# New economy, new worries

## High-flying stocks are suffering credibility problems

***A recent Securities Institute survey of analysts highlighted their concerns about financial reporting practices. A major issue, reports STEVE McCLINTOCK, is the accounting information released by so-called "new economy" stocks.***

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A Securities Institute survey late last year of almost 200 stockbrokers and fund managers revealed a number of concerns that should be addressed by preparers of financial information for "new economy" stocks, standard-setters and regulators.

Understandably, some respondents did not believe that a new economy existed and questioned whether so-called new economy stocks were simply start-up companies hitting the market in large numbers in a short period. Common perceptions of new economy stocks were:

- start-up vehicles with no financial history and directors or management with no track record;
- loss-making businesses with high "cash burn" rates with projections for exponential revenue and profit growth;
- significant value assigned to intellectual property (often in unproved or immature markets).

Eighty-six per cent of analysts had concerns about the financial reporting practices of these stocks, particularly relating to cost capitalisation, revenue recognition, cash burn rates, optimistic projections/valuation of intellectual property and accounting treatment of acquisitions.

It was no surprise that on 10 January 2001, ASIC announced that it had asked 53 new economy stocks to clarify their financial reporting and disclosure. ASIC said typical areas of concern included "the accounting for acquisition of businesses, the reporting and amortisation of intangibles, the accuracy of quarterly cash flow statements and the recognition of revenue".

### IF IT'S A DEBIT IT MUST BE AN ASSET

High on the list of concerns about new economy stocks was cost capitalisation: 73% of analysts expressed dissatisfaction with capitalisation policies adopted, with most demanding information on:

- what has been capitalised
- why it has been capitalised, and
- how it will be expensed to the profit and loss account

Accounting standards and guidance are weak in this area. The only specific reference to the capitalisation of costs was in AAS 9 *Expenditure Carried Forward to Subsequent Accounting Periods*, which was withdrawn in October 1996, in part as a result of the issue of the much-maligned Statement of Accounting Concepts 4 *Definition and Recognition of the Elements of Financial Statements*.

For costs to be capitalised, they must meet a SAC 4 definition of an "asset" that has three essential characteristics:

- there must be future economic benefits;
- the entity must have control over the future economic benefits such that it is able to enjoy the benefits and deny or regulate the access of others to the benefits; and
- the transaction or other event giving rise to the entity's control over the future economic benefits must have occurred.

SAC 4 states that an asset should be recognised in the statement of financial position only when it is probable that the future economic benefits will eventuate and the asset possesses a cost or other value that can be measured reliably.

To be fair, the issue of cost capitalisation is a vexed one. The Urgent Issues Group has recently issued guidance on website development costs which reinforces the concepts embodied in SAC 4. Guidance on other areas of cost capitalisation would clearly be welcome.

An example is the dispute between ASIC and OneTel which was settled in April 2000 with OneTel writing-off expenditure of $110 million which had been recorded as an asset in its balance sheet at 31 December 1999.

# What's bad about financial reports

The Securities Institute survey highlighted analysts' views on a number of reporting issues as well as the concerns about new economy stocks described by Steve McClintock.

Matters discussed included:

- Ranking of financial reporting issues
- Goodwill
- Identifiable intangibles
- Research and development
- New economy stocks
- Financial instruments

**RANKING OF FINANCIAL REPORTING ISSUES**

The top six issues of concern to analysts were:

- Harmonisation of Australian accounting standards to international standards
- Capitalisation of costs in new economy stocks
- Disclosure and classification of abnormal items
- Amortisation of identifiable intangibles
- Valuation of intellectual property
- Reporting treatment and valuation of employee/director shares and options

While analysts were not asked to nominate with which set of accounting standards (international, UK or US GAAP) Australian standards should be harmonised, the US is clearly assuming greater importance in world markets and it is therefore important that Australian standards move towards an alignment with the US.

**GOODWILL**

An interesting result was that 82% of respondents believe Australian companies use the goodwill standard to inappropriately adjust reported profits (eg, avoiding the amortisation of acquisition goodwill by attributing excessive value to identifiable intangibles such as brand names and mastheads, or amortising goodwill over periods which are too long).

Of these, 79% said that these practices impair the value of reported profits.

**IDENTIFIABLE INTANGIBLES**

The survey found that most analysts believe that current accounting for identifiable intangibles impairs the value of reported profits.

Most also consider that identifiable intangibles should be amortised and propose that either 20 years or the useful life of the asset are the most appropriate amortisation periods. There were, however, a variety of views on this issue.

**RESEARCH AND DEVELOPMENT**

About half of the survey respondents thought the reporting treatment of research and development expenditure was inadequate. Importantly, 75% of analysts thought that AASB 1101, which allows the deferral of recoverable R&D costs to future years, was inappropriate.

**FINANCIAL INSTRUMENTS**

Fifty-six per cent of survey respondents thought that accounting for all financial instruments should be performed on a mark-to-market basis. This issue will gain particular significance as moves continue towards an international standard for financial instruments. J

OneTel did not accept that the treatment it applied breached the Corporations Law but ASIC's view was unequivocal: "Companies should record as expenses advertising, staff and other costs associated with acquiring customers and the costs of establishing a new business when they are incurred."

In the light of this disagreement, it is not surprising that the survey found that guidance on the capitalisation of advertising costs and the appropriate accounting treatment for mobile handset subsidies would be useful, as would guidance on how these costs should be expensed.

**WHAT'S IT WORTH?**

New economy stocks often start life with intellectual property being "sold" into a listed vehicle or one that is subsequently listed. Consideration for the sale is often shares in the vehicle concerned. In such circumstances, AASB 1015 *Acquisition of Assets* dictates that the acquired asset must be recorded at cost to the company. Cost is defined as the purchase consideration (the fair value as at the acquisition date of assets given, equity instruments issued or liabilities undertaken by the acquiring entity) plus any incidental costs directly attributable to the acquisition.

The issue, of course, is what is the fair value of the intellectual property being acquired. Classic valuation techniques would suggest that the value of an asset is the present value (discounted using an appropriate risk-adjusted rate) of the future net cashflows to be derived from the asset. In the case of unproven or immature intellectual property, particularly where significant or exponential revenue and profit growth is forecast, significant valuation issues arise. Analysts, while appreciating the inherent uncertainties involved in any such valuations, comment that the valuations are often shown to have been optimistic.

**OTHER KEY INFORMATION**

Analysts also strongly support initiatives by the ASX requiring disclosure of quarterly cashflow information included in Appendix 4C of the Listing Rules, with 85% believing that cash burn rates (cashflow information) for new economy stocks should be disclosed on a regular basis. Similar support exists for disclosure of revenue and break-even points.

The challenge for new economy stocks is to improve the credibility of their reported financial information. Responding to feedback from analysts on financial reporting will assist in that process. J