

# **An Alternative to GAAP**

**Unsolicited Comments Submitted to the  
Financial Accounting Standards Board**

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## Introductory Comments

In comments made in the paper *A Critical View of GAAP* it was stated that GAAP is too complex, inconsistent, not disciplined, not transparent, massively incomplete, not comparable, subjective (in a biased sense), irrelevant, costly, outdated and purposeless. This view was supported by detailed arguments and examples.

At the end of this paper it was claimed that the **Accounting For The Future (AFTF)** is simple, consistent, disciplined, transparent, complete, comparable, objective (in a non-biased sense), relevant, auditable, less costly, technological and purposeful. A single website reference was cited but no explanation or support for those claims was given. These comments are designed to briefly describe AFTF and explain and support the foregoing characterizations. More detailed descriptions and discussions are available on the cited website.

A secondary purpose of these comments is to contrast AFTF with GAAP in order to bring GAAP deficiencies into bold relief. For example, it will probably not be clear to why I characterize the income statement as uncoordinated with the balance sheet until the AFTF *statement of values* is described.

## Overview of AFTF

AFTF is a value based accounting/reporting model. Value is defined as the present value of expected cash flows discounted at the shareholders cost of capital. *Assets* are the present value of cash inflows and *liabilities* are the present value of cash outflows. The present value of net cash flows is *shareholder value*. The shareholder cost of capital rate (called the *historic cost of capital*) is the implicit rate that emerges from equating recent past expected cash flows to recent capital market values. This insures that all values adopt the capital market scale and that *shareholder value* is an **economic** value, as scaled by the capital markets.

The AFTF analogue of the balance sheet is the statement of values which shows current year present values, prior year present values, the cost of capital and the value added. The AFTF analogue of the income statement is *value added*. *Value added* for the period is the current value less the prior year value increased by the cost of capital. The status of the company is automatically coordinated with the progress of the company, c.f., the GAAP income statement and balance sheet.

There are other AFTF statement components which provide further analyses. For example, there is a display of current year actual cash flows, current year expected cash flows, their difference and their ratio.

Expected cash flows are based only on management assumptions but the resulting cash flow model must be validated. For example, the cash flow model must fit recent historic cash flows (5 year aggregation). These cash flows are management expectations and provide management guidance to investors. The resulting values (assets, liabilities, shareholder value, value added) are strongly disciplined so that management has little opportunity and little incentive for bias or misrepresentation. Management expected cash flows provide optimal information about **prospective cash flows**.

Providing **economic** values and **prospective cash flows** directly satisfies the two main stated goals of financial reporting.

## Complexity

Part of GAAP complexity results from the multiplicity of accounting/reporting models in use. In contrast, AFTF unifies financial reporting since it adopts the technology which is the common denominator of all financial evaluations and decisions, namely expected cash flows and their present value discounted for the shareholder's cost of capital. Hence management decision measures and methods are the same as the shareholder's, which are the same as the stock analyst's, which are the same as the pricing function, which is the same for merger or acquisition, etc. There is even hope that insurance regulatory cash flow testing might be eliminated or that value added and taxes thereon might obviate the need for special tax accounting. It should be noted that the accounting profession is a principal current user of this evaluation technology.

Part of GAAP complexity arises from choices and judgments the accountant must make. In contrast, AFTF is based foursquare on cash flows which are relatively unequivocal. It might seem that expected cash flows are maximally equivocal but AFTF expected cash flows are management expected cash flows. Management has the knowledge, skill, authority and responsibility for expected cash flows just as with the short term guidance that management currently provides the capital markets. The auditor has no direct role in choosing or judging expected cash flows. Under AFTF the auditor is only responsible for enforcing disciplines that apply to model validation and measures of expected cash flows. The auditor's role is well defined and precise. This vastly simplifies financial accounting and reporting. Under AFTF the auditor need not be an industry expert or be familiar with company structures, practices or plans. He does not assume responsibility for future results or for difficult judgments under uncertainty.

Likewise the role of the standard setter is vastly simplified. One only needs look at the multitude of industry/situation specific FASB statements (150 and counting) to see how much AFTF simplifies. AFTF has no need to address specifics.

Part of the GAAP complexity results from uncoordinated and irreconcilable income statements and balance sheets. The GAAP income statement is primarily retrospective whereas the balance sheet is primarily prospective. In contrast, the AFTF statement of values is purely prospective. There is no dilemma as to whether the progress of the company should be measured retrospectively based on past transactions or measured prospectively based on the balance sheet. The progress of the company (value added) is **defined** as the change in sequential valuations (adjusted for the cost of capital). Each valuation represents the capital market economic value of the company and will directly guide share price. Value added in turn will guide share price changes. Settling on a single reporting perspective will simplify; settling on a prospective value based accounting/reporting model will increase the utility of financial reports.

GAAP's fundamental flaws have required many complex and specific fixes and patches. AFTF is based on simple and proven technologies with little room for flaws or inconsistencies

Part of the GAAP complexity results from ill considered changes such as the "fair value" concept and its implementations. There is no AFTF need for a "fair value" hierarchy. Values are based foursquare on stated management expected cash flows. These will be values-in-use for

a going concern, not market or liquidation or other value. The measurement hierarchy is collapsed to a single economic method and scale.

Part of GAAP complexity results from attempts to bridge the gap between accounting measures or accounting “values” and obvious economic values. A classic example is the spontaneous creation of value when a company is acquired. A company may have a “net worth” or a “book value” far below its market value or acquisition price. After acquisition the value of the company is suddenly and magically increased by its “goodwill”. Such blatant inconsistencies create complexity. AFTF, in contrast, measures economic value so that the chasm between accounting values (book value, shareholder equity, assets) and economic values is eliminated. Under AFTF, there is no reason that management couldn’t anticipate a pending merger in its valuations or reported value added. Such timely disclosure has substantial merit; accounting discontinuities would be reduced.

Part of the GAAP complexity results from voluminous financial reports. It is expected that AFTF financial reports will be simpler and shorter. Much of GAAP reporting is devoted to providing context and explanation of GAAP measures; this won’t be needed under AFTF. Management discussion and analysis will be simplified. There will be no need for guidance since management expectations are guidance. There will be no need to reconcile GAAP to cash flows. The AFTF statement of values replaces both the GAAP income statement and the GAAP balance sheet. In general AFTF tends to replace data with more processed, condensed and decision useful information.

GAAP reports ostensibly provide enough data, guidance and context for the reader to construct **economic** values and to **assess prospective cash flows**. Ignoring, for the moment, the fact that investors don’t have the time, tools, energy or expertise to make meaningful assessments; the data needed is overwhelming. In contrast AFTF directly provides **economic** values and **prospective cash flows** obviating the need for massive and futile data.

In the discussion of GAAP deficiencies the relative lack of relational measures was examined. GAAP provides a surfeit of absolute measure but little in the way of relational measures that give useful context and meaning. AFTF provides more relational information such as actual-to-expected cash flow ratios or the shareholder’s implicit yield. Such measures convey useful and actionable “essential truths” generally missing from GAAP financial reports.

Complexity also results from the level of issues that FASB/IASB addresses. Most FASB statements, for example, address specific issues within specific industries. These are not standards: standards must have some general application, must involve basic concepts, and must conform to basic principles. Standard setters addressing specific issues will inevitably get bogged down since there is no end to such minutia. Accountants will be overwhelmed by complexity and conflicted with detailed prescriptions which don’t quite fit their particular situations. In contrast, AFTF has no industry, situation, country, or time specific prescriptions. They simply are not needed.

I hope that FASB might be attracted to the simplicity of AFTF and appreciate the relative complexity of the current GAAP implementation.

## Consistency

AFTF is purely prospective unlike GAAP which has a conflicting retrospective/prospective perspective. Being prospective AFTF is anticipatory reducing the inconsistency from discontinuities. Cliffs or thresholds are avoided with AFTF. For example, under GAAP, there might be a 50% trigger which determines the accounting treatment. Under AFTF the expected value would be a blend depending on the probabilities; values phase in, i.e., no threshold trigger.

FASB readily admits to inconsistency between and among statements, concepts and principles. While I haven't examined them, my instinct is that they do not exist under AFTF.

Unlike GAAP, which has many special rules, all companies, industries and situations are accorded the same treatment under AFTF. For example, under AFTF immediate recognition, based on current expectations, has no exceptions. There would be no time re-allocation of recognition such as prior period restatement or deferral.

Another source of GAAP inconsistency is the inability of the Boards to identify end user needs. There is no bright beacon to guide accounting and reporting. AFTF has the bright beacon of economic value and a specific path (management expected cash flows and present values) to get there. GAAP uses fireflies.

The recent development of "fair value" creates inconsistencies. One glaring "fair value" inconsistency is the insistence on using observed capital market prices for financial measures of individual assets, yet no attempt is made to match the capital market value of the company as a whole. Unless, of course, the company is acquired, when "goodwill" comes to the rescue. Under AFTF the part and the whole are treated consistently. The sum of the parts is the whole.

A basic tenant of GAAP is said to be the "going concern" assumption which makes the working assumption that business operations will continue indefinitely. This is at odds with the liquidation values that "fair value" requires. AFTF employ value in use for the going concern.

The "consistency principle" requires the use of the same accounting principles and methods from year to year. Unfortunately current practices like prior period restatements, the spontaneous generation of goodwill, fresh start accounting, discounted liabilities, cliff treatments<sup>1</sup>, and massive write-downs violate the principle. AFTF has few choices to begin but is also anticipatory insuring a consistent approach over time, although there may be lumps.

GAAP earnings are often negatively correlated with the creation of economic value. Such perverse measures are not useful to investors. AFTF "earnings" are economic value added which is well correlated with itself.

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<sup>1</sup> GM did not lose \$40B last year. They instead fell off an insane accounting cliff. They lost the entire value of their net operating losses as the possibility of realization fell from 51% to 49%. Bloggie levi from queens

Requiring complete and immediate disclosure of liabilities and not doing so for assets is inconsistent and not useful for investors. It is also inconsistent with the monetary quantification principle which requires monetary measurement and expression of all economic values. AFTF treats assets and liabilities consistently.

Many recent corporate failures show how inconsistent the current reporting model is to its professed purpose. Although AFTF won't guarantee no failures, I doubt that Enron or WorldCom would have occurred with the AFTF implementation.

Most GAAP inconsistencies are not present under AFTF. AFTF has few, if any, inconsistencies of its own.

## Discipline

The GAAP revenue and expense concepts are undisciplined. Both can be defined and manipulated to suit. There are too many choices and judgments in their measurement. By way of contrast, cash flows, based on ledger entries, are unequivocal: subject to double entry discipline, balanced and auditable to the penny. There is no comparison. Indeed, the discipline of the cash flow model is gradually replacing the more traditional revenue/expense model.

But are management expectations any better disciplined than GAAP? Are they worse? AFTF has a subtitle: *A Disciplined Approach to Value Added Accounting*. First, the cash flow model developed by management must fit the past five years in aggregate and in reasonable detail. It does not have to match each year separately. Second, the cash flow model's present values must match the capital market values (Market CAP) again over five years in aggregate. This is done using a goal-seeking spreadsheet function to find the implicit discount rate (called the *historic cost of capital*) that creates the match. This insures that present values are scaled to capital market or economic values. Hence if expected cash flows are somehow exaggerated (difficult to do if the cash flows fit) the discount rate rises to offset. The present values will not be exaggerated.

There is another strong discipline. Part of the AFTF statement is the *current period cash flow record* which shows: the actual cash flows, the expected cash flows, their difference and actual-to-expected ratio. If the actual-to-expected ratio is much less than 1.00 the capital markets will take quick notice and retribution, as it currently does for "missed guidance". This will probably force cash flow model revision but, even if it doesn't, the lower share price will force the *historic cost of capital* up so that values are nevertheless revised downward.

AFTF values will be very stable until destabilizing factors emerge. If for example, a company, say Intel, produces a much faster processor which uses much less current (a technological breakthrough) management can and should immediately adjust expected cash flows which will result in value added and an expected share price increase. Hence the model is not anchored to current values but reacts in a measured economic manner. Under AFTF price/value ratios will be about 1.00 for all companies. Ratios lower than 1.00 are a buy signal. In contrast GAAP price/book values have huge variations over time, between companies or industries. It would be unwise to use such undisciplined ratios as a basis for a buy or sell decision.

GAAP often appeals to economic value to support its model but will not directly adopt economic values. There is no standard scale for accounting/reporting measures. They can be no quality control or discipline unless there is a standard measure. Reports will not be useful until that scale has some meaning and significance. AFTF values are economic or capital market values which provide a meaningful standard scale.

Under GAAP two companies with radically different risk profiles may report similar results yet have substantially different economic or capital market values. There is no capital market feedback mechanism to take into account risks assessments (shareholder cost of capital). AFTF employs the *historic cost of capital* which incorporates the capital markets' risk premium for the company in question.

Today's forward looking statements have an undeveloped theoretical foundation and little discipline. AFTF statements are disciplined forward looking statements.

Another aspect of discipline is holding management responsible for the statements they produce or sanction. AFTF does this directly since management expectations are used. There is no need for legislative accountability requirements (Sarbox). Bonus grants based on value added would reflect long term results. Payout of those bonuses might be made dependent on unfolding actual-to-expected ratios. This will discourage undue optimism. Likewise, taxes based on reported value added will forcefully discourage optimism.

Under AFTF management is directly and solely responsible for all guidance (expected cash flows). The external auditor AFTF is limited to the application of unequivocal disciplines. There is less need to legislatively require separation of accounting services and auditing functions.

AFTF provides information in context, i.e., relational information. Such information is its own discipline, while disciplining management and the shareholder. Examples include the statements of values (whose context is economic value), actual-to-expected cash flows, the cost of capital, and the estimated yield.

It will be difficult to verify management expectations except in the fullness of time. AFTF uses management expectations but they are quantified as present values within AFTF financial statements. Those reported present values are tightly disciplined and precisely verifiable. This is the principle AFTF audit function. Traditional GAAP bean counting is replaced by more relevant and disciplined methods and measures.

AFTF has many implicit principles not found in GAAP. Several of these principles have been made explicit and furnished to FASB. These explicit principles discipline AFTF but are missing from GAAP. Two examples will be cited. The *oath principle* requires the truth, the whole truth and nothing but the truth. This comes into play when it requires AFTF representations to be complete, i.e., AFTF does not omit intangible values. It also comes into play when the reporting period is the entire future not just some arbitrary past period with some accruals. A second example is the *cake principle* which says you can't have your cake and eat it too. This comes into play by forbidding prior period restatements, for example.

AFTF has the discipline of stability. AFTF is based on the long term future and long term assumptions which create stability. In addition, AFTF has stability mechanisms which correct and smooth valuations. For example, the *historic cost of capital*, being based on 5 years experience, moderates the discount rate and resulting values. See the mechanism example in the Technology section.

A further AFTF discipline that comes into play is the disciplinary force of actual-to-expected ratios. Management will work cautiously to take actions most likely to succeed, work hard to insure proper execution, and quickly terminate or redirect ill advised or unsuccessful endeavors. Hence, even in the absence of a validated cash flow model, management expectations have meaning and perform a function. They are the sword by which managements live or die.

Management performance will be illuminated. Under AFTF management performance is clearly defined, easily measured and visibly disclosed. Management is now explicitly responsible for all accounting and reporting judgments. The link between today's management decision and tomorrow's result is made explicit in management expectations. In contrast, GAAP performance measures are less clearly defined, hard to express, and poorly correlated with economic results.

AFTF will also discipline management. Management will be forced to anticipate, quantify and confront the future. This will encourage more a more proactive, dynamic and responsive management.

A fundamental principle or precept in medicine is "First, do no harm." AFTF starts off with values that are very close to current market values. These are unlikely to produce harmful disruptions so that little harm is possible when AFTF is implemented. Thereafter, AFTF stabilizes reacting only in a disciplined and measured way to new factors or expectations. AFTF is also aligned with accounting purpose and traditions. AFTF leaves most accounting untouched. It adopts technology familiar to most accountants. FASB itself has researched present values extensively. Value based accounting is a familiar concept although the disciplines of AFTF are somewhat new.

AFTF has inherent and explicit disciplines that are lacking under GAAP. GAAP disciplines are audit conveniences not especially relevant for investors.

## Transparency

GAAP transparency is impaired by complexity, inconsistency and lack of discipline. AFTF does better in these areas.

GAAP “values” are a misnomer. Seldom do GAAP “accounting values” correspond to the common or natural use of the term. For example, “fair values” would much more accurately be described as fair **prices** or market **prices**; they bear little resemblance to the values that shareholders or management understand or use for decisions. AFTF values are “going concern” values or **economic** values in the transparent common use sense.

Similarly, the jabberwocky terms “net worth”, “stockholder equity”, “revenues”, “expenses”, “depreciation”, “goodwill”, “liabilities”, “assets”, etc., are not tightly defined within accounting and do not correspond to natural or commonly understood meanings. AFTF terminology is more approachable, natural and meaningful. For example, shareholder value (the *company valuation*) is what the words imply. GAAP stockholder equity is anything else but transparent.

GAAP is semi-opaque revealing only a glimpse of the whole picture. AFTF provide a clear, complete, and useful view of the future. Of course the future is not guaranteed<sup>2</sup> but AFTF is reliable in that it accomplishes what it purports to, namely, express management expectations. It also accomplishes what GAAP purports to do, namely, provide information about **economic** values and **prospective cash flows**.

AFTF is prospective and anticipatory, facilitating, indeed requiring, timely disclosure. GAAP “after the fact” is a day late and a dollar short. AFTF reports on the foreseeable future, not some arbitrary and largely irrelevant past period. How does GAAP deal with a changing outlook? It doesn’t, unless supplemented by AFTF style guidance.

AFTF is based on current expectations. There is no room for or need for prior period restatements, fresh start accounting, “other comprehensive income”, depreciation, amortization, accrual adjustments or indeed any arbitrary allocations that obfuscate or subvert transparency. AFTF present values satisfy the matching principle perfectly, with no time value distortions.

Outside legislation (Sarbanes-Oxley) to mandate or impose increased transparency in accounting is not required if the accounting model itself is transparent. AFTF is based on real and transparent cash flows not artificial “revenues” or “expenses”. It is based on clear present values not arcane accounting allocations. It reports useful and meaningful measures, not murk.

Transparency must involve full disclosure. Management must disclose what they know, what they’ve decided, what they expect. AFTF requires this. GAAP excludes this, except for current liabilities. Under AFTF management performance is manifest; under GAAP often hidden or disguised.

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<sup>2</sup> “In a phrase, analysts prefer information that is equivocally right rather than precisely wrong. Inexact measures of contemporaneous economic values generally are more useful than fastidious historic records of past exchanges.” AIMR 1993  
*Qualitative Characteristics of Financial Statements from Financial Reporting in the 1990s and Beyond*

## Completeness

GAAP conveniently<sup>3</sup> restricts its attention to current or past accounting tangibles. In contrast, AFTF includes intangibles in its measures. Unlike GAAP, which attempts to tally transactions, identify, inventory and value each separate asset, AFTF skips a few steps. The goal of AFTF is to report monetary measures of cash flows. This does not require the identification, inventory or separate measure of each intangible value; it only requires some reasonable estimate of the cash flow effects of those intangibles. For the most part these effects are already inherent in the cash flows and new intangible effects (like a new drug approval or new microprocessor patent) can be added to the existing cash flow stream. In practice, this may have been done well in advance. The point is that, since we are only interested in the effects, we can bypass the cause. This is fortunate since identifying, inventorying and valuing intangibles in a complete and mutually disjoint manner is impossible ... unless you use “fair values”<sup>4</sup>.

Intangible assets are not imaginary: they are just as real and significant as liabilities. GAAP ignores them producing “net worth” measures that are what they are. AFTF incorporates the cash flows effects of intangibles producing economic values. In fact, any reasonable cash flow model automatically includes intangibles (except for new ones adding value).

It’s not just assets which are incompletely accounted for. There may be intangible liabilities. Like intangible assets, intangible liabilities may be more easily accounted for as cash flow effects than through the traditional GAAP inventory process. For example, Enron expected cash flows may have picked up the understated liabilities.

GAAP Accounting measures the cost of capital from debt service but the cost of equity capital goes unrecognized and unmeasured. The cost of equity capital (*historic cost of capital*) occupies a central role in AFTF. For one it is the implicit rate which sets the measurement scale (through discounting) to economic values. Second, it reflects the capital market evaluation of all components of the discount rate; this includes: the real time value of money, expected inflation, general economic expectations and any risk premium. Note that this cost of capital is customized for each company to reflect differing inflation effects, the industry, the quality of management, the effect of expected economic conditions, past actual-to-expected results, etc. The cost of equity capital is also used to obtain the value added.

In addition, the income statement can be distorted through incomplete accounting. A case in point is WorldCom which capitalized ongoing expenses, thus understating expenses and overstating net income. Capitalized expenses (and other accounting allocations) are never used or needed with AFTF.

The more common situation is the understatement of income. Almost all marginal capital expenditures are investments made with the purpose and expectation of some future net benefit

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<sup>3</sup> If we look at the Wikipedia History of GAAP the first sentence reads “Auditors took the leading role in developing GAAP for Business enterprises”.

<sup>4</sup> joke

or net gain. However such positive net gains are NEVER measured under GAAP.<sup>5</sup> Under AFTF all expected cash flows (positive or negative) are recognized. GAAP sends a reverse message to shareholders, which doesn't exactly encourage management to undertake profitable endeavors.

Another aspect of incompleteness is the failure of current accounting to produce quality high level information. Accounting theory and practice does not meaningfully process information; statements remain substantially data oriented. As mentioned above, the relational context is often missing. Reporting measures themselves are geared to auditing convenience rather than useful investor information. AFTF provides more complete measures.

The whole premise of the current reporting model is to provide enough information to allow the investor to make value judgments (such as future cash flows and present values). There is no annual statement complete enough to support such assessments. Investors don't have the experience or knowledge possessed by management and its accountants. Investors may not know of exogenous or future factors or plans that management has. Generally, individual investors lack the energy, time and expertise to make meaningful economic value judgments. It is unrealistic and hypocritical to expect the investor to do what accounting avers it can't do. Management, accountants and auditors have vast expertise, data and processing power, large budgets and ample time to produce high level information such as economic values. AFTF does precisely this.

AFTF requires a cash flow model. This is true, fair and complete representation. GAAP could be a true representation, is seldom a fair representation and is never a complete representation.

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<sup>5</sup> gains are immediately recognized under GAAP but limited to the associated expense.

## Comparability

AFTF is value based. All values are included. All values are economic values. All values are adjusted to the capital market scale and include provision<sup>6</sup> for risk, inflation, variance, the quality of management, the past performance record, etc., **for that company**. Hence one can readily compare the electric utility with the copper producer with the high-tech outfit with the insurance company with the railroad. Try that for GAAP! Comparing GAAP price/earnings ratios or GAAP return on equity ratios quickly reveals the lack of comparability.

For example, all AFTF price/value ratios will be close to 1.00. Comparisons can be made since meanings are the same and measures use the same capital market scale.

All AFTF measures are comparable across time, industry, and country. There are no special rules or exceptions for any company, industry, or situation. GAAP has at least 150 special rules.

GAAP accounting and reporting do not provide good measures for comparisons. As mentioned above, contextual or relational measures are preferred but even when provided they are based on shaky data or information. AFTF provides more meaningful relational information.

GAAP comparability is further impaired by lack of external purpose. Financial reports have become formalities whose purpose is to satisfy requirements (USGAAP and similar).

What is being measured? “accounting values”.

What are “accounting values”? That which is being measured.

This creates the problem that there is no fixed scale, no standard measure that permits comparison. In contrast, AFTF adopts the capital market scale which is standardized and meaningful.

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<sup>6</sup> The *historic cost of capital* is the capital market’s best assessment of this discounting factor.

## Objectivity

Accounting is replete with subjective judgments. Revenues, expenses, earnings, assets, liabilities, goodwill, expense capitalization, depreciation, accrual adjustments, and many other accounting items require definition, identification, measurement, summarization and disclosure. At each stage subjective judgments are required of management, the accountant and auditor. In contrast, AFTF is based on cash flows for which definition, identification, measurement are much easier. AFTF values are well defined and unequivocally determined present values. AFTF value added is likewise well defined and objective.

GAAP is deliberately and necessarily conservative. AFTF measures assets and liabilities in a balanced and disciplined manner. There is no need for some conservative margin of error.

Management expected cash flows are not necessarily objective even though they are strongly disciplined. They are however reliable in the sense that they are exactly what they purport to be: expressions of management's experience, judgment, plans, outlook, commitments, and responsibility. This is the management role: exactly what management willingly undertakes, exactly what the shareholder willingly delegates, exactly the guidance capital markets can base decisions upon.

As mentioned expected cash flows are strongly disciplined which reduces or eliminates bias but it doesn't eliminate uncertainty. For example, management may objectively expect that a coin flip to come up heads half the time. This is unbiased, useful and actionable information even though actual outcomes will vary. Stock investors understand and willingly undertake such outcome risk provided they are fully informed by management. Only when management's expectations are known can shareholders make necessary judgments. Were management's judgments and expectations off base? Was management's execution of its plans inadequate? Did exogenous factors, like recession, interfere?

For shareholders the only information that is expected to be decision-optimal are expected values.

## Relevance

AFTF financial reports are designed with the end user's convenience in mind. AFTF doesn't require the time, tools, energy, expertise and diligence needed to convert the GAAP annual statement data into **prospective cash flows**, not that this is or could be done anyway. AFTF doesn't require conversion of GAAP values into **economic** values, not that this is or could be done anyway. AFTF provides these relevant measures directly. In addition, AFTF provides many other useful and relevant measures, such as actual-to-expected ratios, shareholder yield, price/value ratios, etc.

AFTF is more consistent, stable and disciplined than GAAP. Hence AFTF is trustworthy and more actionable ... more relevant to shareholder decisions.

As mentioned previously all shareholder value resides in the future. A retrospective model is naturally of limited utility or relevance. A prospective model, like AFTF, is necessary (and sufficient) to a relevant accounting/reporting model.

GAAP generally fails to account for intangibles which have become important if not dominant values. An incomplete picture limits the relevance of financial statements, especially since a biased view is generally produced. AFTF provides a complete and neutral economic representation (model). GAAP is not a faithful representation.

Reporting based on the costs or "fair value" is less relevant to reporting economic values than value in use (as well as being antithetical to the going concern assumption).

The quality of management and the capital market judgments are two important factors in determining share value. GAAP ignores both; AFTF pays attention to both.

GAAP obviously has some utility. However, it is not generally relevant for management or business decisions.<sup>7</sup> Pricing, capital budgeting, mergers and acquisitions, profit studies, cost/benefit analyses, and business valuations, all use the present value of expected cash flows discounted at a shareholder cost of capital. AFTF uses this universal technology.

Comparisons are a relevant activity and limited comparability limits relevance.

FASB justifiably believes that "accounting values" are relevant and useful for investors. But it also true that they are of limited utility and that much better and more relevant measures exist.

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<sup>7</sup> SFAC #1 The objective of financial reporting is to provide information useful to business and economic decisions.

## Costs

A complex and inconsistent accounting/reporting model will be costly. It will be costly to standard setters who must continuously rationalize or repair the current model. It will be costly to managements, accountants and auditors who struggle to understand and comply. AFTF is simple from an auditing standpoint. Management's expected cash flow model will require some effort but not more that good management requires anyway.

The lack of high level processed GAAP report information means that each investor must reinvent the wheel and must pay the price: time, energy, expertise, diligence. In contrast AFTF provide **prospective cash flow** and **economic** value information. Such information, once produced, is infinitely divisible at no additional cost

But the largest cost is borne by the capital markets which cannot operate efficiently with a flawed accounting/reporting model. As economies change, the toll taken by a static and outdated accounting model accumulates and may eventually reach a tipping point. AFTF will increase capital market efficiency especially in information based economies.

The current accounting model looks backward. For example, economically profitable investments are NEVER currently recognized. The GAAP implementation does not measure or encourage innovation, R&D, growth, human capital formation, or, more generally, a proactive perspective. GAAP is focused on and emphasizes the short term. AFTF recognizes intangibles and is focused on the future. This should permit and encourage more progressive and effective management. This, per se, won't reduce costs but the benefits should increase. A more forward looking management may avoid problems or take timely corrective action.

The multiplicity of current accounting models multiplies costs. Basing shareholder reports on management measures, as AFTF does, would reduce costs, with the added bonus of more closely aligning management decisions with shareholder interests. AFTF uses the universal evaluation technology and will unify accounting implementations.

The GAAP definition of revenue, its recognition and measurement had been a costly conundrum for decades. The fact that so many resources have been expended with so little result is an important clue. AFTF cuts the Gordian Knot by defining the progress of the company as value added. AFTF "revenue recognition" is based on management expected cash flows ... done. Measurement of value is defined as the present value, discounted at the cost of capital, of those expected cash flows ... done.<sup>8</sup>

The current accounting/reporting models clearly deliver more positive benefits than negative benefits (such as recent accounting failures), but the benefits, at best, are limited and the costs are high. We should and can do better. FASB should be aware of the opportunity cost as well as the current costs of the current GAAP implementation. AFTF will increase benefits with little, if any, increase in accounting/reporting costs.

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<sup>8</sup> The two step process of recognizing expected cash flows and measuring them as present values is called the *recognition of value*.

## Technology

The current GAAP accounting implementation is an artifact. It is based on concepts, elements, measures, and practices developed and useful in the past. These are less relevant in today's predominantly service/information economy where intangible values are dominant. AFTF uses a variety of new technologies to keep pace with new economies.

AFTF makes use of data. It makes full use of past cash flows: in creating the cash flow model, in actual-to-expected cash flow ratios, and in determining the cost of capital. It makes full use of capital market data in scaling value measures to the capital market scale. The historic cost of capital incorporates a comprehensive and customized discount rate including provision for: inflation, real return, risk premium and the quality of management, as judged by the capital markets. It makes full use of management's: education, company experience, skills, judgment, industry and general economic outlook, decisions and plans. These are all incorporated in management expected cash flows. This is formalized and disciplined within an intelligent cash flow model. Under AFTF this model must conform to the *dual validation procedure* which simultaneously validates expected cash flows and set value measures to the capital market scale (a technological breakthrough<sup>9</sup>).

AFTF uses modern data processing to build cash flow models and to convert data into true, complete and useful representations (a technological breakthrough).

AFTF establishes a dialogue with the capital markets to help both management and the shareholder (a technological breakthrough). For example, capital market prices provide feedback which determines the cost of capital which in turn scales values measure which in turn affects capital market pricing. This feedback loop is self correcting and stabilizing.

The cost of capital separates real progress from the illusion of progress. For example, if inflation is the dominant or only component of the cost of capital then AFTF subtracts that inflation cost in determining real value added. This is not something GAAP does. Similarly for other cost of capital components.

AFTF easily includes the value of intangible values (a technological breakthrough). It does this, not by identifying and valuing each intangible, but by simply observing that it is the monetary result of intangibles that we seek. For the most part, this monetary effect is already present in past and/or expected cash flows.

AFTF vastly simplifies accounting and reporting (a technological breakthrough). It does this by eliminating troublesome accounting allocations. For example, accrual adjustments and capitalized expenses are no longer needed. It does this by eliminating the need for the auditor to have detailed knowledge of the industry or company. It does this by providing the end user with natural, relevant, complete and completed information.

All that is needed to make use of these technologies is a willingness to change.

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<sup>9</sup> These technological breakthroughs are not new. The breakthrough is their implementation.

## Purpose

GAAP has two main stated purposes: to provide information to assess **prospective cash receipts** and to provide information about **economic** resources and changes therein. GAAP fails on both fronts, in part, because auditing convenience was the design constraint. AFTF was designed with those purposes foremost. In fact, AFTF was reversed engineered starting with **prospective cash flows** measured **economically** (using the capital market scale).

GAAP is essentially retrospective with the progress of the company defined by the backward looking income statement and the status based on current tangible accounting assets and liabilities. In contrast, AFTF is focused on providing complete (including all assets), processed and assembled information. AFTF requires more of management but less of the auditor and much less of the end users.

The main purpose of financial reporting is to satisfy end user needs but, up to now, the end user has essentially been ignored. Auditors, accountants and standard setters have tacitly conspired to preserve the status quo. This is perfectly acceptable if the status quo is acceptable. But I don't think that Generally Accepted Accounting Principles are acceptable for end users, although I admit GAAP has been accepted.

AFTF can permit and promote effective management, make the capital markets more stable and efficient, inform and protect the individual investor, and make life easier for auditors and standard setters.

### **AFTF Validation Mechanism: Simplified Example**

In its simplest form a least squares fit (an easy spreadsheet function) thru 5 past net cash flows creates a reasonable cash flow model. The present values of these net cash flows are then equated to 5 past market capitalizations using a discount rate (the *historic cost of capital*) easily found by spreadsheet goal seek function. The cash flow model together with the discount rate determines AFTF valuations and value added. This simply, we have a vast improvement over GAAP.

What if the model is not perfectly accurate (this is expected)? For example, it might understate the actual cash flows that develop. When it does, the actual-to-expected ratio will show that management guidance was conservative and the market will react favorably. In addition, the cash flow model will correct itself with the new data. In addition, the discount rate will decrease and adjust values upward. Hence AFTF is self correcting. Note that both the cash flow model and the discount rate have the stability of a 5 year base period, in contrast to the actual-to-expected ratio. This creates a reactive progress report with stable valuations.

Such a simple model is illustrative and not recommended. The expected cash flow model should be made intelligent, at least incorporating management knowledge. In fact, in order to hold management responsible and accountable for results, expected cash flows must be a management expression.

## Further remarks

Where did GAAP come from? Clearly it was created by auditors and for auditors. It was not designed by end users or for end users.

Why was it created? It was designed to improve upon reporting based on past period cash flows.

How does it do that? It does that through adjustments that partially recognize future income. GAAP adjustments are complex and disguise themselves but they are, at heart, immediate recognition of future positive cash flows. Accrual adjustments, depreciation, amortization, goodwill are all limited or curtailed recognition of future income. There is no other way expenses become assets. For example, expenses are capitalized if and only if recoverable, i.e. there exists a future stream of associated revenue. Hence the expense asset is really future income capped at the level of expense. This cap is conservative and has the auditing convenience (no surprise) of easy measurability. The problem with capping the future revenue stream is that it also caps the utility of GAAP.

Such partial recognition has become increasingly limiting to financial reporting. Much of the economic value and value added in today's economy arises from intangibles which don't have conveniently auditable associated expenses. They are consequently ignored. The solution, of course, is not to back into revenue recognition via the half-baked and limiting expense route but to fully and immediately recognize all positive income, just as all negative income are immediately recognized.

In this sense, AFTF finishes and perfects what GAAP started.

But what about the audit function? Have we not undermined the auditor's role? Does the auditor now have a more difficult and dangerous task? The answer is no. The AFTF auditor has NO responsibility for judgments or expected cash flows, other than the application of precise disciplines to those expected cash flows and their present value measures. No longer will the auditor have to be expert in the industry, with exogenous factors, with the future outlook or plans of management. In fact, accounting and reporting in general will not be involved with or responsible for any industry or situation specific issues.

With AFTF, WorldCom and Enron would not have occurred. Enron's auditors, Anderson & Co., would not have been responsible or scape-goated. The venerable Anderson Company would still be in operation.

The AFTF auditing role is easier and safer.

## A Personal Experience

Thirty years ago when my son was a teenager, he and I were discussing pari-mutuel probabilities (like horse races). I mentioned that if one knew all true probabilities one should bet on the horse with the greatest probability of winning. Having a PhD in math and being an Actuary (FSA) was my proof. My son said I was wrong and that one should bet on all horses in proportion to their probabilities. I scoffed at this idea and, using a spreadsheet with a random generator, created a model which generated horserace outcomes according to the probabilities. After 10,000,000 races, it was clear ... I was wrong. My son explained this quite simply: **more information always helps and never hurts**. I was using only some of the information, only the probability for the favored horse.

In a similar fashion AFTF makes use of more information than GAAP does. This is significant since it accounts for the vast differences in the characteristics of the two implementations as outlined in these comments, *An Alternative to GAAP*, and the prior comments, *A Critical View of GAAP*.

AFTF makes full use of management expectations (probability assignments) which involves management experience, skills, judgment, and knowledge. AFTF makes fuller use of past outcomes: 5 years of actual cash flows. AFTF makes use of capital market information: 5 years of capital market assessments. AFTF makes fuller use of data and processing technology. AFTF makes use of the entire future, not just limited accrual adjustments. AFTF takes into account the cost of capital which scales measurement and provides for inflation, risk, the real time value of money and other similar discounting (and accumulative) factors. AFTF makes use of smart cash flow models which can incorporate such things as: interrelationships, non-linearities, demographics, economic or social trends, anticipated regulatory or tax changes, etc. AFTF contains full asset information, including important intangibles. In short, AFTF goes beyond the confining borders of audit convenience.

## Concluding Remarks

As far as effective representation for end users, I don't think it exists. End users have been told by the experts (standard setters and auditors) what they can have, with little regard to what they want or need. There is no balance. There is little formal recognition of user needs and no formal structure or discipline to those mechanisms that tend to satisfy end-user needs. For example, forward looking statements and guidance have become more important and determinative than GAAP income statements, yet are neglected by standard setters. Similarly, cash flows are more trusted than the income statement so that cash flow statements and reconciliations to cash flows are increasingly desired and available, yet cash flows have undeveloped reporting structures and absent accounting standards.

One thing that would help the FASB/IASB structure is to have investor representation and working participation at least equal to that of the standard setters. They should not be auditors or accountants.

Once an alternative solution, such as AFTF, is compared with GAAP, the advantages of the AFTF implementation become, by contrast, crystal clear.

The website below contains ample descriptive AFTF materials.

<http://home.sprintmail.com/~humphreynash/indexback.htm>