Book Reviews

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This book by London School of Economics and Political Science economist Gabriel Zucman is an easy, relatively short nontechnical read that is aimed at the nonacademic reader, although it might be of interest to tax accounting academic readers and academics interested in income distribution and social equity issues. The headline grabber is that wealthy individuals hide an estimated $7.6 trillion, or 8 percent of a total $95.5 trillion of household financial wealth, giving rise to an annual loss in government tax revenue estimated to be $190 billion. The book is also timely given the revelations in the April 2016 release of the so-called Panama Papers, which listed individuals and companies with bank accounts registered in Panama, and the European Commission’s recent Apple-Ireland ruling.

The book contains five chapters plus a short introduction and conclusion section, and a forward by Thomas Piketty, author of Capital in the Twenty-First Century, who also is Zucman’s adviser and occasional co-author. The core of the book is that the ability to hide wealth by wealthy individuals and multinational corporations enables tax evasion. The title is somewhat misleading as it is not the wealth of nations that is being hidden but that of individuals and businesses. The thrust of the book is well summarized by this quote: “Each country has the right to choose its forms of taxation. But when Luxembourg offers tailored tax deals to multinational companies, when the British Virgin Islands enables money launderers to create anonymous companies for a penny, when Switzerland keeps the wealth of corrupt elites out of sight in its coffers, they all steal the revenue of foreign nations . . . Nothing in the logic of free exchange justifies this theft” (p. 1–2). The chapter on multinational corporate taxation might be of most interest to readers of this review with the caveat that Zucman’s focus is U.S. multinationals, as if they are the only multinational corporate tax avoiders. The book is also somewhat Euro-centric except for this chapter on U.S. multinationals—which likely reflects Zucman’s French origins, the magnitude of wealth in Europe (both declared and hidden), and the long-term role played by Switzerland, and more recently Luxembourg, in helping the world’s wealthy hide financial assets.

Chapter 1 provides a high-level overview of the development of tax havens that enable the wealthy to hide both wealth and income from tax authorities.1 The value of bank secrecy emerged in Switzerland after World War I as European countries raised individual tax rates to help pay off public debt and finance recoveries from the ravages of the war. For example, in 1920 France raised the top marginal tax rate from 4 percent on dividends in the pre-war period to 50 percent after the war to 72 percent in 1924, offering tremendous incentives for wealthy French individuals to transfer their ownership of financial assets to Switzerland. Because Swiss banks did not communicate with other countries, these wealthy individuals could then hide their income and evade taxes in their home countries. Much of what is known about the size of Swiss bank operations is due to two commissions (the Volker Commission and Bergier Commission conducted in the mid-1990s) investigating Swiss banks’ role during World War II, including trying to identify dormant accounts belonging to those persecuted by the Nazis. Swiss offshore (i.e., wealth belonging to non-Swiss residents) grew from 10 to 125 billion Swiss francs between the two world wars—a tenfold growth. While initially this growth was touted by the banks as enabling the persecuted to protect their savings, Zucman argues that this myth was debunked by the Volker Commission: only 1.5 percent of the accounts belonged to victims linked to the

1 There is no generally accepted definition of a tax haven and even though the title of the book includes The Scourge of Tax Havens, Zucman does not really offer a definition but rather labels the two main villains in his narrative, Switzerland and Luxembourg, as tax havens.
Holocaust and that the growth mostly occurred in the 1920s, before the rise of Hitler and Nazism, when France was increasing its top tax rates and most depositors were wealthy French. Further, as is the case today, this wealth is invested in non-Swiss financial stocks and bonds with the Swiss banks playing the role of intermediaries. Zucman argues, “For a customer, the main reason to deposit securities in a Swiss bank is and always has been for tax evasion.” (p. 17). Post-WWII, Swiss banks came under attack for their role during the war and the U.S. froze Swiss bank assets in the U.S., which were mostly thought to be owned by the French. The Swiss banks agreed to provide ownership details of all holdings but Zucman argues the Swiss banks falsified records and asserted that the assets were actually owned by Swiss citizens or companies located in Panama. Zucman does not hold Swiss bankers in high regard, asserting that “everything points to the dishonesty of many Swiss bankers” (p. 19). And given their history of falsification, he argues that any fix for the problem cannot rely on unverified claims by these bankers. What is clear is that Swiss bank holdings grew tremendously in the 35 years after WWII, and wealthy Europeans appear to hold 5 percent of their total financial wealth in Swiss banks (based on data from U.S. Treasury surveys of who owns U.S. stocks and bonds). The first oil crisis of the 1970s also contributed to Swiss bank asset holdings as now-wealthy Mideast Gulf princes sought to hide their wealth. Beginning in the 1980s other countries started developing wealth management expertise including London, Hong Kong, Singapore, Jersey, Luxembourg, and the Bahamas (including the Cayman Islands). However, many of the banks located in these countries are actually Swiss-owned, so the influence of Swiss banks has not declined with the emergence of these other tax havens. Further, the wealthy no longer just hold individual stocks and bonds but rather put their money into investment funds located in Luxembourg, Ireland, and the Cayman Islands (but the cash initially flows through Swiss banks or their affiliates). Because of the tax treaty between the U.S. and Luxembourg, no withholding taxes are due on U.S. stock dividends and bond interest paid to funds located in Luxembourg, and this income is neither taxed in Luxembourg nor in the investors’ home country because the initial funds for investment were routed through Swiss bank accounts. Since 1998, the Swiss National Bank has released monthly data on Swiss bank holdings—in 2015 foreign wealth in Switzerland is estimated to be $2.3 trillion, mostly belonging to non-Swiss Europeans ($1.3 trillion for residents of Germany, France, Italy, and the U.K.). However, some of the wealth is owned by African countries and other developing countries, which reduces the tax base and revenue of these countries.

In Chapter 2, Zucman sets out to estimate what he labels the missing wealth of nations—which is really the hidden wealth of individuals residing in these nations rather than the wealth actually belonging to the countries or governments themselves. He estimates that about 8 percent, or $7.6 trillion of a total $95.5 trillion of households’ financial wealth, is held in tax havens with approximately one-third or $2.3 trillion of this held in Swiss accounts. To arrive at these estimates, Zucman first assumes that wealthy individuals just do not park their cash in Swiss or tax haven bank accounts but actually invest it in financial assets to earn a rate of return. These investments are mostly stocks and bonds in non-Swiss companies and government securities. Second, he sums up the listed financial assets and liabilities across all countries. For example, all U.S. financial assets owned by non-U.S. citizens and residents are listed as liabilities of the U.S. On the other hand, countries list as assets the (declared) financial assets held by its citizens. If one sums all financial assets and financial liabilities, they should equal. However, there is an asset shortfall due to not all individuals declaring hidden assets. As an example, Luxembourg funds list $3.5 trillion ownership of financial assets, yet the sum of Luxembourg funds listed as being owned by the rest of the world is just $1.5 trillion, a $2 trillion shortfall.

The same problem occurs in Ireland and the Cayman Islands, where most of the world’s mutual funds are domiciled. Using this asset/liability imbalance Zucman arrives at a figure of $6.1 trillion of missing assets—specifically stocks, including mutual funds, and bonds. The remaining $1.5 trillion of the $7.6 trillion is due to undeclared bank deposits. Zucman is clear that these figures are estimates although he claims it is likely a lower bound estimate because it ignores holdings of bank notes in vaults and nonfinancial wealth (yachts, artwork, held off shore, etc.). Given this estimate of hidden wealth, Zucman then arrives at an estimate of $200 billion in lost worldwide annual tax revenues. Since 2005, European citizens can declare their assets and hence income on the Swiss accounts or be taxed at 35 percent directly by the banks. Zucman argues that about 20 percent of the assets are voluntarily declared, however, the 35 percent tax is easy to avoid so about 80 percent of European assets held in Swiss accounts goes untaxed. Applying this 80 percent figure to all tax havens Zucman arrives at an estimate of $6.1 trillion of assets (0.80 times $7.6 trillion in hidden assets) on which income escapes taxation.

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3 See Zucman (Figure 2, p. 31) for a listing of major countries. U.S. residents are estimated to hold $80 billion in Swiss banks.

4 An alternative approach to estimating hidden wealth, albeit not aggregating across all tax havens, is provided in O’Donovan, Wagner, and Zeume (2016) who examine the stock market reaction to public firms named or implicated in the Panama Papers. They find a risk-adjusted decline of US$230 billion in the market value of the 1,105 firms with exposure to the Panama Papers. They also find that firms in countries where political leaders were named suffered similar declines in their market value.

5 It is not clear that if Europeans and others declare 20 percent of their assets in tax havens, then indeed these assets are hidden and should be counted in the $7.6 trillion. Additionally, Zucman uses the term interest on Swiss accounts when referring to whether Europeans declare the assets or pay a 35 percent tax on the interest on the accounts. I assume the term interest encompasses not only interest on bonds, but also dividends on stock in which the money in Swiss accounts is invested.

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Next Zucman estimates the annual lost tax revenue on these hidden assets. Assuming the money in hidden accounts is invested in stocks and bonds, applying an estimate of 5 percent per annum as the average realized return on private capital, and using tax rates of the countries in which the owners of the hidden assets reside (listed in his Figure 2), Zucman derives an estimate of $125 billion in lost income taxes in 2014. Note that Zucman does not provide an estimate of the lost income (which in total can be calculated as $7.6 trillion \times 5\%). To the $125 billion in lost income taxes he adds $55 billion lost per year in estate taxes and a further loss of $10 billion in wealth taxes in those counties that have a wealth tax (such as France), for a total annual loss of $190 billion (which he later rounds up to $200 billion, a nice round number). His Table 1 lists the estimated offshore wealth and tax revenue loss for Europe, the U.S., Asia, and other countries—and it is instructive to look at the U.S. numbers to check the veracity of the numbers. Zucman estimates that in 2014, U.S. citizens had $1.2 billion in offshore assets, which was 4 percent of the world’s offshore wealth with an estimated tax revenue loss of $35 billion. At an earnings rate of 5 percent, $1.2 billion of assets earns $60 billion of undeclared income, which implies a U.S. tax rate of 58.33 percent, which is far above the combined statutory federal and state tax rates. Some of the estimated tax losses could be due to estate taxes (as the U.S. does not have a wealth tax). $60 billion of undeclared income taxed, say, at a high 45 percent gives $27 billion in lost income tax revenue, leaving the estate tax to fill in the void of $8 billion in lost tax revenue, which might or might not be a reasonable number. Of note is that Zucman’s estimates assume that all income and any estates will be taxed at the top statutory tax rates—which one might question—he ignores any behavioral response by the holders of the hidden wealth. Given that these individuals engage in tax evasion, it is likely that they would arrange their affairs differently if their wealth was subject to taxation. Zucman estimates the lost $200 billion in annual tax revenue is about 1 percent of the total revenues raised by governments worldwide, which leads to either reduced government spending (not surprisingly Zucman argues that this lost revenue could be spent to improve the welfare of the poor—social justice), increased taxes on others (the poor and middle class), or increased public debt. He also points out that the lost revenue as a proportion of tax revenue raised is far greater in developing countries, thus the problem of the wealthy hiding their wealth is greater in developing countries.

Before setting forth his proposals to address the problem of hidden wealth and tax evasion, Zucman analyzes past attempts to address the problem in Chapter 3, “Mistakes,” so that we might learn from our past failed attempts to combat personal tax evasion (the discussion of multinational tax evasion is deferred until Chapter 5). Possibly reflecting his French origins, Zucman analyzes one of the first attempts to prevent Frenchmen from escaping inheritance taxes—a 1901 law introduced the requirement of automatic exchange of information between banks and the French government. Banks were required to inform the government of all inheritances that they were aware of so that the government could tax the recipients. Note the similarity to the U.S. requirement of employers, banks, brokers, and others to file W2 and 1099 forms with the IRS (and taxpayers), which can then be electronically matched to individual tax returns—which increases compliance and makes it more difficult to evade taxes (but does give rise to the underground cash economy and barter economy). However, the French law only applied to French banks, which led to the predictable outcome of the wealthy transferring their assets to out-of-country banks—in Switzerland. In 1908, France signed a treaty with England such that English inheritances could not be completed until the U.K. court handling the estate had informed the French authorities of any amounts inherited by French citizens—the first international tax treaty with automatic sharing of information. A century later little has changed: mandated by the G20 countries, in 2009 the Organisation for Economic Co-operation and Development (OECD) instituted an on-demand exchange of information. If a country had a well-founded suspicion of tax fraud by one of its residents, then it could request information from a tax haven after having provided its suspicions.

Although tax havens signed many treaties to provide information, the havens have apparently provided little information in response to these requests because the treaties have no teeth given that there are no penalties for non-response. Evidence of failure is the fact that since 2009, foreign wealth in Swiss accounts has increased 18 percent and among all tax havens combined by 25 percent. Zucman also discusses the U.S. Foreign Account Tax Compliance Act (FATCA), which requires automatic information sharing with the IRS by any foreign bank with regard to the bank holdings of any U.S. citizen; and while there are some issues with the law, the requirement that any foreign bank that refuses to disclose accounts will be subject to a 30 percent tax on all dividends and interest paid to that bank is a deterrent to noncompliance, but it can be avoided if the banks invest their clients’ money in Europe or Asia rather than in the U.S. In 2013, the OECD recognized that automatic sharing of information by banks is required—however, to date there is no formal mechanism to enforce compliance, and opacity in the banking system leads to dissimulation. Zucman argues that the Swiss bankers will say few accounts are held by U.S. citizens—because they are held by shell companies, trusts, and foundations that conceal true ownership. Zucman also discusses in detail the shortcoming of the 2005 European Union Savings Tax Directive. First, not all European countries are required to share information—in particular, Luxembourg and Austria were granted favorable terms so that instead of information sharing, they must apply a withholding tax of 35 percent on interest but not dividends, and given that the 35 percent rate is less than the top rate in France, wealthy French still avoid some taxes (individual accounts are not specifically identified with the withholding tax). Second, the directive only applies to accounts held in individuals’ names, not shell companies incorporated in other tax
havens. Thus, the main effect of the directive has been to encourage wealthy Europeans to transfer and invest their wealth through shell companies.6

In Chapter 4, Zucman offers an action plan consisting of three elements. The first element is to levy sanctions against the tax havens that are proportional to the costs that tax havens impose on other countries—the lost tax revenue. Of course, an estimate of these costs is required, which Zucman provides in Chapter 2. But how to levy sanctions? Withholding taxes can be avoided, especially in the absence of financial registers of who holds what (the second element below), and at what rate should they be levied. If it is a flat rate, then taxpayers in high-tax countries might still evade some taxes. Zucman suggests that trade tariffs on tax havens that total the amount of lost tax revenue emanating from that haven could work. The tariffs would have to be applied not by one or two trading partners of the tax haven—otherwise the tax haven will trade with someone else—but be widespread among many countries.7 Luxembourg (again) represents a special case because it is protected from trade tariffs through its European treaties. Zucman raises the question as to whether Luxembourg should be excluded from the European Union because of its extensive use as a tax haven and because of its tax deals with U.S. multinationals and, in fact, he argues that unless Luxembourg falls into line, it should be threatened with removal from the EU followed by a financial and trade embargo by its three bordering countries—a taxing recommendation indeed.

Second is the creation of a worldwide register of financial wealth that lists the actual or beneficial owner of all stocks and bonds (not the names of the shell companies) because it is financial assets that are most easily hidden with the income thereon also being hidden from the relevant tax authorities. Such a register partially already exists to facilitate the trading of stock and bonds—the Depository Trust Company in the U.S. and the Luxembourg bank Clearstream. A financial register would also make money laundering, bribery, and terrorist funding harder. The idea here is to remove the imbalance between assets and liabilities. While Zucman calls for the register to be public, he recognizes that some countries might object to this level of financial transparency and thus he is willing to settle for the register to be non-public but available to the appropriate authorities (but of course in the hands of the wrong authorities could lead to blackmail and other unintended consequences). A world financial registry would also enable those countries that wish to impose a wealth tax to do so.8 Accountants well understand the need for information when some action plan is being considered. However, Clarke (2016), in his review of Zucman’s book from a legal perspective, argues that the legal definition of ownership varies across countries and legal systems and thus a registry of ownership is not as easy to implement in practice.

The third element is a rethinking of the way in which countries tax multinational companies. Chapter 5 discusses tax avoidance by multinational companies. This topic is more in the wheelhouse of tax accountants. I note however that discussion of corporate tax avoidance in the same text as tax evasion by individuals without emphasizing the clear distinction between evasion (breaking the law) and avoidance (tax planning within the law that takes advantage of ambiguities or inconsistencies in laws and definitions between countries) will likely lead to conningling or even equating of the two in many readers’ minds.

Under either the worldwide taxation system used by the U.S. or the territorial systems used in most countries, multinationals have incentives to locate profits in low-tax countries and tax havens. Profit shifting (as opposed to locating real operations and real profits) is achieved though interest stripping (intra-company loans with lenders [borrowers] being located in low-tax [high-tax] jurisdictions) and transfer pricing—both are well known to academic tax accountants and both are allowed under existing tax laws. U.S. multinationals are Zucman’s target in this chapter. He estimates tax avoidance of approximately $130 billion a year by U.S. multinationals, which is the same order of magnitude of income tax evasion by wealthy individuals. Most readers of this review will be able to track how Zucman estimates this $130 billion (see p. 105). He also recognizes that there is little incentive for U.S. multinationals to repatriate these profits given the magnitude of U.S. incremental taxes—the locked-out earnings/cash problem.9 Zucman argues that this tax avoidance has led to a decline in corporate effective tax rates (although he is somewhat vague as to how he estimates effective tax rates—it is not clear if he is using cash taxes paid, the current tax expense, or total tax expense as reported on firms’ financial statements or national income accounts). Dyreng, Hanlon, Maydew, and Thornock (2016) provide a detailed examination of the decline in corporate cash effective tax rates—cash taxes paid/pretax book income—and show that the ETRs of both U.S. multinationals and U.S. domestic firms have declined and that within U.S. multinationals, the ETR on both their foreign and domestic operations have declined so that it is not just international tax avoidance by multinationals driving the decline in U.S. corporate ETRs.

Zucman proposes an apportionment system whereby the firm’s worldwide pretax profits are apportioned or allocated to the countries in which it actually has customer sales, workers, and facilities. This formula-based apportionment system is similar to

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6 See Zucman (Figure 5, p. 73) for a plot of the percentage of foreign wealth held in individuals’ names versus shell corporations.
7 As an illustrative example, Zucman discusses the application of trade tariffs with Switzerland.
8 A global wealth tax is proposed by Piketty (2014).
9 See Graham, Hanlon, and Shevlin (2011) and Blouin, Krull, and Robinson (2012) for a discussion of locked-out earnings. Markle (2015) documents that multinationals domiciled in territorial jurisdictions engage in greater income shifting than firms domiciled in worldwide systems, which suggests that Zucman might also have included a discussion of European multinationals.
the way in which U.S. states tax firms.\textsuperscript{10} Such an approach requires country-by-country reporting of sales, employees, and property, plant, and equipment, for which a reporting system is proposed by the OECD in its Base Erosion and Profit Shifting (BEPS) project (OECD \textit{2013}).\textsuperscript{11} Obviously, this recommendation is of interest to tax accounting researchers. One advantage of an apportionment system is that transfer pricing and interest stripping no longer exist as viable methods of lowering taxes. Transfer pricing regulations appear to have failed to stop income shifting, which is instructive to the U.S. debate on corporate tax reform, which debate appears to favor a territorial system with reduced statutory tax rates and more stringent transfer pricing rules. However, it is difficult to envision such rules putting a crimp in firms’ income shifting. My favored approach for the U.S. is a continuation of the current worldwide system but with lowered statutory tax rates and \textit{no} deferral of U.S. incremental taxes. With no deferral there is, again, no incentive to shift profits via transfer prices and interest stripping. Of course this approach is not likely to be popular with corporations, which are pushing for a territorial system, it does not address the worldwide issue of corporate tax avoidance that is of concern to non-U.S. countries, and it does not stop firms wishing to invert (that is, change their country of tax-domicile) to a tax haven with a zero corporate tax rate.

While Zucman’s call for public registers has political support, countries labeled as tax havens are not likely to peacefully acquiesce and, in fact, at an anti-corruption summit in London in May 2016, senior officials of the Isle of Man and the Cayman Islands fought back by calling on the major developed countries to open up company registers to the public.\textsuperscript{12} One senior official from the Isle of Man is quoted as saying, “When Mr. Obama took over he attacked a single building in Cayman for having 19,000 companies registered there. There is one building in Delaware which has 285,000 companies registered in that one building and they do not know the beneficial owners of any of them.” David Cameron, the U.K. Prime Minister, shared this opinion regarding the need for the U.S. to be more transparent if we are to have a worldwide public register of financial assets, a goal he supports.\textsuperscript{13}

Further, while I am neither defending the use of tax havens to hide assets to escape taxation nor their use by corporations to lower their taxes, some might argue that governments are not particularly efficient or effective in spending tax revenues and/or that the wealthy, through their charitable contributions and efforts, might lead to a greater social good than what the governments might do with the lost tax revenue—especially in developing countries and/or in countries with corrupt governments. Having said that, equity does require that taxpayers see the tax code as fair (although defining fair is subjective) and thus that the wealthy undermine the tax system by hiding their financial assets and under-reporting their income. Additionally, Zucman argues that democracy is in jeopardy—but individuals, including government officials themselves, from countries with all types of government including dictatorships and communism, all hide wealth, as evidenced by the disclosures in the Panama Papers. Thus, it is not just a problem for democratic countries.

In conclusion, the book is an easy read, and while it reflects the political biases of its author, it does provide some eye-catching numbers and suggestions worthy of further discussion, especially by those interested in addressing the problem of tax evasion and tax havens.

\textbf{REFERENCES}


\textsuperscript{10} Clausing (\textit{2015, 2016}) provides an excellent discussion of the apportionment approach to corporate taxation. Cavelti, Jaag, and Rohner (2016) discuss the advantages of apportionment taxation as a response to the BEPS project on transfer pricing, while Klassen and Shackelford (1998) and Goolsbee and Maydew (2000) provide some evidence on incentive problems offered by apportionment systems using Canadian and U.S. data.

\textsuperscript{11} I think the book could have discussed the OECD BEPS project in more detail, especially the country-by-country reporting, but the project was in its infancy when the book was written. Country-by-country reporting is a precursor to formulate apportionment taxation of corporate profits.

\textsuperscript{12} See Penny and Baker (2016).

\textsuperscript{13} The role of Delaware in corporate tax avoidance has been examined by Dyreng, Lindsay, and Thornock (2013) and a detailed analysis of Google’s use of Delaware is provided by Bogenscheidner and Heilmeier (2016).


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Over Professor Baruch Lev’s distinguished career, he has received numerous awards and accolades for his thought-provoking and impactful research articles and books. His most recent monograph, *The End of Accounting and the Path Forward for Investors and Managers*, with Professor Feng Gu, continues his long tradition of raising central questions about the role of accounting in capital markets. I believe *The End of Accounting* will be a highly cited work in the debate about the increasing complexity of financial accounting standards.1

The intended audience of this pithy and well-written book is not academics, but rather investors, lenders, corporate managers, accountants, capital market regulators, and (the authors hope) financial accounting standard setters. Lev and Gu (hereafter, LG) argue via extensive empirical evidence and logic that the usefulness of financial accounting statements has declined substantially over time to the point that investors find financial reports nearly useless in making informed investment decisions, especially about complex, knowledge-based, intangible-laden firms such as biotechs, ecommerce, media and entertainment, and so forth. After building their case, LG offer a way forward. No doubt, their prescriptions will draw fire from all sides. I will offer a few. But LG have added to the debate—one which I see as the age old argument over the role of accounting. But I am getting ahead of myself. Before discussing my views, I first summarize the book’s key elements, its major conclusions, and recommendations.

**SYNTHESIS OF LG**

Part I of LG provides large-sample evidence that documents the longitudinal decline in four commonly used earnings quality metrics. First, they examine the value relevance of accounting data by computing long-window associations between

1 See Financial Accounting Foundation, “Simplifying and Improving GAAP” at http://www.accountingfoundation.org/jsp/Foundation/Page/FAFBridgePage&cid=1176164540272#section_2
stock returns and accounting variables (earnings, book values, SG&A, etc.). Second, using short-window (three-day) abnormal returns around 10-Q (quarterly) and 10-K (annual) SEC filings, LG examine the information content of accounting reports. Third, they examine the predictive ability of accounting by examining the median absolute prediction errors from regressing next year’s ROE on this year’s ROE. Finally, they document an increase over time in analyst forecast dispersion around the consensus forecast. They interpret this growing analyst disagreement as accounting becoming less precise and, hence, providing less useful information. LG conclude Part I with “We have presented ... comprehensive evidence that clearly portrays a continuous and steep deterioration in the usefulness of financial accounting information to investors” (Chapter 7).

In Part II, LG trace what they view as accounting’s terminal malaise to the treatment of intangible assets, voluminous accounting estimates, and the mistiming of key business events. Chapter 8 describes the secular rise of intangibles (patents, brands, information technology) and how they are becoming the primary value driver in most (many) companies. Since accounting immediately expenses these internally generated assets rather than valuing them at historical cost net of accumulated amortization, earnings and assets of intangible-intensive firms are becoming less informative. Chapter 9 documents an increase in the number of subjective estimates and projections that managers must make to comply with recent accounting standards such as mark-to-market accounting and stock option expense. Chapter 10 argues that the asymmetric delaying of unrealized gains (such as FDA drug approvals) and accelerated recognition of unrealized losses (expensing restructuring costs but not the benefits from restructuring) further impairs accounting’s usefulness. Part II also provides supporting evidence for the claims in Chapters 8–10.

Part III infers the information investors really want by examining the kinds of questions raised by analysts in conference calls following earnings announcements. Not surprisingly, analysts want to understand the company’s valuable intangible assets, how they are created and sustained, key strategic advantages and risks, barriers to entry, how the firm generates excess profits, and so forth. Using these conference calls, management presentations, and media sources, LG identify the various strategic resources, the ways these resources are developed, and the value created by these strategic indicators. Based on their analysis of media and entertainment firms (Chapter 12), property and casualty insurance companies (Chapter 13), drug/biotech companies (Chapter 14), and oil and gas firms (Chapter 15), LG design what they call “A Strategic Resources & Consequences Report” (SR&CR) for each industry studied. LG’s SR&CR for each industry contains line items pertaining to the creation, maintenance, and protection of the firm’s core intangible assets, and the value created by those assets specific to that industry. For example, LG maintain that investors in Sirius XM or Verizon want basic data about customer churn, franchise royalties, customer acquisition costs, movie and TV content, and so forth. LG propose that accounting standard setters should, working with managers and auditors in each industry, design a principles-based SR&CR that captures the unique strategic elements and intangible assets in that industry, and the risks to these assets. They go on to argue that their industry-specific SR&CR report should supplant the current complex GAAP financial statements.3

Part IV discusses implementation issues. LG stress that many elements in their SR&CR already exist because they were able to construct sample reports from publicly available information that was voluntarily disclosed by leading firms following best practices. For example, LG point out that even though detailed data on their drug pipelines is highly proprietary, many pharma companies voluntarily disclose this information because analysts demand it. They argue that the SR&CR should capitalize and amortize all intangibles, and the intangibles should be disaggregated based on the strategic importance and type of the intangible.4

Further, LG reason most existing complex standards that require highly subjective managerial estimates should be repealed, and mandated quarterly reports should be replaced with semiannual reports. Eliminating complex standards and moving to semiannual reporting would encourage managers to adopt LG’s SR&CR model. Finally, LG contend that investors should advocate for these changes as they have the most to gain, and executives should support the proposal in return for a simpler, less costly set of GAAP.

COMMENTS AND CRITIQUE

I found much to agree with in LG. Their documentation of the declining earnings quality metrics in Part I is compelling and consistent with prior studies (Dichev and Tang 2008; Hand 2005; Srivastava 2014). While accounting researchers can, and undoubtedly will, nitpick LG’s various empirical findings and their interpretations, LG go out of their way to consider and refute alternative explanations for accounting’s lost relevance.5 I found Part II’s explanation for the decline in earnings

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3 LG assume that managers know all the risks they face, they are forthcoming in their risk disclosures, and their auditors can detect any omissions. Marriott’s 2013 Annual Report did not mention the risk it faced from Airbnb.

4 See Skinner (2008) for the counterargument as to why intangibles should not be capitalized.

5 While LG document a decline in all their earnings quality metrics, this could, in part, be driven by new alternative, more timely sources of company information such as Tweets, blogs, and Google searches. These alternative information sources cause the market to anticipate accounting numbers earlier. Nonetheless, audited financial reports remain important confirmatory signals to investors, and as such, incentivize quality in other disclosures.
quality (increasing intangible intensity, more subjective estimates, and mistiming of key business events) intuitive and it reinforces my priors. The chapters in Part III are interesting and informative about how investors should think about investments in strategic resources, the types of strategic resources, and how these resources are protected, deployed, and create value.

Given space constraints of this review, I focus my criticisms of LG’s Part IV on the following issues: accounting standard setters’ incentives, other uses of accounting than just providing information for investing, transition costs of LG’s proposed GAAP reforms, competition from private equity markets, and the incentives of vested interests in the standard setting process.

ACCOUNTING STANDARD SETTERS’ INCENTIVES

While at times skirted, LG never quite address why accounting standard setters are either so inept as to have produced a nearly worthless set of accounting standards, or misguided. In Chapter 17 they argue that extant accounting standards are the result of managers and auditors who push standard setters for rules-based standards “to limit the legal exposure of managers and auditors to allegations of misreporting, since following GAAP is an effective defense against such allegations” (Chapter 17). The authors seem to suggest that accounting standard setters are captured by the executives and auditors who want detailed rules-based standards to reduce their expected litigation costs. Kothari, Ramanna, and Skinner (2010, 251) discuss alternative theories of regulators, and conclude that current GAAP is likely “the combined result of special interest lobbying and standard setters’ ideologies about accounting principles.” Kothari et al. (2010, 281) then conclude “We do not have clear evidence on how the FASB (or the IASB) makes decisions . . . For example, how important are political considerations . . . relative to strongly held ideological perspectives.”

It is important to understand the incentives of standard setters to be able to evaluate LG’s suggestions for implementing their proposed GAAP. For example, LG argue, “Accounting complexity can be substantially reduced if regulators would decline to rule on every specific request by companies (‘just say no’)” (Chapter 17). The current incentives of standard setters have yielded very detailed and complex rules-based GAAP. LG are silent as to how to change the regulators’ incentives to “just say no,” other than massive pressure from investors.

OTHER USES OF ACCOUNTING THAN JUST PROVIDING INFORMATION FOR INVESTING

When viewed through the LG lens that the only, or primary, objective of accounting is to aid investors in making investment decisions, much of their remaining treatise follows. In LG’s view, accounting does not provide direct valuations of firms, but rather should provide inputs that assist investors in valuing firms. They justify this position by reference to FASB Statement of Financial Accounting Concepts No. 8, Conceptual Framework for Financial Reporting. Many studies aside from LG rely on the FASB’s stated objective to assess the value relevance of accounting, and a particular accounting standard. Holthausen and Watts (2001, 13) review this literature and conclude that actual FASB accounting standards reveal that providing information for making investment decisions “is only one of multiple financial reporting roles.” In other words, while the FASB’s stated objective is to provide information for investment decisions, it does not explain GAAP or the actual standards chosen. These other uses of accounting numbers include contracting (controlling agency conflicts among shareholders, debtholders, and managers), litigation, regulation (regulatory agencies conducting stress tests on financial institutions, approving mergers, setting utility rates), and taxes. In fact, Kothari, et al. (2010, 248) argue that the contracting role of accounting emerges “as a consequence of economic forces shaping a GAAP designed to facilitate efficient capital allocation.” For example, conservatism arose as an efficient solution to stem managerial opportunism, protect debtholders, and reduce litigation costs.

We know that these other uses of accounting cause vested interest groups to lobby on proposed accounting standards, and that this lobbying affects the final standards (see Watts and Zimmerman 1978, 1979; Ramanna 2015). Different vested interests lobby on accounting standards depending on the standard. Public utilities lobbied for deferred taxes, whereas high-tech firms lobbied against expensing stock options. Accounting arose from a stewardship function and only as a result of the 1930s’ Securities Acts assumed an information role in valuation (Zeff 2013). LG assume providing information to investors is the only valid role for accounting now, and based on this assumption they conclude that accounting’s value has declined. But accounting’s value in other uses could be the same or even increasing. For example, accounting’s value in debt contracting or in reducing expected litigation costs could have increased over time.

TRANSITION COSTS OF LG’S PROPOSED GAAP REFORMS

An extensive literature in accounting documents the contracting role of accounting (Kothari et al. 2010). We know that a very large fraction of bank loans, lines of credit, and debt agreements rely on GAAP-based covenants to provide early “trip
wires” that allow creditors to accelerate loan repayments or renegotiate the loan agreements prior to debt payment defaults. These covenant provisions allow borrowers to lower their costs of debt by reducing lender risk. Some loans contain provisions that adjust the interest rate up and/or down based on reported accounting numbers such as EBITDA (Asquith, Beatty, and Weber 2005). Most of these accounting-based covenants must be met on a quarterly basis. Aside from loan covenants, many other agreements such as joint venture arrangements, supply contracts, and government contracts depend on GAAP numbers. Following LG’s proposals to reduce accounting standard complexity and to move from quarterly to semiannual reports requires virtually every agreement and contract using accounting numbers to be modified. A clear boon to the legal profession.

In short, LG do not discuss or contemplate what I believe will be enormous transition costs arising from the multitude of contracts using extant rules-based GAAP numbers.

**COMPETITION FROM PRIVATE EQUITY MARKETS**

LG focus entirely on public capital markets. The past three decades have witnessed enormous growth of private equity markets to finance start-ups, leveraged buyouts (LBOs), and secondary buyout pools. Fueled by long-run institutional investors such as pension plans and foundation endowments, private equity funds do not require the liquidity of public capital markets. The number of public companies in the U.S. has fallen, and more companies are choosing to remain private or seek to be acquired by other public companies rather than going public. There are now over 150 “unicorns”—private companies with market values in excess of $1 billion (i.e., Uber). Private equity investors seek board seats and are active managers of their investees. These active investors want simplified GAAP to better monitor and evaluate managers of their investees. These active investors want simplified GAAP to better monitor and evaluate managers of their investees (Zimmerman 2015). Competition from the private equity markets will bring increasing pressure to bear on public-company accounting standard setters to be more cognizant of the costs and benefits imposed by public-company accounting standards. Consistent with this pressure, the Financial Accounting Foundation created the Private Company Council (PCC) in 2012, which has issued a number of simplified GAAP to reduce the complexity of public-company GAAP. In 2009 the IASB published IFRS for small-and medium-sized entities (IFRS for SMEs; see: http://www.ifrs.org/IFRS-for-SMEs/Pages/IFRS-for-SMEs.aspx). At only 250 pages compared to full IFRS at over 3,000 pages, IFRS for SMEs requires far fewer disclosures and greatly simplifies the recognition and measurement principles in full IFRS. Hence, we observe dual GAAP—one for public companies and the other for private firms.

Firms self-select to be public or private, and one factor driving this decision is the relative costs and benefits of public-company GAAP versus private-company GAAP. LG’s call to reduce GAAP complexity is already occurring as the PCC and IFRS for SMEs undo accounting standards written for public companies. For example, the PCC issued a new goodwill accounting standard (ASU No. 2014-02) that allows private companies to use either the existing public-company standard or a simpler set of rules for private companies. As private-company GAAP continues to simplify public-company GAAP, and as more firms choose to remain private, pressure will mount on the public-company accounting standard setters to simplify GAAP. But clearly, this pressure is unlikely to produce the epic reforms LG demand.

**INCENTIVES OF VESTED INTERESTS IN THE STANDARD SETTING PROCESS**

Accounting standards are set via a political process that involves an ever-changing set of participants, depending on the particular standard debated (see Watts and Zimmerman 1979, 1986, 1990; Ramanna 2016). In a few cases, even the U.S. Congress inserted itself when the accounting standard setters proposed highly contentious standards, such as stock options. Since its founding 33 years ago, the FASB has issued increasingly complex and more rules-based standards. In 1968, U.S. GAAP was described in one 223-page paperback (AICPA 1968). In 2015, four loose-leaf volumes were needed to publish FASB accounting standards. The political and economic forces creating the incentives that cause the FASB to issue more rule-based standards continue unabated. The U.S. standard setting process appears to be in “equilibrium” in the sense that the standards being issued are increasingly detailed.

Some readers of LG might view as naïve their proposal that investors should unite to push for reforms. Investors are widely dispersed and wide-ranging, consisting of individuals, sophisticated institutional investors, and buy/sell-side equity and debt analysts. Surmounting the enormous free-rider problems of these investors appears overwhelming. Investors have failed to unite in 40 years. Their unification does not appear imminent. The combined resources of the relatively few large public accounting firms and their collective legal exposure to class-action litigation likely overwhelms the cooperation needed by diffuse investors to overcome their free-rider incentives. Despite LG’s call for reform, the current political economy

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6 Demerjian and Owen (2016) examine 7,200 loans on DealScan. Their data suggest that about 90 percent of the loans had at least one financial covenant.
“equilibrium” seems well entrenched. Public-company accounting standards issued by the FASB and IASB most likely will continue the increasingly rules-based path followed for the last 40 years.

CONCLUSIONS

The real strength of LG is bringing the decline in the usefulness of financial accounting statements for investors and the causes of this decline to a wide audience of managers, accountants, and regulators. They do this in an intuitive and lively way. Nonetheless, their proposed reforms most likely will fail. LG’s value-relevance studies in Part I have limited usefulness for evaluating financial accounting standards (Holthausen and Watts 2001). Aside from providing information to investors, financial accounting statements are used for contracting, regulatory compliance, tax enforcement, and in litigation. These other purposes also affect the content and nature of GAAP. LG’s radical GAAP reforms will generate colossal transition costs, as all the agreements such as debt covenants that rely on current GAAP must be rewritten. Finally, the current GAAP-setting political regime is in “equilibrium” in the sense that over the last 40 years GAAP has become more complex and rules-oriented. LG, despite their best efforts as to how to change the standard setting process, underestimate the enormous power of vested interest groups that have so heavily influenced the process. The only foreseeable force on the horizon to check the ever-increasing complexity of public-company GAAP is the rise of private-equity-financed private firms that are able to circumvent public-company GAAP. Seeing a decline in the number of their publicly traded firms, stock exchanges may provide the clout to implement some of LG’s suggested reforms.

REFERENCES


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7 See Barth, Beatty, and Landsman (2001) for an alternative discussion of the merits of using value-relevance studies to assess the quality of accounting standards.