Speaker 1: Hello and welcome to the CPA Australia podcast. Your weekly source of business, leadership, and public practise accounting information.

Ram: Hello and welcome. I'm Ram Subramanian, Policy Advisor in Reporting at CPA Australia. Joining us today is Professor Feng Gu. Feng is the Chair of the Department of Accounting and Law at the University of Buffalo and he's also an associate professor at that University.

Feng is a very well published accounting academic who has contributed numerous articles that have been published in top research journals. Notably, Feng has conducted groundbreaking research with another well-known US based academic, Professor Baruch Lev. Their findings have been published in the now famous book, *The End of Accounting, and the Path Forward for Investors and Managers*.

The key message from the book is that despite the efforts of regulators around the world who strive to improve accounting and corporate transparency, the financial information they require to be disclosed no longer truly affects the performance and value of business enterprises.

Feng is in Australia to participate in CPA Congress 2018, where he will be speaking at multiple locations around the country, on the research findings showcased in The End of Accounting book. As part of his visit, he has also kindly accepted our invitation to record this podcast, where we hope to get some useful insights into his seminal research. Welcome Feng.

Feng: Thank you Ram. Thank you very much for having me. It's a great pleasure to be here.

Ram: Thank you. Look, maybe to kick off the conversation, can you share with listeners the motivation behind why you and Baruch understood the research that led to the book?

Feng: Absolutely. Yeah. This book took us a few years to complete. Took us a lot of time to think about it. The whole motivation came from some of the research we did together more than 10 years ago, in which we find out that accounting relevance for some firms from some industries, actually has been going down for quite some time. This is very much consistent with the evidence discovered by other researchers, starting from the late 1990. If you remember during that period of time, the world economy was going through a lot of changes, particularly in the area of new technologies and new innovation.

Some researchers, including us, started noticing that investors' response to traditionally prepare the accounting information was not as strong as it used to be. We also noticed that a lot of nonfinancial type of performance indicators will be coming more and more relevant for investors. This is when we started thinking about taking a deeper look at the relevance of account information. As time went on, about five, six years ago, we decided that this was the right time to write a book, to look at what has happened to the overall usefulness of accounting information over time, and to understand what is driving the changes in the usefulness of accounting.

Then to think about, really carefully, about what kind of changes are needed for the future direction of accounting. This is how we got started with our book.

Ram: And the rest is history as they say.

Feng: That's right. That's right. Yeah.

Ram: Just an interesting question. Looking at your book, I've obviously read your book. You initially wanted to call it the Death of Accounting, but you decided not to use that term, but instead call it End of Accounting. Any reasons why you changed your mind on that?

Feng: Well, the idea of this book is not to tell people Accounting is no longer needed. Instead we're trying to shake our thinking about what accounting should look like in the future. We don't want to sound completely pessimistic. We want to get people thinking about what's wrong with our current accounting model, and then start a conversation about what changes are needed, what direction we should be taking in the future in order to make sure accounting continues to play an important role in our economy today, and in future.

Ram: Broadly speaking, we are really trying to rethink our focus and where we want to head into the future is essentially what this book is trying to achieve I guess.

Feng: That's exactly the point of this book. You're absolutely correct.

Ram: Can you just share with us some of the key findings from the book?

Feng: Yeah, absolutely. Our book consists of three parts. In the first part, we devoted a total of five chapters to find out if today, investors still care about accounting numbers. For example, earnings are traditionally described as a moving force for financial market. We want to find out using empirical tests whether or not this is still true today. That's very much the focus of the first part. In this part, we show that the relevance of account information has declined sharply over the last 60 years, particularly more so for firms operating with new business models and in new economic sectors.

There in the second part, we asked the question about what economic forces have made accounting less relevant in the last couple of decades? Again, we base our findings on rigorous empirical tests using large quantity of data, going back to the last 50 to 60 years. Our results show that three factors are responsible for most of the decline in the relevance of account information. The first factor is the dramatic increase in the amount of investment in tangible assets, such as technology, branding, business process, designs and so on. This change has been taking place over the last 20 to 30 years, but it's not a overnight shift from one model to another. Instead, it's an increase gradually over time, and sometimes the increase may be interrupted by economic crisis, recessions, and so on.

Yet, the overall trend is very clear. Over the last 30 years, investment in tangible assets in major developed economies have overtaken investment in tangible assets, such as

building, land, equipment, to become the most dominant and vibrant form of investment in the modern economy. This is a very important change. We demonstrate it in this part of the book that this factor is responsible for a pretty large amount of the decline and relevance of accounting information. The reason this factor plays a role here is very straightforward.

Under the current accounting rules, investment in tangible assets, such as technology, brand name, innovation, so on, are not recognised as an economic asset in accounting reports. Instead, they're fully expensed when companies spend money on these activities, and as a result, there's a lot of distortion in the financial statement information we communicate to investors, such as earnings, book value, equity and all the important financial ratios that are based on these accounting numbers.

This is the first factor. The second factor we have identified in this part of the book is the widespread use of accounting estimates. Over the last 20, 30 years, more and more estimates have been incorporated into financial statements. For example, fair value estimates. This is gaining a lot more adoption in financial statements. The problem with these estimates is they're not always reliable. They are based on very subjective, and often unreliable inputs from the manager. There are a lot of problems of incorporating these estimates into financial statements.

We show empirically that these estimates have decreased the relevance of account information. The third factor has something to do with the long term tradition of accounting conservatism. Since the creation of accounting system more than 500 years ago, accountants have always followed this idea called conservatism, under which losses are recognised immediately as soon as they become evident, and the gains in asset value and economic profits, are often delayed, for a relatively long period of time.

As a result of this kind of tendency, a lot of important business events are really ignored and delayed in financial statement recognition. This also creates a lot of bias in the financial statement we sent to investors. This has become another factor responsible for the loss of accounting relevance over time. These are the three factors we have documented in this part of the book.

In the third part of the book, we come up with a proposal about how to reform accounting to make it a more relevant part of our information system in the modern economy. We come up with three proposals. One is to recognise intangible investment as assets. Consistent with their contribution to firm's performance and the shareholder value. The second proposal we have is to streamline the current accounting process, particularly removing the use of many unreliable and subjective estimates. That's the second idea. The third idea, which I think is more important for making sure accounting remains to be relevant in future, is all proposal focusing on firm's strategic resources.

Strategic resources are more important than other types of assets, such as commodities, that every firm may have access to at the same cost. Strategic resources are relatively well in supply. They're valuable, and they're difficult for competitors to imitate. This is where a firm can get most of its competitive advantage from. We believe it's important for accounting to focus on strategic resources that a firm has, such as the investment

that goes into these resources, the protection firm has, as well as the [inaudible] a firm creates each period of time from using these assets in its business operation.

This is really the most important part of our proposal. It calls for a new focus on this type of important asset called strategic resources.

Ram: Thank you for that Feng. Going back to the three factors that you have identified as the key factors that have led to the loss of relevance that you've identified in your book. If you just focus on the first of those factors that you identified, which is to do with intangibles, you refer to intangibles as economic assets, which clearly they are, and the problem to me, at least, seems to be that there is a mismatch between the identification of intangibles as economic assets, and the recognition, the measurement and recognition of those intangibles as accounting assets. Would you say that that is an issue that does need to be addressed? A mismatch between what is an economic asset and what is an accounting asset?

Feng: That's exactly the problem we're facing now. Economically speaking, as we have seen from the change in our economy over the last 20 to 30 years, intangible assets, such as technology, brand name and other types of innovation, have become a driving force for economic growth and creation of wealth. Also to industries and across many, many countries. The economic role of intangible assets in modern economic development and growth is very clear. Yet in accounting, we have been following the same standard for many, many years, and we still ignore the economic contribution of intangible assets, and we treat them as something that does not provide any benefits beyond the current period of time.

That's exactly the mismatching problem you just mentioned Ram that is making account information less and less relevant, particularly for firms that invest a lot of money in technology related innovation, brand name creation, and other types of innovation.

Ram: Before we move on to the three proposals where you propose a solution to this problem and the other problems that you've identified in the book, maybe I'll just focus on the other two factors. This is just a thought that occurred to me when looking at those two factors. One has to do with the prevalence or the increase in prevalence of accounting estimates, and the other issue is the management conservatism, or the conservatism expressed by managers and others, in preparing financials.

To me, there seems to be a tension between those two ideas. On the one hand, there is an increase in estimates, so more estimates. On the other hand, there's more prudence, or more conservatism in the application of their thinking behind the numbers. Could you just explain whether there is a tension or not between those two factors?

Feng: Sure. This is a very important question, I'm glad you just brought it out. Under some conditions, it might be a tension between the two. If you look at the use of an estimate, the purpose here is to show loss and gains before these items are even realised. Let's say you have a financial asset. Over time, the value of this financial asset has increased. Under the current accounting rules, if you meet certain conditions, you can recognise

the gain. However, if you go with the long-term tradition of accounting conservatism, it tells you, No, you should wait until you have already realised gain when you sell the asset on the open market right?

This creates the tension here. On the other hand, if we have a loss situation, let's say the value of your financial asset has decreased over time, I know you have no problem. You would get exactly the same answer from both perspectives right? Under the use of accounting estimates, you would recognise a loss right away. Accounting conservatism would also require you to recognise the loss as soon as possible. Things get a little bit more complicated when we look into the details of how we deal with each different scenario. This creates another set of problems that accounting currently faces, the lack of consistency.

Ram: Okay, thank you for that. Before we move on to the proposals and just exploring a little bit of the proposals with you, your research has primarily focused on the US market. The Standard and Poor stock exchange listed companies, space. You've looked at it in the context of the FASB, accounting standards that are part of the accounting framework in the US.

In Australia, we obviously use IFRS based financial reporting. Our accounting standards here are based on international financial reporting standards. There is a view, and I don't necessarily have a view myself on this, but there is a view that the FASB accounting standards are more rules based, and the IFRS accounting standards, are more principles based. There is a view that that is the case. Could that be one of the reasons why your findings are somewhat negative in the U.S., because of the rules based approach to financial reporting?

Feng: This may be one of the in explanatory factors for the differences between the US setting and Australian setting. However, I think there is a more important reason behind the difference we have seen here. I think it has something to do with the intensity of innovation and investment in tangible assets. US firms are very unique compared to firms from other markets in the sense that US firms invest more in innovation activities, and US firms are also more related to emerging new technologies and new industries.

Firms elsewhere for example, in Australia, their investment level in tangible assets and innovation is not as high as what we have in the US. This I think is a more important economic factor. Speaking of the difference between IFRS and the US accounting gap, there are several noticeable differences. For example, the reporting of intangible assets, under IFRS, if firms meet certain requirements, for example, technological visibility, if we can demonstrate our project has achieved a technological visibility, then they can go ahead and capitalise the remaining cost of further developing their project, and start marketing their products to their customers.

This is not allowed in the US, except for the case of software products. Now this already is better than not recognising intangible investment as assets at all. There's a lot of limitations if you think about the details because firm tend to spend a lot of money up front before they can achieve technological visibility. In many cases, once they have demonstrated technological visibility, the remaining part of their development cost is

relatively small. In some cases, very small compared to the upfront and development cost that is not recognised as an asset.

I'm not exactly sure how the IFRS rules would really help making sure that accounting information reflects the economic reality here.

Ram: Okay. Thanks for that Feng. You obviously mentioned that there may be some differences in the markets itself. Maybe there's a difference between the American market and the Australian market itself that could contribute to these differences. As you already know, we've sort of closely followed your research methodology, and CPA Australia has funded a research, a piece of research, that has been undertaken in Australia, and the reports are currently being produced and published as we speak. You are well aware of our findings here, which somewhat contrast the findings that you've discovered and explained in your book. Can you share with us some of the thoughts maybe you have around why there may be differences? I think you may have already alluded to one of those differences, which is a difference in markets, but maybe there are other reasons why you think there may be difference between the two findings?

Feng: Sure. There are a couple of noticeable differences between my research setting based on US firms, and the research setting here, based on the experience of Australian firms. The first difference I noticed is the time period covered by the study. In the US setting, we have a lot more data available, going back to a much earlier period of time, like the beginning of the 1950s. I understand Australian studies based on a more recent period of time, starting from the '90s, and covers a smaller number of firms than the US setting provides. That might be one of the explanations for why there are some differences.

The second reason is related to the fact you already mentioned before. The large difference in innovation intensity between these two economies, not just the types of firms we cover each study, but also the general economic trend here. This is confirmed by a lot of reports put together by economies around the world. There is a 2016 report put together by OECD that tracks innovation activities in different countries in the G20 group. Both US and Australia are included in this group. This report covers a lot of details about not just the level of investment in innovation, but also the trend over time, as well as the main contributors.

There are large firm, small to medium sized firms, government funded research, and so on. Overall, the level of investment innovation in Australia is, in some areas, even below the average across the G20 countries. Of course, there are some good news here. Their report shows that the small to medium sized firms in Australia have increased their investment innovation, has become much more active in this area. In the US, it's not just a higher level of innovation. It's just one wave, after another wave of new innovation and almost every 10 years, you want to see a new generation of new firms, with brand new technology, brand new business model coming to the market.

Then some of the older generations of firms in the older generation, were to fade away if their business model stops working. This kind of, if you call it, evolution of firms over time, is not really something we can see everywhere. In that sense, the setting of US is very unique. Maybe this has contributed a lot to our research finding. We actually have

some results showing that if you go back to the 1950s and look at firms that enter the stock market during that time and stay in the stock market, maybe for 10 years, 20 years, or maybe 50 years, until when we ended the sample in 2013. These firms have very high and stable accounting relevance. You don't see any decrease in their accounting relevance.

Yet, when we move into the '90s and early 2000s and focus on the newer generational firms that enter the stock market with much newer business model and newer technology, we see a very large drop in their accounting relevance. This is a different kind of firms. The current accounting model just doesn't do a good job reflecting their performance capturing their value.

Ram: Thank you for that. If we just turn to the solutions that you proposed in your book, and obviously you mentioned those three proposals when you were talking about them earlier, if I just focus on your main theme, which is essentially strategic resources and consequences report. Having gone through what you're proposing in that form of report, to me, resonates somewhat closely with another form of reporting, which we are very strong supporters of, which is integrated reporting. I was just wondering if there is any connection, or any similarities, between what you're proposing in your solution for a report, compared to the integrated report that is issued by the International Integrated Reporting Counsil.

Feng: Sure. Yeah. Integrated reporting has become a very powerful force around the world. It's a very innovative idea of incorporating as many perspectives as we can into the reporting process. I don't think there's a huge amount of overlap between our proposal and the proposal on the integrated reporting. There might be some overlap in some areas for firms from some industries, but the focus here is very different. If I understand the focus of integrated reporting correctly, they're trying to expand the current focus of shareholder based reporting to look across a broad set of stakeholders. In corporate, not just financial information, but information that is relevant for other stakeholders to evaluate the performance of the firm, not just the financial performance, but also the firm's contribution to social development, environmental protection and so on, this is definitely a wonderful idea. I don't see why it should not be considered.

Our proposal, however, has a much more clear focus. We want to focus on understanding how a firm is using its strategical resources to create value for shareholders. Like I said before, in some areas that you might see overlap between integrated reporting and our focus, in most cases, I think we have a different focus here.

Ram: Thanks for that Feng. The reason I asked the question is just looking at the capitals that you get on the integrated reporting, and the value creation through those capitals. One of them is intellectual. Looking at your findings, you obviously a problem with the recognition of intangible assets and the value with intangibles.

Feng: Yeah.

Ram: To me, that seemed to be a connection that's probably worth considering.

Feng: Absolutely. Absolutely. Just like I said before, in some areas, there is more overlap between approach and integral reporting, in other areas, there might be less overlap. In the area of intellectual capital in tangible investment, I think we have a lot in common. We both believe this is becoming a very important factor for firms to report. The current reporting model we have is not doing a very good job. That's why we need to shift the focus here, we need to identify new information variables that will shed light on the valuable of intangible asset a firm has. That's exactly what we're trying to do here in our proposal that focuses on strategical resources.

In many industries, the most valuable strategical resources for a firm is in fact, their intangible investment.

Ram: Thanks for that Feng. If I maybe just move away a bit from this particular book and the topic that this book covers, maybe there is some relationship, but I will just explore that with you if I may. Once I was hearing you speak, I heard you talk about a mismatch having arisen in the last few years between recognition of revenue, and the recognition of expenses. I think you explained that that mismatch has contributed to this loss of relevance.

Going back to fundamental concepts of accounting that I'm used to, we talk about revenue being recognised as it's earned, and expenses being recognised as they arise. We've moved away from what they used to call the matching concept basically, which doesn't exist anymore in the framework for financial reporting.

Are you suggesting maybe move back to that? That's certainly something that we wouldn't want, or is there another way you think that issue can be resolved?

Feng: Yeah, this is a very important question. The matching principle is really something we have to think carefully about our position here. Traditionally speaking, matching principle has been one of the most important ideas behind the whole income statement, the idea of reporting income statement information is to match revenues generated, given a period of time, with expenses, which are defined as the resources that I utilise and consume.

To generate the revenue that we report on the top line income statement, there was a survey several years ago. The survey covered a large number of CFOs from several thousand firms, small firm, large firms and all types of firms from a large number of industries. More than 90% of the CFOs who participate in this survey responded to this question about the importance of matching by saying that they believe high quality matching between revenues and expenses is what drives the usefulness of account information. In other words, if we get away from a good level of matching between revenue and expenses, we'll have a problem with the relevance of accounting.

I think this makes a lot of sense. That's what really people care about in terms of the economic performance of a firm. Now, starting from the '80s, the whole focus of accounting standard setting and reporting have shifted from income statement matching between revenues and expenses, to balance sheet relevance. That's why we

have a lot of fair value estimate, that's why we have a lot of one-time items as a result of making sure that our balance sheet reflects more relevant information about what investors see on the financial market on the daily basis.

This may sound like a good idea, but even before this shift was started, there was always a tension between balance sheet and income statement. There's a lot of examples I can give here if you focus more to make sure that balance sheet information is more relevant, more timely. Then you're going to sacrifice the quality of matching between revenues/expenses, and vice versa. There is never going to be a perfect model that will allow you to achieve both. These two objectives simply cannot exist together, in my opinion.

Now, with the shift to balance sheet focus, we have sacrificed a lot of matching quality on income statement, and we have seen the problem. It's not just that our research shows accounting relevance has declined. If you take a look at the way investors respond to account information these days, it's definitely not as strong as used to be. On top of that, you might have noticed that more and more firms are starting to report a type of information that is completely different from what accounting standards require them to do.

This is so called a non-gap information. Alright. It started from non-gap earnings, and now we have non-gap revenue, non-gap expenses, non-gap assets, non-gap liabilities, you know, non-gap cash flows. There are different definitions of free cash flows, and a bunch of financial ratios that are really different from the way we used to think about accounting.

My understanding about why more and more firms are doing this is because they know. They are the preparer of account information. They see the reaction from investors and they understand that the current model is very limited. It does not allow them to share the most relevant information. That's why they're starting to create their own version of financial performance indicators and communicate these indicators even more strongly with investors and traditionally define accounting numbers.

Ram: I think the International Accounting Standards Board has certainly acknowledge and recognised the importance of non-gap information. They've obviously got a project looking at how to accommodate non-gap information within the literature that they have in the IFRS framework. We shall have to wait and see how that progresses. That's quite a useful insight. Thank you for that.

Maybe if I just slightly shift focus a little bit, again. Clearly, this is a very important aspect of the profession. This is financial reporting and accounting that your book covers. The issues that you've identified around the loss of relevance, to me, looking at the various other factors that are impacting on the profession at this point in time. This isn't just the one. You've got artificial intelligence, you've got digital disruption. You've got data analytics. There is a growing swell of thinking that the role of the accountant has to evolve and shift and change to accommodate these new changes and these differences that are arising.

It's not just about the demands from the marketplace on the information that they receive through accounting, it is also these technological changes that are going to have an impact too. Do you have any thoughts around how the accountant should prepare himself, or herself, for the future in this new world?

Feng: Oh yeah. Absolutely. This is a very important question, and I'm glad we now have some time to talk about it. I'm a researcher in accounting. I'm also educator. I'm responsible for the learning of my students. We have a fairly large accounting program that focuses on preparing our students for their future career as public accountants and beyond. We constantly think about implication of these factors you just mentioned for the education needs of our students, and for the success of their future career.

In my mind, there is no doubt, these changes in technology will have large impact on the kind of work accountants will be doing, or how accountants will performs their work in the future. I agree with you. The top challenge here for us to think about is whether this is going to create new opportunities for accountants to remain relevant, or even become more relevant, or they will displace the kind of work many accountants are currently doing.

I think we need to be very careful about the negative side of this. If we are under prepared, then will not be ready to deal with the challenge in the future. I would prefer everybody to be a little bit over prepared, because that's the safer approach.

Most of the technologies we're talking about today are still relatively early, in early stage. We still do not fully understand their implication, but there are already some discussion among my colleagues and from practitioners in the industry that new technologies like blockchain may have the potential to replace many of the things accountants are currently doing. If we don't innovate, if we don't adapt to these new trends, there is no guarantee there will be a future market demand for work.

If you think about what value accountants can add to financial statement, it's basically our ability to verify the relevance and the truthfulness of information. If that as fact, is replaced by new technology, for example, blockchain, a lot of people believe it will be able to generate some kind of embedded verification, even without the work done by third party, like auditing firms. That is going to be a huge problem for us.

We need to carefully think about it and make sure that we prepare the next generation of accountants for this kind of challenge.

Ram: Thank you. I think what I hear in this space is that accountants need to move away from a compliance based approach to their profession, to more analytical, value-add based approach to their profession, where to truly add value to businesses and to the economy as a whole, to an advisory role. Would that be correct?

Feng: I think this is very, very meaningful. I agree with you here. There is a lot accountants can do, but it's not in your areas of some of the work we're currently doing, like projecting what is going to happen in the future. That's not really the strengths of accountants. If

you think about the root of accounting, accounting started from counting right? Counting things, counting things we can verify. I think that still remains relevant today. In the future, this is definitely important direction for us to go back to. We need to keep discovering new directions, new type of information that will add value to financial reporting.

I think this is very much consistent with one of the proposals in our book, that focuses on strategic resources, right? If we believe strategical resources are important, then accountant's job can include collecting and verifying more information about a firm's strategical resources, and provide measures about the performance of these resources, and then use the information to advise whoever may be interested in knowing this kind of information.

There is a lot more accountants can do. We should not limit our attention to what we are currently doing. Some of that is not very relevant.

Ram: Thank you very much Feng. I think you have given us some very useful insights, particularly on your book. Of course, the way forward for the profession as well. Thank you once again for giving us the opportunity to record this podcast. Thank you.

Feng: You're very welcome. It's a good pleasure to talk to you.

Ram: Thank you. For those who have listened to this podcast and are very interested in reading through the book, The End of Accounting book, a link is provided on the page where this podcast resides. We've also provided you with some other links which you may find useful, including the reports that CPA Australia has produced based on the research we did here in Australia. Please feel free to click through and have a read. Thank you.

Speaker 1: Thank you for listening to the CPA Australia podcast. To download the transcript and to access the show notes for this episode, please visit www.cpaaustralia.com.au/podcast/91.