

CONTEMPORARY FINANCIAL REPORTING AND INTANGIBLE RESOURCES: IMPLICATIONS FOR CORPORATE GOVERNANCE

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How to cite: Grove, H., & Clouse, M. (2019).
Contemporary financial reporting and intangible
resources: Implications for corporate governance. *New
Challenges in Corporate Governance: Theory and
Practice*, 49-52. https://doi.org/10.22495/ncpr_13

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Received: 20.06.2019
Accepted: 12.07.2019
DOI: 10.22495/ncpr_13
Keywords: Financial
Reporting, Intangible
Resources, Corporate
Governance
JEL Classification: G3,
G30

Abstract

The key question of this paper is what are the implications for corporate governance from the emergence of contemporary financial reporting and intangible resources? Going beyond traditional financial reporting, Boards of Directors and corporate executives should investigate the intangible resources for contemporary financial reporting. What intangible resources are causing huge price to earnings ratio gaps and the huge market to book ratio gaps for their companies? Such gaps are often driven by intangibles, like global brand names, global licensing, customer loyalty, product quality, and product innovation.

Unfortunately, the short-term focus upon traditional financial reporting by both Wall Street and corporate executives to “make the numbers”, i.e. short-term (quarterly), predicted numbers, has damaged firms’ competitiveness. Such damages include postponing or cutting expenditures on emerging technologies, advertising, research and development, employee training, and maintenance expenses. Research has shown that such earnings management techniques are relatively futile efforts since a consensus earnings miss by a company generally produces an insignificant 1.5% to 2% share price drop. Boards of Directors should inform corporate executives accordingly. To offer solutions to these issues and implications for corporate governance, this

paper is divided into the following sections: the emergence of contemporary financial reporting; asset value migration (the power of intangibles); top five future business value drivers (all intangibles); forward-looking measures for intangible resources; market gaps: "old economy" versus "new economy" companies; global brands and global licensing; hidden intangible values made visible; international perspectives on contemporary financial reporting; and conclusions.

In a 2019 interview entitled "*Regaining Relevance in Financial Reporting*" (Frigo, 2019), Baruch Lev and Feng Gu elaborated the main message of their 2016 book, *The End of Accounting*. They argued that investors are poorly served by arcane accounting methods and new ways to measure companies' performance are needed. The authors stated that traditionally reported earnings and financial statements no longer reflect the realities of businesses but instead follow an arcane set of accounting rules and regulations, established for "old economy" companies, such as energy, steel, autos, and other traditional manufacturing. New metrics are needed for "new economy" companies, such as technology, software, biotech, and internet operators. Also, with the emergence of digital technologies, new metrics are needed for both "old" and "new economy" companies (Grove, Clouse, & Schaffner, 2018). For example, many "old economy" energy companies are adopting new digital and artificial intelligence technologies (Grove & Clouse, 2019; 2017).

Lev and Gu argued that traditional financial reporting has reflected an alternate reality which fails to highlight essential factors that make an enterprise rise or fall. For example, the most important, value-creating investments in patents, brands, information technology (IT), and other intangibles must be expensed, just like salaries and rent, instead of reflecting future value or benefits. Reported earnings include both long-term sustainable growth and one-time, transitory gains and losses and they are based on many subjective managerial estimates, such as prospective bad debts, future pension liabilities, stock-option expenses, and asset impairments or write-offs. Thus, all such reporting results in backward-looking accounting statements those say little about an enterprise's future growth and ability to compete. Research has shown an increasing gap between reported earnings and share prices, especially for "new economy" technology companies, and earnings have lost their ability to predict future corporate performance which is their main use by investors (Lev & Gu, 2016).

Over the last four decades, contemporary financial reporting has shown a migration and reversal of resource or asset values from tangibles into intangibles from a traditional 85%/15% split in 1975 to a new 15%/85% split in 2015, based on percentages of S&P 500 equity market value (Cokins & Shepherd, 2017). Artificial intelligence (AI), like IBM's Watson, has huge potential to help with work standardization and efficiency, as almost any repetitive task can be replaced by AI. Such AI activities have helped lead to this switch in business value from tangible assets into intangible assets in the last four decades (Heitman, 2017). Contemporary measures, like net income and quarterly stock returns,

provide information about the current performance of the company but little to no information about future performance. In contrast, forward-looking performance measures, like customer satisfaction, product quality, innovation, and brand strength, can be leading indicators of both future performance and intangible resource values (Farrell et al., 2017).

This tremendous surge in intangible resource values has huge implications for corporate governance theory and the survival of the corporation. Agency theory has been the dominant perspective of corporate governance, but the question of corporate purpose has been divided into two theories. The first theory is that corporations have a responsibility to maximize shareholder value and the second theory is that corporations have the responsibility to balance the interests of all stakeholders. Since these two theories go in different directions, the central focus of corporate governance has become blurred. In 2015, a third alternative was proposed by the European Parliament's Committee on Legal Affairs: "shareholders do not own corporations. Contrary to popular understanding, public companies have separate legal personhood. The position of shareholders is like that of bondholders, creditors, and employees, all of whom have contractual relationships with companies but do not own them" (Tunjic, 2017). This third alternative is not based upon corporations revolving around the interests of shareholders or stakeholders, but in which shareholders and stakeholders move around the corporation which has interests in various capitals: traditional financial, production, human, social, intellectual, and environmental. The corporation must store and convert each of these capitals to maintain and enhance itself and focus on long-term value creation, not short-term financial engineering to "make the numbers" for executive compensation (Nocera, 2017).

Concerning the key question of implications for corporate governance from the emergence of contemporary financial reporting and intangible resources, this paper has analyzed issues of asset value migration to intangibles, five major future business value drivers (all intangibles), forward-looking measures for intangible resources, market gaps for "old economy" versus "new economy" companies (all driven by intangibles), hidden intangible values made visible, international views on contemporary financial reporting, and conclusions. Major limitations of this research are the fast, ongoing changes to intangible resources which impact the practice of corporate governance by company executives and Boards of Directors. Future research could focus on lessons learned from field studies at companies who are addressing such issues, including earnings management issues (Grove & Clouse, 2019).

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