Role of Losses in the Financial Statements of Digital Companies

U. E. Monastyrsky

Abstract Nowadays, there is a problem that financial reporting does not fully meet current realities and features of digital companies, where intangible assets occupy a special position: developments, brands, organizational strategy, networks of partners and suppliers, client and social relations, computer data and software, as well as the human capital. With the growth of total investments, companies are increasingly faced with a paradox of "digitalization" and do not get the expected profit. The main purpose of this article is to determine how income and losses affect the value of the company, as well as to determine the main criteria for evaluating intangible assets of digital companies. The article presents results of analyzing the role of losses in the financial statements of digital companies. The author reveals the existence of an inverse relation between investments in the company's technological development and the growth of its losses in the financial statements.

Keywords Digitalization · Controlling persons · Bankruptcy · Liability of controlling persons

1 Introduction

The total capitalization of one hundred of the world's largest companies in 2019 amounted to more than 21 trillions US dollars [1], seven of the ten most expensive organizations are technology and online retail companies—Microsoft, Apple, Amazon, Alphabet, Facebook, Alibaba, and Tencent. This fact is a consequence of the digital revolution, the main result of which was the growth of the number of technology and digital companies around the world. The main feature of these companies is not providing physical goods and services, but intangible goods: information, digital goods and services, software, customers and brands [4].

In the study of Capgemini Consulting and MIT Sloan School of Management "Embracing Digital Technology: A New Strategic Imperative", based on the analysis

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results of activities of 400 large companies from different industries, expectations from the use of new technologies and management techniques and the dependence of financial indicators were determined. For example, companies that actively use technologies and new management methods are on average 26% more profitable than their competitors; organizations that actively invest in digital technologies, but pay little attention to management, have financial indicators 11% lower; companies that improve only management receive plus 9% of their profits, but can potentially acquire three times more using digital technologies; companies that do not choose a digital development strategy have negative financial indicators compared to other market players—minus 24% [5].

Digitalization of business models has also brought its own adjustments to monetization strategies, ensuring production efficiency. Meanwhile, with the growth of total investments, companies are increasingly faced with a "digitalization" paradox and do not get the expected profit. As the company's investment in digitalization increases, the paradox becomes more likely, and only a few companies actually achieve high returns that meet their expectations [9].

However, with the rapid growth of the number of digital companies, the assessment of their profitability becomes particularly important [1]. For investors, information about profits and their driving forces is without a doubt the most valuable information disclosed by digital companies. Losses and profits have remained the main indicators of financial reporting over the past decades [16]. However, current trends indicate the inefficiency of traditional correlations between income and loss in the enterprise value assessment in relation to digital companies.

2 Methodology

The methodological basis of this research is a systematic approach to the study of modern practice of providing financial statements of digital companies. When processing the actual material, the author used traditional scientific methods such as dialectical, logical, scientific generalization, content analysis, comparative analysis, synthesis, source studies, etc. Their application allowed ensuring the validity of the analysis, theoretical and practical conclusions.

3 Results

Traditional financial indicators of the company profitability demonstrate that they are not applicable to digital companies. A prime example is Uber, whose net loss in 2019 reached 8.51 billion U.S. dollars, and in 2018, the company made a profit of $997 millions, and spent $172 millions on compensation to shareholders [17]. Despite significant losses, the company held a successful IPO in April 2019. In total,

more than 90 investors have invested in this business. According to some experts, Uber has conducted 23 investment rounds since 2009 [6].

The situation was similar with Twitter and LinkedIn in 2013 and with WhatsApp in 2014. A reasonable question arises: why are technology companies that show a negative balance in demand in the market? Digital transformation exacerbates problems and difficulties for taking financial decision, making financial reporting, and accounting recommendations on which investors and market participants base their capital market decisions. The main reason lies in the goods/services produced by these companies. Valuation of assets of a company that produces physical goods is quite simple—fixed capital and its depreciation in a straight line over several years are taken as a basis. Thus, there is a direct link between the company's losses and the value of its shares.

In another situation are digital companies, a significant part of corporate balance sheets of which currently consists of intangible assets compared to physical assets. Why do investors react negatively to losses in financial statements for an industrial firm, but ignore such losses for a digital company?

4 Discussion

According to experts, financial reporting annually demonstrates less efficiency and applicability to the assessment of the current state of affairs of digital companies [3]. As it was noted earlier, for an industrial company, the profit and loss statement provides a complete description of the state of production assets. However, digital companies often have assets that are intangible in their nature, and many of them have ecosystems that extend beyond the company. Many digital companies do not have physical products and inventory to report. Therefore, the balance sheets of physical and digital companies present completely different pictures [11].

Digital companies' assets are based on intangible assets such as research and development, brands, organizational strategy, networks of partners and suppliers, customer and social relationships, computer data and software, and the human capital.

The Harvard Business Review published results of a survey of chief financial officers of leading technology companies and senior analysts at investment banks who monitor technology companies. Some of these ideas contradict traditional financial thinking, while others seem to be highly controversial.

It is assumed that financial capital is virtually unlimited, while some types of human capital are in short supply. For digital companies, the time of scientists, software developers, and product development teams is the company's most valuable resource. They believe they can always raise financial capital to cover a funding shortfall, or use the company's shares or options to pay for acquisitions and employee salaries. Thus, the main goal of the CEO is not to allocate financial capital wisely, but to direct valuable scientific and human resources to the most promising projects and to return and reallocate these resources in a timely manner when the prospects for specific projects dim. Traditional valuation models view risk as an undesirable

feature. Digital companies, by contrast, are chasing risky projects that have lottery payouts. An idea with uncertain prospects, but at least some possible chance of reaching a billion dollars in revenue, is considered much more valuable than a project with a net present value of several hundred million dollars, but no chance of massive growth [10].

At the same time, for digital companies, in contrast to companies in the traditional manufacturing sector, there is a certain paradox: financing in its intangible assets is not capitalized as assets and is considered as an expense when calculating profits [12]. Thus, the more a digital company invests in building its future, the higher its reported losses are [15]. However, when investing in intangible assets, digital companies have the same goal as non-digital companies. Thus, investors have no choice but to ignore profit in their investment decisions [2, 7].

Intangible assets also have another distinctive feature. Their value increases as more people use a product or service, while physical assets depreciate as they are used [13]. Thus, the fundamental idea behind the success of digital companies (increasing returns from the scale) goes against the basic principle of financial accounting (assets are depreciated with use).

As digital companies become more visible in the economy and physical companies become more digital in their operations, there is a persistent trend that intangible investments have surpassed fixed assets, and understanding fixed assets and equipment as the main way to create capital is no longer applicable [9].

However, there is no place in financial accounting for the concept of network effects or increasing the value of a resource by using it. This actually means a negative depreciation expense in accounting language [8].

In such circumstances, the search for effective methods of evaluation of intangible assets becomes particularly important. It is interesting to use methodologies for generating income and cash flows that are specifically designed to assess the value of intangible assets.

According to S. Krishnan, when a company acquires another company, it is required to distribute the purchase price separately for all assets acquired for financial reporting purposes. As part of the purchase price allocation process, methods such as royalty exemption and excess profit method are used to evaluate intangible assets, which is very convenient when assessing the value of digital companies. Valuation of intangible assets based on these methods gives an accurate picture of where the real value is and what the cost factors are for these digital companies [14].

5 Conclusion

The current financial reporting structure, although necessary and authorized by the financial authorities, does not necessarily reflect incomes from intangible assets, and as a result, levels the value of digital companies, which is a huge disadvantage.

Digital companies generate a significant portion of their value, brand value, and value from intangible assets. The more a digital or technology company invests

in growth and development in the form of intangible investments, the more it simultaneously makes itself less profitable in the form of higher operating costs.

The existing inverse correlation between investments in the company's technological development and the growth of its losses in the financial statements, as well as the lack of information about the growth in the value of intangible assets with their use, determines the search for additional information sources about factors underlying them. Such non-financial indicators are becoming more and more significant in the context of the growth of the digital companies number.

Companies' finance directors are also aware of the growing limitations of the current financial reporting model. As a way out of this situation, some modern digital companies disclose information about users, pricing, and downloads in addition to other performance indicators. Financial as well as non-financial disclosures show investors the real picture of affairs and the value of digital companies.

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