from these expenses would be realized in later years. Unlike the classic industrial company, in which depreciation of its productive assets places expenses and revenues in the same accounting period, AOL's revenues in later years would not be burdened by depreciation. In other words, the losses that it recorded in earlier years when it was sending out disks would have reduced the earnings in those years, but would result in higher earnings in later years when the benefit of those expenses would be reaped.

This process, repeated in many ways for the different kinds of knowledge companies that produce revenues from internally generated assets, substantially reduces the effectiveness of GAAP accounting as a means of financial

disclosure. EPS becomes highly subject to manipulation, as the gap grows wider between the time the expense was incurred and the time the associated revenue was generated. This problem, recognized by the AICPA report in 1990, continues to plague GAAP accounting today.

Therefore, for knowledge companies that rely on internally generated productive assets, there is simply no way to improve the accuracy of GAAP financial statements through better auditing. The problem is fundamental to the GAAP system, which was designed for the companies of a different era. At this point, the inability of GAAP financial statements accurately to reflect the value of today's companies is not a small problem; it has been estimated, for example, that 80 percent of the value of the companies in the S&P 500 is represented by their intangible assets.⁵

Key Performance Indicators

For this reason, the accounting profession and accounting theorists have been calling for years for the development of a system of supplementary information that would enable investors to understand more fully the intrinsic value of these companies.⁶ Beginning with the Jenkins Report, the accounting profession has been working toward a structure for the development of what are called "key performance indicators"—metrics that will reveal information about the current value and future prospects of companies that have large amounts of intangible assets. To be sure, many key performance indicators are commonly used in financial reporting, but these are only of modest value to investors because they are not well defined. Examples are same-store sales for retailers, consumer website visits for online companies, and research and development expenditures for technology or pharmaceuticals companies. To be valuable to investors, these and many other indicators would have to be rigorously defined, used by all industry members, issued for consistent accounting periods, and published regularly over a period of years.

Many other indicators—often used by management but not commonly disclosed by companies—could reveal important information about productivity, the skills of employees, or the quality of products. These include reject rates for products, patents obtained annually and related aging of patents in force, customer satisfaction, employee or customer loyalty, and product development lead-time. Of course, key performance indicators would vary from industry to industry. They must be developed by the companies themselves—by the managements who

understand the principal drivers of value for their respective industries and the best ways to measure and report them—and this will require extensive discussions and widespread agreement on precise definitions.

Although the task will not be easy, it is also not unprecedented. For many years, under the leadership of the accounting industry, industry groups have been meeting to define the terms necessary to report their financial and nonfinancial results in the format required by a new computer language called eXtensible Markup Language (XML). When adapted for use in accounting, XML is called eXtensible Business Reporting Language, or XBRL. The unique element of XML and thus of XBRL is the ability to tag individual concepts (text or numbers) with context, so that financial reports, available over the Internet or elsewhere, can be searched quickly and accurately. For example, the word "bank" can refer to a financial institution, the side of a river, or what an airplane does when it begins a turn. XML will permit each of these words to be given a tag that will signal to a search engine exactly which meaning the word has in the context in which it is used.

In accounting, this means that companies can prepare their financial statements in any way they want. They can call the top line of their income statements sales, revenues, turnover, or anything else, but when reported in XBRL format each of these terms will be given a specific tag identified with a specific definition for that term within the income statement. As a result, when reports are prepared in XBRL, it will be possible for analysts, by computer, to extract in seconds information about a number of companies, without having to download the information in hard copy, find the relevant data in differently organized financial statements, and input this data into their financial models by hand. This will make analyzing individual companies substantially easier than it is today. The definitional work has now been done for so many industries that the Federal Deposit Insurance Corporation has required bank call reports to be filed in XBRL format, and the Securities and Exchange Commission is considering whether to require all public companies to use XBRL in filing their financial and other required disclosures with the SEC.

Clearly, it is easier to define the 3000 or so terms used in financial statements than to agree on and precisely define the underlying elements of the key performance indicators for every industry. But the experience with XBRL shows that it is possible to marshal the resources of companies and industries when the advantages of reaching an agreement are clear.

The trouble is that the advantages of a better system of business and financial disclosure are a lot clearer to investors, investment analysts, accountants, and accounting theorists than they are to companies. Over the long run, of course, better disclosure reduces investors' risks, lowers the risk premia that investors regularly build into share prices, and thus lowers capital costs. But these long-run considerations are not strong motivators for managements that are focused on day-to-day concerns. As a result, the need to spend the time and effort to create key performance indicators is a hard sell to corporate managements. A great deal of educational work is necessary here. Studies have shown, for example, that better disclosure increases share prices, which should be much in the interests of corporate managements.⁷

Nevertheless, under the initial sponsorship of the AICPA, a group is forming that will attempt to demonstrate to corporate managements that the creation and disclosure of key performance indicators is in their long-run interest. Called the Enhanced Business Reporting Consortium (EBRC), the group will ultimately consist of companies, business associations, institutional investors, and specialists in accounting and investment analysis. It has already enlisted the support of Microsoft, the Business Roundtable, the National Association of Corporate Directors, and the AICPA. Its advisory committee includes several people prominent in the world of public policy and finance, including Paul Volcker (former chairman of the Federal Reserve Board), Roderick M. Hills (former chairman of the SEC), David Walker (comptroller-general of the United States), Ned Regan (president of Baruch College), and Norman R. Augustine, former chairman and CEO of Lockheed Martin.

Their first and most difficult task will be to persuade corporate America that a more relevant and transparent system of financial and nonfinancial disclosure will help investors better assess the value of companies in the knowledge economy, and that this in turn will help companies create value for their shareholders. This is the positive side of EBRC's argument. But they also have another arrow in their quiver—the history of government action when the free market and voluntary action fail to solve a problem. In this case, as shown by the Sarbanes-Oxley Act, the government often steps in with a ham-handed solution that may address the issue in principle or appearance but often simply imposes unnecessary costs. Few corporate managements are happy with the reforms imposed by the act, yet the act

appealed to legislators and regulators because it seemed at the time that the private sector offered no solution to the problem of management manipulation of financial results.⁸

Similarly, as it becomes clearer to investors and other corporate stakeholders that GAAP financial reports are unable to capture the value of intangible assets, pressure will build for a legislative or regulatory solution. When that solution comes, it will be imposed from the top and will have all the deficiencies that top-down regulation implies. It is far better, EBRC will argue, for the U.S. business community to begin now the development of the key performance indicators that will be necessary for financial reporting in the future. The success of XBRL shows that this kind of industry-wide cooperative effort can succeed.

Clearly, developing key performance indicators for every significant industry will be a huge and long-term undertaking. But as difficult as it will be, there is really no alternative.

Notes

1. For a more complete discussion of this issue, see Robert E. Litan and Peter J. Wallison, *The GAAP Gap*, AEI Press, 2000.

2. AICPA, "Improving Business Reporting—A Customer Focus" (The Jenkins Report) <http://www.aicpa.org/members/div/acstd/ibr/appiv.htm>, February 21, 2000.

3. Indeed, in the mid-1990s, AOL attempted to treat its promotional expenses as an investment by capitalizing them—i.e., placing their cost on the company's balance sheet as an asset rather than writing them off as incurred. However, since the capitalization of these expenses was inconsistent with GAAP and had the effect of showing operating profits where conventional accounting principles would have shown operating in losses, in 1997 the Securities and Exchange Commission forced AOL to change its accounting method. The company was required to write off all these expenses in the years in which they were incurred, and to restate three prior years of its financial statements; the company was also required to pay a substantial civil fine.

4. Despite all the attention paid to EPS in the mass media, sophisticated investors and financial specialists know that the value of companies is determined by the market's estimate of their cash flow and particularly their free cash flow—the amount of cash flow that can be anticipated from their future operations discounted by an assumed rate of return. It is important to note that enhanced business reporting, as described in

this report, would also assist in the estimation of future cash flow, which is a difficult task in itself.

5. Baruch Lev, *Intangibles: Management Measurement and Reporting*, Brookings Institution Press, 2001.

6. Although key performance indicators are intended to supplement GAAP, it is not necessarily true that this will increase reporting requirements or paperwork. Just as reporting companies can substantially reduce their reporting costs by using eXtensible Business Reporting Language for the preparation of the narratives in their annual reports to the SEC on Form 10-K narratives, as well as the associated financial statements, the publication of key performance indicators could

reduce the importance of—and hence the detail required in—GAAP financial statements.

7. See, e.g., Alison Thomas, “A Tale of Two Reports,” in *European Business Forum*, issue 16, Winter 2003–2004: 79.

8. Few commentators have noted that state and federal rules and regulations impeding corporate takeovers have contributed to the problem Sarbanes-Oxley was intended to solve. Management manipulation of financial reports, excessive management compensation, and inattentive directors and audit committees would all have been less common if it had been easier for companies that were not well-managed to become takeover targets.