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Account of Service Sectors in the Digital Economy

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ABSTRACT
About the Author Patricia (Pat) Meredith is a CIGI senior fellow and a global thought leader, award-winning author, and consultant in the emerging field of strategic governance. Pat is the director of many public, private, and not-for-profit organizations. She was executive vice president, chief strategy officer of a major financial institution, and senior strategy adviser to financial services and technology companies for a global strategy consultancy.

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Executive Summary The digital economy is being driven by investments in intangible assets, such as design branding and software, not by tangible assets, such as machinery, buildings and computers, of the industrial economy. However, accounting standards have not kept pace with the shift. They do not recognize investments in intangibles unless they are purchased from a third party. It is not that accountants do not know how to record these assets, as the methodology used to determine if purchased intangibles are impaired could be expanded to include internally manufactured assets. But doing so would require a change in mindset, from ensuring that in hindsight, assets were not overstated, to recognizing with foresight those assets likely to create future value for stakeholders. Shifting this mindset is much more difficult than changing accounting standards.

History has demonstrated in previous economic revolutions that shifting mindsets and accounting standards is necessary to capture future economic prosperity. Without formal recognition of intangible assets and alignment of accounting with the new economic reality, it is difficult for lenders to make loans, for investors to make investments and for governments to tax value creation. The profession cannot accomplish such a massive task on its own. It needs active support from policymakers and regulators, investors, creditors, managers, and directors. It may also need a crisis response, such as mandated net-zero carbon emissions, to make the necessary changes. Introduction Some prominent historians, notably Niall Ferguson (2018, 82–9), have argued that society would never have achieved the prosperity of the industrial age without the benefit of double-entry bookkeeping. But while the accounting system that requires equal and corresponding entries for every item may have been just the ticket for nineteenth-century factories and shops, it is ill-equipped for the knowledge-based businesses driving the digital economy.

Double-entry bookkeeping, as it is still practiced today, cannot capture the intangible assets that drive all businesses, especially technology companies such as Facebook, Google, Microsoft, and Netflix. It does not give corporate leaders the real-time information they need to direct resources to the activities that society values most. Nor does it tell others with an interest in a company's success, such as employees, customers, suppliers, investors, and regulators, whether the business is creating or destroying value for them. Finally, it is not terribly helpful in managing future risks and uncertainties. If the accounting profession is to continue supporting economic prosperity and effective corporate governance in the information age, it must develop new tools better suited to our times. So far, it has lacked the mindset, training, and tax incentives to do so.

The International Accounting Standards2 (IAS) framework, the set of rules that guides accountants around the world, defines an asset as "a resource with economic value that an individual, corporation, or country owns or controls in the expectation that it will provide a future benefit" (IAS 1). This definition clearly encompasses the intangible assets driving the information economy. Yet the application of this framework has not kept pace with the dramatic changes in the global economy over the past 20–30 years. The problem is not that accountants do not know how to measure intangible assets. IAS 36 spells out an approach (known as value-in-use) to valuing purchased intangibles to determine whether they are impaired. Likewise, IAS 38 provides guidance on how to recognize internally generated intangible assets and how to revalue them in a few specific situations. The real problem is that accountants have an outdated view of economic reality. Rethinking Capital, a London, UK-based think tank, has been advising companies for the past 20 years on how to apply IAS 36 and 38, as well as the IFRS Foundation's conceptual framework to intangible assets.3 It suggests using "normative" accounting rules. As described by Richard Mattessich in the 1950s, "normative accounting represents theories of accounting, often based on deductive logic and reasoning, that prescribe the accounting procedures and policies that should be followed rather than observing or describing those that are followed in practice" (Mattessich 1984). Using this normative approach, Rethinking Capital applies the following principles:

- Intangibles are the assets that create and sustain value in today's economy.
- Accounting practices systematically write off investments in intangible assets as expenses.
- Depending on company size, 40–60 percent of expenditures over a three-year period could typically have been capitalized.
- Current accounting practice therefore substantially understates a business's assets, equity and profitability.
- Properly capitalizing and reporting the current value of intangible assets based on actual customer demand will reflect their fair value.

Rethinking Capital has concluded that with a shift in mindset, accountants can use existing standards and conceptual frameworks to value intangible assets. Rather than using the IFRS's conservative "prudence" principle and IAS 36 and 38 only to write down impaired intangible assets, the profession can use the same value-in-use principles to recognize and continually revalue these assets. Since standards already exist for auditors using this methodology, it should not be difficult to extend them to cover intangible assets. The "prudent" mindset is reinforced by the Income Tax Act, which already encourages companies to write off the costs of creating intangible assets to reduce their tax bill. This approach is misguided because it reinforces the attitude that intangible assets have no value, when in fact they can be crucial for a company's growth and competitive advantage. Given the key role of innovation in driving economic growth, it would surely make sense to rewrite the rules to encourage recognition of intangible assets. Although Canada's national accounts record some intangible assets, a shift in accounting rules would provide a more accurate and favourable picture of the country's ability to mange its debt. Historically, accountants have managed to adjust their practices to accommodate shifting economic trends.

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