

Let's Close the GAAP Gap

by

Richard J. Frazier and Peter J. Wallison

Given the wide divergence between market values and book values, investors obviously see something in companies that conventional accounting is not recording. Take eBay. With a book value of approximately \$4 billion and a market cap of \$31.5 billion, it's safe to conclude that the bulk of eBay's value is based more on the "reputation" the company has built among the public than on its tangible assets.

According to some estimates, about 80 percent of the value of companies listed in the S&P 500 is attributable to their intangible assets. Dr. Leonard Nakamura, a senior economist with the Federal Reserve Bank of Philadelphia, estimated that the corporate sector's investment in intangible assets in 2000 was about \$1trillion. This staggering amount nearly equaled the total corporate sector investment in property, plant and equipment—about \$1.1trillion. This represents an important change in how our economic system creates value and requires a change in how we account for, report on and disclose the financial significance of that value.

Fighting the Last War

In striving to ensure companies and their auditors strictly adhere with Generally Accepted Accounting Principles (GAAP), we are in a real sense fighting the last war. Much of the current debate about whether Generally Accepted Accounting Principles are properly applied or disregarded, may be beside the point. The fact is, in an economy where the principal assets that generate revenues and cash flows for companies are intangible assets, GAAP financial statements do not provide the information that investors really need—information about whether key intangible assets are increasing or decreasing in value. Knowing for instance, whether eBay's reputation—an intangible asset—is strengthening or declining, would be far more useful to investors than a more accurate accounting of the company's balance sheet net worth.

Financial Institutions Have A Special Responsibility

Clearly investors would like to know as much as possible about the assets that produce future revenues, earnings or cash flows. For more and more companies, the health of their intangible assets determines their future financial performance, but investors are largely left to guess about how well these assets are being managed. This is not a healthy situation. If investors are left to guess, they are taking risks. Risk raises the cost of capital, promotes volatility, and ultimately distorts the allocation of capital. But this situation is not the result of a deficiency in the accounting profession, or of companies withholding anything they are otherwise required to disclose, or of existing laws and regulations not being vigorously enforced. It is in large part due to changes in our economy—changes that have made intangible assets the real drivers of corporate value.

In their new book, *Building Public Trust*, Sam DiPiazza and Bob Eccles write:

"Recognizing that transparency is necessary to create and protect value, [shareholders and other stakeholders] will no longer accept being left in the dark. Financial institutions have a special responsibility here because of their role in allocating both equity and debt capital on which companies depend for their growth. Financial institutions must demand transparency from companies in order to improve this capital allocation process. What should be obvious is that they must practice what they demand of others."

A sizable information gap exists between what financial services companies are required to report and what really determines their long-term health. Specifically, both executives and investors are left in the dark when they have poor or little information about customer asset performance. For financial services firms, this intangible asset is the prime source of sustainable earnings that provides future cash flows and it has more value producing, or value destroying potential, than the sum of all tangible assets covered by GAAP.

The SEC Nudge

There is clearly a need to provide investors with information that supplements conventional GAAP financial statements. What is also needed is the will to voluntarily proceed. In fact, the Securities and Exchange Commission has been encouraging companies to do so. In a recent review of the 2002 annual reports filed by the FORTUNE 500, the issue that raised the most concern for the SEC was the inadequacy of the boiler plate information contained in Management Discussion and Analysis. In 2001, SEC Chief Accountant Robert Bayless offered guidance on the type of information that would make MD&A more useful to investors. Specifically he stated the need for fuller discussion of:

- The underlying causes of reported financial results and the relationship to the long-term value of the business.
- The intangible assets of a company and how these contribute to its value.
- What steps management is taking to develop, protect and exploit these intangible assets.

Financial institutions can adhere to these guidelines by subjecting the customer asset to a more thorough and disciplined examination. Despite the resources it consumes and the far greater contribution it makes to corporate value than a firm's tangible assets, audit committees rarely include the customer asset as part of their internal and external audit process. One reason for this oversight is that many audit committee members and their outside auditors are unaware that unlike many

intangible assets, the value producing potential of a financial institution's customer asset can be quantified and monitored and its contribution to market capitalization can be computed.

An article in the September 30, 2002 issue of *FORTUNE* ("Will this customer sink your stock?") provided a checklist for assessing whether the overall value of the customer asset is increasing or declining. Most notably, the article revealed why customer profitability models that exclude operating and capital costs provide a distorted view of customer asset performance.

This distortion ultimately infects all customer related indicators, including customer satisfaction and retention. For instance, in 2001 Providian Financial was recognized with a national quality award as an industry leader in customer satisfaction and retention—the same year in which the stock price fell from \$59 to \$3. While customers were happy and sticking around, investors were unaware that the overall economic health of Providian's customer asset was deteriorating. By contrast, Westpac Bank has realized a 50% stock appreciation since the company began providing analysts with "customer value" indicators that demonstrate how well the customer asset is being managed as a means for delivering value to shareholders.

By giving investors the information they really need anyway, financial institutions can begin to rebuild public trust while simultaneously closing the industry's GAAP gap. It stands to reason that if investors are provided with more valuable, forward-looking information, their perceived risk will be lowered. Less risk means lower capital costs. Surely a few firms can volunteer for that.

Rick Frazier is the founding principal of Booth Morgan Consulting, LLC and coauthor of *Wnning the Race for Value*, amacom, 1996.

Peter Wallison is a Resident Fellow at the American Enterprise Institute and coauthor of the *GAAP Gap*, AEI Press, 2000.