

---

# HOW ACCOUNTING CAN DISTORT VALUATIONS

Jeremy Schwartz – Global Chief Investment Officer  
11/24/2020

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 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.

For more investing insights, check out our [Economic & Market Outlook](#)

View the online version of this article [here](#).

**IMPORTANT INFORMATION**

**U.S. investors only:** Click [here](#) to obtain a WisdomTree ETF prospectus which contains investment objectives, risks, charges, expenses, and other information; read and consider carefully before investing.

There are risks involved with investing, including possible loss of principal. Foreign investing involves currency, political and economic risk. Funds focusing on a single country, sector and/or funds that emphasize investments in smaller companies may experience greater price volatility. Investments in emerging markets, currency, fixed income and alternative investments include additional risks. Please see prospectus for discussion of risks.

Past performance is not indicative of future results. This material contains the opinions of the author, which are subject to change, and should not to be considered or interpreted as a recommendation to participate in any particular trading strategy, or deemed to be an offer or sale of any investment product and it should not be relied on as such. There is no guarantee that any strategies discussed will work under all market conditions. This material represents an assessment of the market environment at a specific time and is not intended to be a forecast of future events or a guarantee of future results. This material should not be relied upon as research or investment advice regarding any security in particular. The user of this information assumes the entire risk of any use made of the information provided herein. Neither WisdomTree nor its affiliates, nor Foreside Fund Services, LLC, or its affiliates provide tax or legal advice. Investors seeking tax or legal advice should consult their tax or legal advisor. Unless expressly stated otherwise the opinions, interpretations or findings expressed herein do not necessarily represent the views of WisdomTree or any of its affiliates.

The MSCI information may only be used for your internal use, may not be reproduced or re-disseminated in any form and may not be used as a basis for or component of any financial instruments or products or indexes. None of the MSCI information is intended to constitute investment advice or a recommendation to make (or refrain from making) any kind of investment decision and may not be relied on as such. Historical data and analysis should not be taken as an indication or guarantee of any future performance analysis, forecast or prediction. The MSCI information is provided on an "as is" basis and the user of this information assumes the entire risk of any use made of this information. MSCI, each of its affiliates and each entity involved in compiling, computing or creating any MSCI information (collectively, the "MSCI Parties") expressly disclaims all warranties. With respect to this information, in no event shall any MSCI Party have any liability for any direct, indirect, special, incidental, punitive, consequential (including loss profits) or any other damages ([www.msci.com](http://www.msci.com))

Jonathan Steinberg, Jeremy Schwartz, Rick Harper, Christopher Gannatti, Bradley Krom, Tripp Zimmerman, Michael Barrer, Anita Rausch, Kevin Flanagan, Brendan Loftus, Joseph Tenaglia, Jeff Weniger, Matt Wagner, Alejandro Saltiel, Ryan Krystopowicz, Jianing Wu, and Brian Manby are registered representatives of Foreside Fund Services, LLC.

WisdomTree Funds are distributed by Foreside Fund Services, LLC, in the U.S. only. You cannot invest directly in an index.

## 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 time.

**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.