

The End of Accounting

Investors are poorly served by arcane accounting methods, a new book argues. New ways are needed to measure companies' performance



Earnings reports and financial statements don't reflect real businesses, the authors argue. *PHOTO: GETTY IMAGES*

By
BARUCH LEV and

FENG GU

June 21, 2016 1:13 p.m. ET

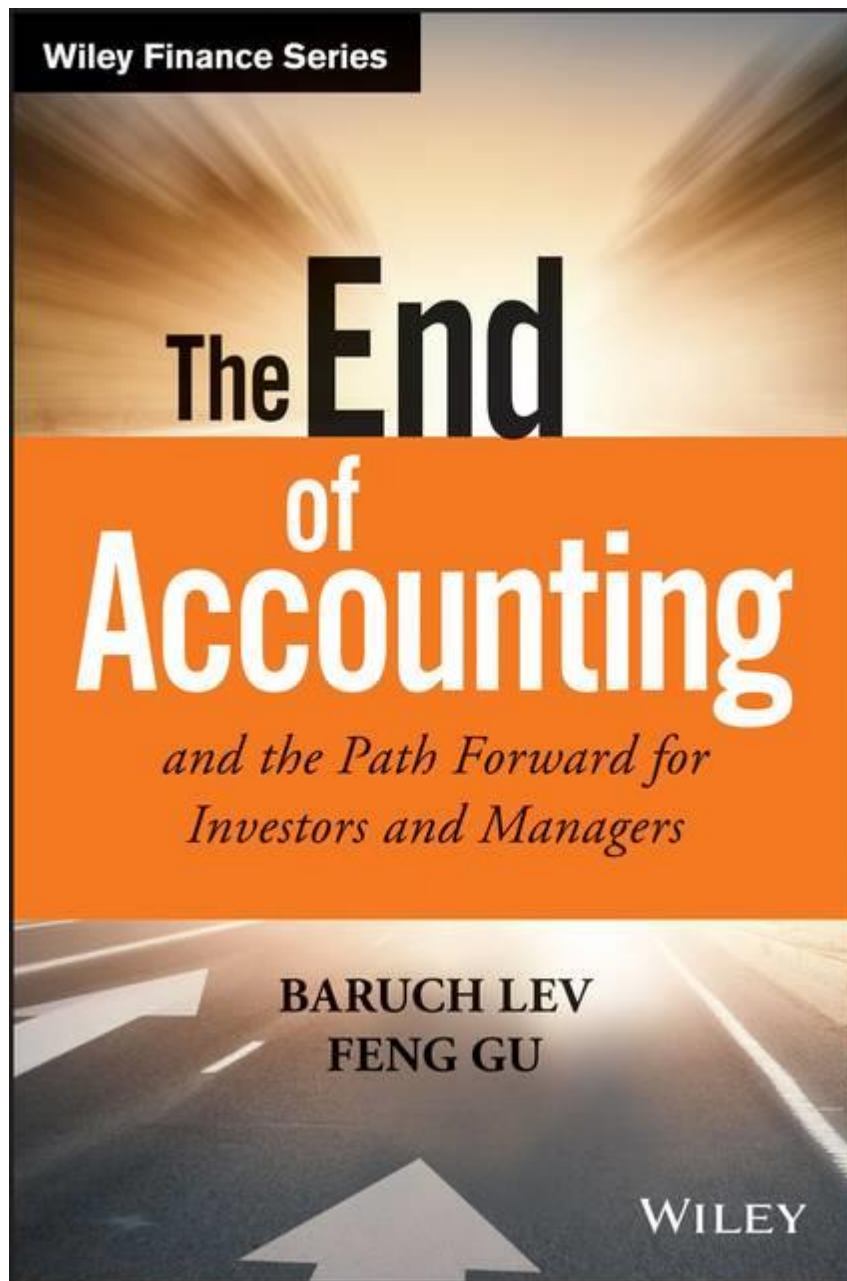
[53 COMMENTS](#)

Whenever I read these complaints about GAAP accounting, I get the distinct feeling the author doesn't understand the purpose of accounting, like someone complaining that his wrench makes such a lousy hammer. –Comment from a reader

When [Netflix](#)'s quarterly earnings announcement in April fell short of the consensus estimate of analysts, its share price surprisingly rose almost 18% on the announcement. An investor blackout? No. Investors justifiably ignored the backward-looking accounting information, reacting enthusiastically to a sharp rise in the forward-looking new-subscribers indicator: 4.9 million vs. expected 4 million. Furthermore, astute investors noticed that a major reason for the earnings shortfall was Netflix's large investment in future growth—technology development; 9% of sales—which accountants expense in the income statement.

Book Excerpt

Adapted from “The End of Accounting and the Path Forward for Investors and Managers,” by Baruch Lev (New York University Stern School of Business) and Feng Gu (State University of New York at Buffalo), to be published by Wiley Finance on June 27.



Netflix is not an aberration. **The problem with reported earnings, and financial statements in general, is that they no longer reflect the realities of businesses.** Instead, they follow an arcane set of accounting rules and regulations. An alternate reality which fails to illuminate essential factors that make an enterprise rise or fall, where, for example:

—The most important, value-creating investments in patents, brands, IT and other intangibles are considered regular expenses, like salaries or rent, without future benefits.



—Reported earnings are a mixed bag of long-term items (indicating sustained growth) and one-time, transitory gains/losses (restructuring costs, for example), having negligible effect on corporate value. (A case in point: Netflix’s one-time foreign-exchange loss had a major role in its earnings shortfall.)

—Nontraded assets/liabilities, like privately placed bonds, which have no market values are nevertheless required to be marked-to-market in the financial reports. This, of course, is an oxymoron.

If that’s not bad enough, accounting earnings are based on multiple subjective managerial estimates and projections (depreciation, stock-option expense, asset write-offs, prospective bad debts, future pension liabilities, etc.), prone to errors and manipulations. **All this results in backward-looking accounting statements that say little about an enterprise’s future growth and ability to compete.** Take Amazon, for example: Its earnings fell short of analysts’ consensus earnings estimates in eight of the 16 quarters of 2012-2015, alarming some investors, yet **obscuring its phenomenal growth and competitive prowess.**

No wonder that research shows an increasing gap between reported earnings and share prices, particularly for new-economy technology and science-based companies, and that earnings have lost their ability to predict future corporate performance—their main use by investors.

Most analysts’ and institutional investors’ questions in conference calls with corporate managers and in “investors’ days” are about the metrics missing from financial reports precisely because accounting standards do not require them. It is metrics like customer growth and churn rate, test results of products under development, policy renewal and cancellation rates of insurers, or capacity utilization of transportation companies, that reflect the business strategy and its execution, rather than reported assets, liabilities or profits.

But rank-and-file investors still take reported earnings seriously, as clearly indicated by share-price declines upon announcements of earnings missing consensus analyst estimates (declines that are often quickly reversed, locking in investors' losses). Rather than leveling the playing field, deficient financial reports exacerbate information differences and disparities in investment gains among investors.

A few deep-pocketed investors have direct access to corporate managers and can afford research teams using expensive real-time data (weekly drug prescription sales, or satellite scanning of retailers' parking lots), while most investors still rely on deficient accounting reports.

The damage of the relevance-challenged financials is not restricted to investors. The obsession with quarterly earnings hitting predetermined targets or beating the consensus estimate infects managers who waste precious time and resources on "managing" reported earnings, occasionally postponing or cutting advertising, R&D, employee training, or maintenance outlays to "make the numbers." A totally futile effort, since a consensus miss will produce a mere 1.5%—2.0% share price drop, on average.

'A few deep-pocketed investors have direct access to corporate managers and can afford research teams using expensive real-time data, while most investors still rely on deficient accounting reports.'

Moreover, the deficiencies of reported earnings make it hard for managers to convey to investors the real performance of the enterprise. Is Tesla a failing operation, as reflected by mounting losses (\$888 million and \$294 million, respectively, for 2015 and 2014), or an extremely successful innovator and marketer? Managers often resort to non-GAAP earnings to report performance more realistically, but that generally creates suspicion and even derision ("the best non-GAAP earnings is EBE: earnings before expenses"). There must be a better way to report enterprise performance and growth prospects; and, indeed, there is.

The remedy for the corporate earnings problem lies in the systematic disclosure of information that **focuses on the fundamentals of the business**, such as customer acquisition costs, additions and churn rate for internet, telecom and media companies; the progress and risk diversification of the product pipeline of pharma and biotech firms; capacity utilization and route

changes (coverage) of transportation enterprises; or frequency and severity of claims for insurance companies.

Unlike the backward-oriented financials, these are forward-looking indicators of performance and growth that highlight the strategy of the business and the success of its execution. Certain companies provide such information in conference calls or the Management Discussion & Analysis, but in a haphazard and inconsistent manner. Others do not offer it at all, making it impossible to systematically analyze and compare companies.

Those bits and pieces of nonaccounting information that some companies disclose are difficult to comprehend and often garner no investor attention: [Exxon](#), on Feb. 2, 2016, reported quarterly earnings that beat analysts' forecast and was "rewarded" by a 2.2% share-price decline. Alas, investors largely ignored the far more consequential news, announced a few weeks later, that for the first time in two decades Exxon failed to fully replace the oil and gas it pumped during 2015 (only 67% replacement ratio)—a disturbing future growth signal.

The fundamental indicators (like same-store sales or the book-to-bill ratio) should be developed into industry-specific, coherent and uniform strategic information frameworks that focus on the strategy of the company and the success of its execution and value creation by managers.

The time has come for firms to regularly provide information of true value to investors to supplement accounting's serious shortcomings.

Excerpted from "The End of Accounting and the Path Forward for Investors and Managers."
Copyright 2016 by Baruch Lev and Feng Gu. Printed by permission of Wiley Finance, a division of [John Wiley & Sons](#) Inc.