## Lev, Baruch & Gu, Feng – The End of Accounting

*John Wiley & Sons, 2016, [Business]* Grade ★★★

There is something wrong with the accounting. It doesn't appear to serve its purpose anymore. Baruch Lev and Feng Gu, two accounting professors at NY Stern and the University of Buffalo respectively, in a legible way explain why this is and what to do about it. This is not a book for those who want to understand the intricacies of today's accounting, it's a book that argues for a total overhaul of the way we practice accounting. The aim is to mobilize investors to lobby for a change towards a better accounting methodology.

In the main sections of the text the authors first try to convince the reader of their thesis that the usefulness of accounting numbers is in decline, then they give their main reasons for this and finally present a reform package in a section of the book that also contains a number of case studies from various industries.

So, what are the issues that Lev and Gu single out as indicators of a quality problem? They show how even having the gift of perfect foresight in forecasting quarterly EPS numbers has yielded gradually less outperformance since the 1990s. With a start in the late 1980s they show a declining correlation between historical sales, profits and book values and future ones rendering historic numbers less practical when making forecasts, with regards to what moves share prices new accounting data now contribute 5% of the movements compared to 10% two decades ago. This leads to higher estimate errors and increased estimate dispersion from analysts while the volatility of the underlying businesses has dropped. All this is, in the authors' view, indications of the declining relevance of accounting numbers with regards to their key target group of analysts and investors. Although they present a convincing case this part of the book is a bit too agitating for my taste.

A large part of the explanation for the declining efficiency is that while the core principles of accounting haven't changed for at least a century there has been a big shift in the structure of businesses. The center of gravity of the business world is gradually moving towards what's called asset light companies. The thing is that even those companies have assets; they're just not accounted for. In the 1970s the unaccounted intangible assets were estimated to equal half of the tangible ones on the balance sheet. Today, the ratio is the reverse. Thus, the number of non-accounting events that affect the value of a company has gone up. Further, the amount of subjective managerial decisions in deciding on values in the accounts has increased dramatically. Lev and Gu count estimate-related terms in financial reports ("expected", "estimated" etc.) and show that they have increased 400% in just two decades and further that this change correlates well in time with the growing difficulty of using historic numbers to forecast future ones.

By decoding a vast amount of conference call Q&A transcripts from when companies report their quarterly earnings the authors try to reverse engineer what investors truly focus on. They conclude that companies should report 1) what the strategic resources of the company are that will help them get a sustainable competitive advantage, 2) how they invest in these resources, 3) what the risks are towards the resources value creating ability and what management is doing to mitigate them, 4) outline the strategies with regards to how the resources are deployed and 5) measuring and reporting the resulting value creation through a cash flow based economic profit measure that deducts the full cost of the capital used. This would create a relevant, industry- and company specific reporting. To not just add more things for companies to report they further suggest full semi-annual reports instead of quarterly and the abolishment of much of fair value accounting going back to cost based numbers to leave the valuation to investors.

After a, in my view, too sensationalist first half the authors actually present an unconventional and interesting solution on how to reform accounting.

Mats Larsson, April 22, 2018