HOW ACCOUNTING CAN DISTORT VALUATIONS

Jeremy Schwartz — Global Chief Investment Officer
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Last week, we had the pleasure of interviewing Baruch Lev, Philip Bardes Professor of Accounting and Finance at NYU Stern, on his views about the distortions in earnings statements that make these reports less relevant to investors. Lev wrote *The End of Accounting and the Path Forward for Investors and Managers*. This is an important topic we will explore in future research.

There used to be a cleaner line between the "investments" companies made to generate cash flows in the future and the "expenses" for physical structures like the buildings they needed to operate their current business. There was a clean matching between revenues and the cost for delivering those revenues.

But 25 years ago, the structure of corporations changed, and now there is greater investment in intangibles, research and development, and brands. Intangible investments are around $2.5 trillion now, and tangible investment are just half those levels.

The challenge with accounting for intangibles is that they are deducted from the *current* income statement, resulting in a large mismatch with the expenses generated today for future revenues.

Lev cited 2019 as a boom year, when 45% of all the companies he tracks reported losses and 70% of high tech and health care companies reported losses. While people refer to earnings as the bottom line, Lev thinks they are rather irrelevant.

In addition to the standard GAAP earnings, companies provide non-standardized measures of earnings and other non-accounting metrics to report on business trends. Subscription service companies provide customer counts, custom acquisition costs, and churn rates—none of which are accounting numbers—which can be used to determine the lifetime values of customers to illustrate the longer-term trends for their business.

Cycle of Investments

If a firm is increasing intangible investments, its earnings are generally understated. But if it is on the downslope of investments, its earnings are likely inflated. This furthers the complications of adjusting intangibles.

Are Cash Flows Better Than Earnings?

Lev would still adjust cash flows for investments in long-term assets—essentially intangible investments—as those lower current cash flows.

Will Officials Ever Change the Standards?

The accounting board deleted intangibles twice from its agenda of reforms, so Lev is not optimistic the standards board will get this right.

Lev also recently wrote a paper, "Explaining the Recent Failure of Value Investing," that looks at where value strategies went wrong. One finding was that value investing relied on "mean reversion" and a "bouncing up" of stocks that were depressed in valuation and a "bouncing down" of stocks that were at higher valuations. Mean reversion has slowed down in the last 20 years, and Lev thinks the displacement of top companies is different now: The intangible investments give more protection, while the companies with low valuations don't make enough intangible investments to move up.

You can listen to this important conversation at the link below.

Behind the Markets on Wharton Business Radio · Behind The Markets Podcast: Baruch Lev

For standardized performance and the most recent month-end performance click here NOTE, this material is intended for electronic use only. Individuals who intend to print and physically deliver to an investor must print the monthly performance report to accompany this blog.

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DEFINITIONS

Cash flows : a measure of how much cash a business generates after taking into account all the necessary expenses, including net capital expenditures.

Generally Accepted Accounting Principles (GAAP) : Principles of accounting utilized in the U.S. that deal with different aspects and assumptions that are deemed acceptable in calculating the earnings of a firm.

Value : Characterized by lower price levels relative to fundamentals, such as earnings or dividends. Prices are lower because investors are less certain of the performance of these fundamentals in the future. This term is also related to the Value Factor, which associates these stock characteristics with excess returns vs the market over tim.

Mean reversion : The concept that a series of returns has a tendency to return to its average level over longer periods, even if shorter periods can exhibit wide swings.

Valuation : Refers to metrics that relate financial statistics for equities to their price levels to determine if certain attributes, such as earnings or dividends, are cheap or expensive.