all material respects, the financial position of the company and the results of its operations and its cash flows in accordance with GAAP" seems a to be relevant and comprehensive but does it satisfy shareholder needs? Part of the problem is that the traditional income statement and balance sheet are fundamentally the wrong approach so that "financial statements", which by definition and practice incorporate those elements, are fundamentally flawed.[12] The second problem is "in accordance with GAAP".[13] GAAP does not satisfy end user needs.

AFTF defines an easy, accurate and meaningful audit function. First, management expected cash flows are 100% a management responsibility. The auditor assumes no responsibility for them beyond verifying that the cash flow model fits past cash flows (see the *dual validation*).[14] He does not have to be expert with the industry, company characteristics, the competitive environment, economic conditions, regulatory or tax policies, management decision or plans. This is management's job. The auditor must verify that the discount rate (the *historic cost of capital*) that emerges from the *dual validation* is calculated correctly and applied correctly to expected cash flows. Hence the public audit function is tightly defined and precise. Of course, the accountant or internal auditor may assist management but the external auditor has narrow but important AFTF role. This auditability enhances reliability.

It would seem that management expectations might result in highly variable management reports to shareholder. Two similar companies might have very different reports or that a steady state company might report differently from year to year. If such reports are not consistent and reproducible, can they be reliable?

The *dual validation* ensures consistency. First, the cash flow model must fit historical patterns of past cash flows. This anchors the model substantially but leaves future cash flow open to management. To a degree this is a good thing since it encourages or at least permits prudent risk taking. We want management to be optimistic and to make decisions or take action to realize those expectations. But it doesn't matter what expected cash flow model is adopted. As discussed above, the *dual validation* essentially eliminates any bias from management expected cash flows. The dual validation equates historic present values of cash flows to historic capital market valuations through the implicit discount. For example, grossly exaggerated future expected cash flows will produce a higher offsetting discount rate so that measures always reflect the capital market scale, i.e., economic values. Any new exaggeration comes home to roost very quickly because any value added in one reporting period raises the bar for following period and because the ongoing actual-to-expect cash flow ratios reveal.

There is another forceful discipline on management expectations, namely *The Private Securities Litigation Reform Act of 1995*. The "safe harbor" provision, which permits forward looking information in the first place, only does so in the absence of "the company's knowledge of falsity". Hence management has little or no incentive to bias and has a strong legal disincentive. The *Sarbanes–Oxley Act of 2002* makes it crystal clear that management is ultimately responsible for all financial reports; ignorance or delegation is no excuse. *The AICPA Guide for Prospective Information* provides valuable and constraining guidance for all forward-looking accounting and reporting applications. Management is on a tight rope; it is suicidal for management to stray from the straight and narrow. This ensures consistency and reproducibility, contributing to reliability.

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[12] The income statement and balance sheet are uncoordinated, c.f., AFTF *Statement of Values*.
[13] GAAP, among other things, is incomplete and does not support or report economic or shareholder values. GAAP statements are not true representations
[14] A validated cash flow model will be a true representation, reasonably complete and fair.

AFTF technologies are self correcting and AFTF valuations tend to converge on economic values and vice versa. In addition, AFTF's long term perspective encourages capital market stability.[15] AFTF's self-control contributes to reliability.

How reliable can a prospective accounting and reporting model be? At least as reliable as GAAP.

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[15] Compare with fair values which may require market (current liquidation) values and may push the pendulum. See the essay Capital Market Stability on this website for further discussion.

Appendix F

Fair Value

by Humphrey Nash

c. 1999

Abstract

Fair value is the attribute that will guide the use of present values in future accounting developments and pronouncements. The use of present values is most welcome; the use of fair value is not. This article explains why and sounds the alarm.

Introduction

In recent years the Financial Accounting Standards Board (FASB) has researched, developed, and promoted the use of Present Value of Expected Cash Flows (PVECF) as a measure of economic value. FASB has done a commendable job of introducing the concept of expected cash flow based on probability-weighted outcomes. FASB has also illuminated the concept of present value as a sum of interest discounted expected cash flows.

In order for a measure to be relevant it must represent some observable attribute. For PVECF the attribute recently proposed is fair value. This attribute is what PVECF is intended to represent and hence fair value

provides theoretical guidance in calculating PVECF or judging whether or not PVECF is appropriately representative.

The adoption of a PVECF attribute is critical to the future of accounting, accountants, and accounting organizations. It is vital to get it right.

In its exposure draft *Using Cash Information and Present Value in Accounting Measurements*, FASB has defined Fair Value to be,

"The amount at which the asset (or liability) could be bought (or incurred) or sold (or settled) in a current transaction between willing parties, that is, other than in a forced or liquidation sale."

If there is an active market for the asset (or liability) then the observed market price is a fair value and a PVECF measure should approximate or be that price. If no active market exists then a similar PVECF should be employed to inpute an appropriate market price. If PVECF meets this goal it is then said to have satisfied the fair value attribute.

The definition of fair value seems reasonable and it is difficult, perhaps un-American, to challenge a term like "fair value". In fact, I like the term and I support both the concept of fairness and the concept of value. The only thing I have a problem with is the interpretation of the definition.

What Fair Value Is Not

Fair value is one of several competing attributes of PVECF. FASB cites two others in its exposure draft, namely, entity-specific value (similar to value in use) and cost accumulation value (a terrible term). FASB distinguishes these two attributes from one another and from the fair value. Without going into detail, I believe that entity-specific and cost accumulation are, in practice, identical concepts.

The table below is taken from the FASB exposure draft and compares fair value with cost accumulation.

Fair Value	Cost Accumulation
Expected cash flow approach	Same
The entity's labor costs, which management believes are consistent with those that others would incur	The entity's labor costs, regardless of whether others would incur similar costs
Allocation of overhead and equipment charges	No allocation of fixed charges
Contractor's markup	No markup
Market price of items manufactured by the entity	The entity's cost to produce those items
Value of salvaged equipment	Same
Expected cost of subsurface crash based on 1-in-10 probability and estimated cost of $100,000	Same
Market risk premium	None
Adjustment to reflect the entity's credit standing	Discount rate based on the entity's embedded cost of liabilities

The choice of attribute has created some controversy among the FASB board members. At least two members (the Dissenters) strongly favor the cost accumulation attribute and their views are well represented within the exposure draft. Despite the lack of agreement, FASB has tentatively chosen fair value.

> "In future standard-setting deliberations, the Board expects to adopt fair value as the measurement attribute when applying present value

techniques in the initial and fresh-start measurement of assets and liabilities."

The Dissenters have no quarrel with PVECF, which they seem to like, only with fair value as an attribute of PVECF. It is stated that they support fair value under certain circumstances, but I think that statement is a mischaracterization, in that it appears they support fair value only when it coincides with cost accumulation, for example, in the case of an actively traded financial instrument held short-term. In general the Dissenters

> "... agree with that description of fair value and with the notion that fair value is an estimate of a current price, even though current settlement may not be possible. However, they do not consider market-based assumptions to be relevant if the entity does not intend to acquire a non-financial asset or settle a non-financial liability in a current transaction. "

They further hold that,

"Using fair value to measure non-financial assets and liabilities has troublesome recognition implications. " (for example, recognizing non-existent liabilities)"

and that,

"Using fair value to measure non-financial assets and liabilities also produces income statements that are confusing and less useful than those produced by a cost-accumulation approach."

The crux of the controversy boils done to a simple observation: fair value is not value-based. It is price based and would be better labeled "fair price". This follows directly from the definition; "fair price" is the amount at which that asset can be bought in a current transaction between willing parties.

Is there a difference between price and value? It depends. In the case of an actively traded financial instrument held short-term, there is no difference. In the case of the seller of an asset there is no difference. For the buyer of an asset to be held or used, there is a difference, often quite large.

Why is there a difference? The answer is that the buyer of an asset has an economic or comparative advantage in using that asset. The asset is worth more to the entity than the price; this motivates the purchase in the first place. The value to the buyer of a rational purchase exceeds the price or cost. If the measurement of value is the goal then fair value as, an attribute of PVECF, should not be used.

Should value be the goal? If we want to make rational economic decisions, we must measure value. If we want to exploit comparative advantage, we must measure value. If we want accounting to be more forward looking, we must measure value. If we want to use PVECF, we must measure value.

Fair value is a price based concept. It continues the historical cost perspective of traditional accounting. This retrospective view is at odds with the prospective view of PVECF. To assign a retrospective attribute to a prospective measure is inconsistent and self-defeating.

An Alternative View

The Dissenters have provided an alternative to fair value. This alternative, to its credit, is value oriented. But cost accumulation is incomplete or, at least, not explicitly complete. "To provide relevant information in financial reporting, present value must represent some observable measurement attribute of assets or liabilities." Fair value represents observed price (PVECF to the seller), but has no connection to PVECF to the buyer. Fair value observes,

but observes the wrong thing. What is the observable attribute of the cost accumulation approach? What value does it represent? What value should it represent?

A clue to what it is, or should be, can be found in the basic purpose of accounting and financial reporting. Accounting and financial reporting is intended to be relevant to shareholders and their representatives (management, analysts and portfolio managers). The value they are concerned with is shareholder value. This value is readily observable in the capital markets. PVECF should have shareholder value as the observable attribute.

Prospective Accounting

The draft proposal *Accounting For The Future* (AFTF) outlines a prospective accounting model based on shareholder value as the observable attribute of PVECF. AFTF provides a relevant attribute, but also provides specific disciplined technology to ensure that the attribute is satisfied. Fair value does not provide a relevant attribute and provides little methodology and little discipline.

AFTF resembles cost accumulation. In the Comparison Table AFTF would be identical to cost accumulation, except for the final two items. AFTF uses an embedded historical cost of (equity) capital rather than an embedded debt rate. This AFTF cost of capital implicitly includes a provision for capital market risk and uncertainty.

Suggestion

Interpret fair value to be,

"The **capital market** amount at which the asset (or liability) could be bought (or incurred) or sold (or settled) in a current transaction between willing parties, that is, other than in a forced or liquidation sale."

The fair value of the company is the market capitalization. The total price of

the company stock is the total value to the company because the company is the seller.

Indictment of Fair Value

The criticisms below present a summary of the many faults of fair value as an attribute of PVECF.

1. Fair value omits intangibles, especially assets. These values are dominant today and can't be ignored.

2. Active market values exist or they don't exist. If they exist, there is little use for PVECF. If they don't exist, it will be very difficult to determine or verify the fair value of an asset or a liability. Fair value is observable only in those cases where it is not needed.

3. The fair value of an asset is the value to the seller not to the buyer. The value to the buyer must reflect the comparative advantage that the buyer has, otherwise that advantage withers.

4. Only in pathological cases is the value equal to the price, for example, in the case of a financial asset held for short term trade or in the case of forced liquidation. In these cases all alternatives to fair value would also equate value to price to reflect the real cash flows.

5. Fair market value is unsuitable for decisions. Decisions (for a publicly traded company) are made with the goal of adding value. Measuring cost or liquidation values is not oriented towards this goal.

6. The fair value concept is more strained for liabilities than for assets.

"Buying liabilities" even sounds perverse. For an ongoing enterprise it is doubtful that liabilities can be fully discharged to a third party.

7. Fair value would tend to diminish assets and increase liabilities compared with current accounting practice. This may discourage prudent risk taking and stifle economic progress.

8. As defined, the fair value of component assets and component liabilities will not add up to the fair value of the total company. This value, the capital market fair value, is well defined by an active stock market. If the component measures don't add up to a well established total then those measures must be redefined.

9. PVECF is patently incompatible with fair value since expectations are prospective from the entity's perspective whereas prices are retrospective and are from the seller's perspective.

10. Fair value does not provide procedures, discipline, or uniformity. Fair value provides no guidance in determining expected cash flows or discount rates. Unless a fair market value is observable there will be no discipline on "value" assignments. Interest rates, risk and uncertainty premiums, projected cash flows may vary with each asset or liability.

Appendix G

Specific Concept 7 Comments

In this appendix CON7 is examined in detail with selected comments, criticisms, suggestions or solutions to improve the language or analyses.

CON7 Highlights Section

It is stated that CON7 provides a framework for the interest method of amortization. It seems to me that amortization or any allocation scheme is superfluous when using PVECF.

It seems strange that CON7 is being considered as the basis for accounting measurements at initial recognition or fresh start recognition yet recognition issues are not addressed. This is like pouring a house foundation with no blueprint. To be useful CON7 must be applicable to recognition, especially since recognition issues are so unsettled. AFTF settles recognition issues simply with the *recognition of value* concept.

Standard setters must develop and set general standards. Project-by-project response is not the hallmark of a robust model or a standard. It complicates, produces inconsistencies, damages comparability, increases choice and possible manipulation; it should not be tolerated in standards which are meant to be general guides not metastisized rules.

<u>One</u> objective of present value is to capture economic differences in cash flows with different timing. However "the" objective of present values is the economic value itself.

When discussing the attribute of PVECF it is important to distinguish between buying and selling an asset or equivalently the buyer's perspective and the seller's perspective. FASB seems to not be aware of the differences ... or perhaps it is aware and chooses to conflate. Also there seems to be no awareness of the capital marketplace as a "highest and best use".[16] What another investor or an acquirer is willing to pay is surely relevant. If economic values, to which accounting pays lip service, are the goal then capital

[16] Admittedly there is no capital market for individual assets, except implicitly. This does not affect AFTF which has no individual assets (assets are the present value of all expected cash inflows). The capital market value attribute for AFTF works like a charm.

market values should not be ignored and liquidation values should be. The capital marketplace values are the same as "values in use" or "entity specific values". CON7 deals with PVECF, i.e., expected cash flows. Expected cash flows are generally not liquidation flows.

The "fair value" hierarchy specifies that expected values are to be used except when (liquidation) market values are present. This exception is complicating, unnecessary and wrong.

Probabilities applied to a range of possible values at a point in time produce expected value. This handles one aspect of uncertainty. Variance is more difficult and probably shouldn't be tackled by accounting or the accountant. AFTF handles variance and risk cost automatically via the *historic cost of capital* (as a discount).

It is stated that the underlying objective in measuring assets and liabilities is the same for CON7. I doubt this is true since PVECF implies immediate recognition and recognition fo assets and liabilities is different under GAAP, which only partially recognizes asset flows (profits are ignored).

Reflecting credit standing in assessing liabilities produces stupid results. The financial position should not appear better because of poor credit discounts. The fault lies not with the liability discounting but with the fact that assets are missing from GAAP which can't be commensurately discounted. (I've objected to the perverse effect of liability discounts but really it is the asset side which is inappropriate) This is a point which should be reexamined, understood and CON7 revised.

The use of interest in amortization is better than no interest but all allocations are distortions. AFTF doesn't need or permit allocations.

AFTF has only fresh start recognition. Initial recognition, amortized values, fresh start approach, etc., are a typical of GAAP choices and indicate a less than robust accounting model.

The Statements of Financial Accounting Concepts set objectives which identify the goals and purposes of financial reporting. Accountants, auditors and standard setters are experts possessing vast knowledge, skills, training and abilities. But should <u>they</u> determine the goals and purposes of accounting and reporting, standards and regulation. The answer will certainly be yes. But ask the same questions of banks and bankers. Should <u>they</u> determine the goals and purposes of banks, their standards and regulations. The answer will be different; they should be regulated to best serve the interest of the individual and society. GAAP has not adequately served the investor's goals or purposes nor capital market efficiency. CON7 could be the basis of a new improved accounting model which identifies the goals and purposes of the end user.

It is stated that concept statements "will guide the Board in developing accounting and reporting standards by providing the Board with a common foundation and basic reasoning on which to consider merits of alternatives." In fact CON7, as it is currently phrased and reasoned, rules out consideration of alternatives, such as AFTF.

"Statements of Financial Accounting Concepts do not establish standards prescribing accounting procedures or disclosure practices for particular items or events, which are issued by the Board as Statements of Financial Accounting Standards." They do if they assume the current GAAP implementation and characteristics (income statement, balance sheet, allocations, fair value, unsymmetrical treated of assets and liabilities, etc. For this reason CON7 needs to be generalized. One approach, suggested previously is to carefully consider AFTF (one alternative model) and eliminate any phrasings, concepts, measure, structures not general enough to also include AFTF.

What is the purpose of a concept unless it governs GAAP? What is the purpose of GAAP if it is inconsistent with fundamental concepts? However, I agree with letting inconsistencies stand as a practical matter. But this strongly suggests a new accounting implementation needs to be developed.

GLOSSARY OF TERMS

It's alright to define the statistical mode as the single most likely amount but to call it a "best estimate" could be misleading. Why, for example, would anyone use anything other than the "best estimate"? This misleads later on.

The definition of fair value is the old definition and at least could be interpreted as value in use (same as capital market value). FASB might want to at least toy with the question: What is the "fair value" of a company?

Present values are precisely calculated based on estimated cash flows which may be expected cash flows. It may be better to use the term "present values of expected cash flows" rather than the "expected present value". I grant they might be identical anyway. The calculation of expected present values is obscure (I wouldn't know how to do it).

Numbered Paragraphs

5. Five measurement attributes are outlined; too much choice. "Fair value" is missing. PVECF could be used universally and would be economical if "entity specific".

9. I've changed my mind also and agree with the board about credit discounts for liabilities but for my own reasons. See above.

10. "The Board is not aware of any accounting standard setter that has incorporated the objectives and conceptual basis for using present value techniques in financial accounting measurement in its conceptual framework." AFTF does this and FASB is aware.

12. "Paragraph 6 of Concepts Statement 5 defines recognition in the following terms: Recognition is the process of formally recording or incorporating an item into the financial statements of an entity as an asset, liability, revenue, expense, or the like." CON7 (PVECF technology) can be the basis for a value based accounting and reporting model but such a model may not employ traditional asset, liability, revenue, expense concepts and structures. See AFTF for an example. The recognition concept should be generalized to permit wider application of CON7.

13. "While the Board decided that its work on present value should focus on measurement, leaving recognition questions for other projects, it observes that recognition and measurement are related to one another." In AFTF recognition and measurement are directly and tightly linked. AFTF recognizes (records) values which is a two step process of recognizing management expected cash flows and measuring them as present values. Their relationship is not nebulous.

"... the convention that governs recognition and the measurement attribute need not be the same." In AFTF there is a single attribute, namely capital market value. It is simultaneously the origin and destination of AFTF accounting.

15. Why should PVECF play second fiddle to "fair value". PVECF is more relevant, simpler and more robust.

16. " ... standards were developed over several decades. Individual standards usually address specific problems and reflect the compromises and technological limitations of their time." Events, circumstances and technologies (including AFTF) have advanced. Perhaps accounting limitation can now be overcome using an updated CON7. It is suggested in paragraph 16 that the PVECF technology has very broad application. AFTF contends that it necessary and sufficient, i.e, should and always can be used.

"The Board ... will use this Statement in developing future accounting standards as issues arise and are added to the Board's technical agenda."

This is the essence of my agenda request. CON7 is not entirely suitable for "developing future accounting standards" and needs to be generalized. This need has increased as new issues and circumstances have arisen, including:

1. Changing social and economic structures. Faster pace of change. See the *Introduction* (Now is the time ...) to the flacct.com website.

2. Changing values: technology, information, intangibles. Traditional hard accounting tangibles have become bit players.

3 Information processing technology for accounting use (data bases, software, quants, AICPA valuation experts). See the essay *A Context for AFTF* in Appendix C.

4 Increased complexity of GAAP and standard setting. Need to simplify, unify and rationalize. See the essays *A Critical View of GAAP* in Appendix A and *Simplicity* in Appendix D

5. Need for relevance, reliability, comparability, discipline, etc. See *An Alternative to GAAP* in Appendix B.

6. Accounting/reporting models like AFTF.

7. Increased need for capital market transparency and efficiency.

8. Problems with the GAAP model. See *A Critical View of GAAP* in Appendix A.

9. The need for standards for forward-looking statements.

17. "If a price for an asset or liability or an essentially similar asset or liability can be observed in the marketplace, there is no need to use present value measurements." Wrong. The market place referred to here is the liquidation marketplace.

18. FASB questions (my answers)

a. "What is the objective, or objectives, of present value when it is used in measurements at initial recognition of assets or liabilities?" It should be shareholder or economic value not some internally defined accounting value.

b. "Does the objective differ in subsequent fresh-start measurements of assets and liabilities?" Not for AFTF.

c. "Do measurements of liabilities require different objectives, or present different problems, than measurements of assets?" For GAAP the answer has been yes. For example all negative flows are anticipated but not all positive flows are. AFTF is simple and perfectly symmetrical. The only difference between assets and liabilities is the sign + or -.

d. "How should estimates of cash flows and interest rates be developed?" For AFTF management is solely responsible for expected cash flows using a validated model (see *dual validation*). The same *dual validation* produces an unequivocal company customized shareholder cost of capital called the *historic cost of capital*. It is an appropriate discount rate, in fact <u>the</u> appropriate rate. AFTF answers this question CON7 does not ... yet.

e. "What is the objective, or objectives, of present value when it is used in the amortization of existing assets and liabilities?" The objective should be not to use amortization. All allocations are distortions. There is no need or place for allocations in AFTF. Matching is automatic.

f. "If present value is used in the amortization of assets and liabilities, how should the technique be applied when estimates of cash flows change?" AFTF and CON7 both support expected cash flows. There is no need for amortizations or any such allocations.

19. "The present value of estimated future cash flows is implicit in all market prices, including the historical cost recorded when an entity purchases an asset for cash." Whose estimation? There is a difference (comparative advantage) between the seller's and buyer's expected values.

21 "A present value measurement that incorporates the uncertainty in estimated future cash flows always provides more relevant information than a measurement based on the

undiscounted sum of those cash flows or a discounted measurement that ignores uncertainty." Fair value price is undiscounted and ignores uncertainty and expectation.

22. "To provide relevant information for financial reporting, present value must represent some observable measurement attribute of assets or liabilities." AFTF uses capital market value as the attribute both as a origin and a destination. CON7 (PVECF) can do the same or at least not specify the new "fair value".

23 "A present value measurement that fully captures the economic differences between the five assets described in paragraph 20 would necessarily include the following elements:"

a. "An estimate of the future cash flow, or in more complex cases, series of future cash flows at different times."

b. "Expectations about possible variations in the amount or timing of those cash flows." If the estimate is an expected cash flow it already incorporates possible variations. Furthermore, using expected value incorporates timing uncertainty. Point a and b may be collapsed into expected values (not as explicit but just as effective).

c. "The time value of money, represented by the risk-free rate of interest." This may be difficult to assess or coordinate. Currently it seems to be negative (after inflation)!

d. "The price for bearing the uncertainty inherent in the asset or liability." Most of uncertainty is assumed by the probabilities inherent in expected values. Variance is another matter. There is some evidence that the price of variance is negative (lotto/gambling effect), i.e. good variance trumps bad variance. Difficult to assess and coordinate.

e. "Other, sometimes unidentifiable, factors including illiquidity and market imperfections." Illiquidity can be massive, for example with recent CMOs. Market imperfections may be the catch-all or fudge factor. Again hard to estimate. AFTF has an easy unequivocal method for determining an appropriate (customized to the company) total discount (shareholder cost of capital.) See the *dual validation* and *historic cost of capital.*

24. b. "Entity-specific measurement can be applied to capture all five elements. However, the measurement substitutes the entity's assumptions for those that marketplace participants would make. For example, an entity computing the entity-specific measurement of an asset would use its expectations about its use of that asset rather than the use assumed by marketplace participants." Isn't the entity a marketplace participant? Market price is not economic value. Entity-specific measurement is.

25. "The only objective of present value, when used in accounting measurements at initial recognition and fresh-start measurements, is to estimate fair value." This closes the door to economic value and relevance.

26. "Among their many functions, markets are systems that transmit information in the form of prices." Agree. But that information is not necessarily equally relevant to seller and buyer. AFTF uses price information from the capital markets to validate the cash flow model and determine the cost of capital.

"'An observed market price encompasses the consensus view of all marketplace participants about an asset or liability's utility, future cash flows, the uncertainties surrounding those cash flows, and the amount that marketplace participants demand for bearing those uncertainties." This is the rationale behind the *historic cost of capital*.

27. "... the usual condition for using a measurement other than the exchange price is a conclusion that the stated price is not representative of fair value." This refers to the old "fair value" definition which is indistinguishable from value in use (economic value).

"The Board could not identify any persuasive rationale for using a measurement objective other than fair value, simply because the asset or liability is recognized without an accompanying cash transaction." How about the fact that intangibles[17] are now dominant economic values which should be measured and reported?

29. The transaction marketplace is the wrong market to base the "fair value" attribute. Using the capital marketplace supports economic measures and values. It is also the wrong market from which to obtain the interest discount rate. For reports to shareholders the shareholder cost of capital should be used. AFTF uses the correct market and the correct interest rate, if economic value is the goal.

30. Isn't initial recognition a fresh start measurement? Why distinguish?

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[17] Intangibles are real. They affect future cash flows and can be captured and measured as economic values using the PVECF technology of CON7.

31. "The various alternatives to fair value that are described in paragraph 24 share certain characteristics. Each alternative (a) adds factors that are not contemplated in the price of a market transaction for the asset or liability in question," This is not bad AFTF adds economic value (value in use). Unless the marketplace being considered is the capital marketplace price adds factors which alter value in use (economic value).

"(b) inserts assumptions made by the entity's management in the place of those that the market would make," This is the ideal for management reports to shareholders.

"and/or (c) excludes factors that would be contemplated in the price of a market transaction." Certainly useful if they are not relevant.

"Stated differently, each alternative either adds characteristics to the asset or liability for which marketplace participants will not pay or excludes characteristics for which marketplace participants demand and receive payment." The transaction or liquidation marketplace is not relevant to investors." Adding or excluding such characteristics bridges the gap between accounting values and economic values.

32. This paragraph cites some examples where "entity specific" might be preferred to "fair value." These examples are not exceptions; they are the rule. Every capital expenditure is made with the expectation that the acquired asset (or assumed liability) has a value in use greater that the market value (price); this motivates the purchase in the first place. Ignoring the difference means ignoring comparative advantage and economic value.

33. "The items listed above constitute some of an entity's perceived advantages or disadvantages relative to others in the marketplace." This doesn't mean not real; in fact, there is no better assessment than management perceptions.

"If the offsetting entry is to revenue or expense, measurements other than fair value cause the future effects of this comparative advantage or disadvantage to be recognized in earnings at initial measurement." Great! ,This is certainly desirable if economic value is the goal. GAAP avoids immediate recognition (of net gains) and economic value.

35. "Some have suggested that measurements other than fair value, like management's best estimate of future cash flows, are more consistent with the second objective of financial reporting." It is very unfortunate that "best estimate" was defined by FASB as meaning most likely single outcome. This makes it seem that management <u>best</u> efforts cannot

satisfy the stated goals. If management employs expected cash flows then all the objectives can be satisfied. See the AFTF model.

36 "While the expectations of an entity's management are often useful and informative, the marketplace is the final arbiter of asset and liability values." True but which marketplace? Doesn't the capital market have validity. Isn't it the real final arbiter?

"Present value measurements with an objective of fair value are, within the limits of estimation, independent of the entity performing the measurement. As a result, fair value provides a neutral basis for comparing one entity with another." True, neutral but less relevant.

"For measurements at initial recognition or fresh-start measurements, fair value provides the most complete and representationally faithful measurement of the economic characteristics of an asset or a liability." This is triply incorrect. It (fair value) is incomplete, not economic and not representational (cash flow models are true representations GAAP and fair value are not). This sentence should be eliminated since it is so perversely wrong. How can such a good start as CON7 go so wrong?

37 "Finally, fair value represents a price and, as such, provides an unambiguous objective for the development of the cash flows and interest rates used in a present value measurement." Not so unambiguous since the definition of "fair value" used in CON7 refers to "amount" not "price". There may be other unambiguous objectives (see AFTF). Also missing is a method for developing cash flows and a method for developing an appropriate interest discount, c.f., AFTF which has both.

"In contrast, the alternative measurements all accept an element of arbitrariness in the selection of the estimated cash flows and interest rate." Not AFTF.

"Proponents of those alternatives often judge the acceptability of a measurement objective based on the intent of management as to how it plans to use an asset or settle a liability. However, an entity must pay the market's price when it acquires an asset or settles a liability in a current transaction, regardless of its intentions or expectations." What does the price paid have to do with CON7 or PVECF which refer to the future? What does the price paid (sunk cost) have to do with economic value or investor decisions? Warren Buffet, in his inimitably direct manner, distinguished price and value: "Price is what you pay. Value is what you get." What the company gets from an asset is what the shareholder gets and should be the basis for management reports to shareholders.

It should be noted that AFTF makes strong use of prices in measuring present values but it uses the correct market prices (capital market prices) and coordinates expectations and the discount rate to produce economic values.

40. The expected value approach is contrasted with the "traditional approach' (using the discount rate for more than interest discounting) AFTF is a hybrid where expected cash flows capture one dimension of uncertainty and the *historic cost of capital* captures all other discounts (risk free rate, inflation, risk cost (from statistical variance), liquidity premium, capital market imperfections, confidence in management, etc.). AFTF provides an easy and unequivocal method for determining and coordinating expected cash flow and the discount rate. I can't imagine how this could be done using the "fair value" attribute.

41. "The techniques used to estimate future cash flows and interest rates will vary from one situation to another depending on the circumstances surrounding the asset or liability in question." Not for AFTF

"a. To the extent possible, estimated cash flows and interest rates should reflect assumptions about the future events and uncertainties that would be considered in deciding whether to acquire an asset or group of assets in an arm's-length transaction for cash. " I agree with this, but if the purpose is management reporting to shareholders then the group of assets in question is the entire company. Why use PVECF to determine imputed prices of individual assets when the direct goal is the company PVECF?

c. "Estimated cash flows and interest rates should be free from both bias and factors unrelated to the asset, liability, or group of assets or liabilities in question. For example, deliberately understating estimated net cash flows to enhance the apparent future profitability of an asset introduces a bias into the measurement." This could be a problem for AFTF however low-balling or high-balling are both disarmed by the *dual validation*. Actual-to expected cash flows differing much from 1.00 are a red flag. In any event the AFTF *historic cost of capital* acts to offset. For example, low-balled expected cash flows (conservative bias) will be detected by the capital markets which will raise prices and decrease the implicit interest rate and raise the company valuation.

45. "The Board found the expected cash flow approach to be a more effective measurement tool than the traditional approach in many situations." Under AFTF there would be little or no difference between the approaches. If, for example, contractual cash flows were used rather than expected cash flows, the discount would rise commensurately to produce a similar PVECF. Again note that the AFTF approach is holistic, measuring

and reporting at the company level, not for individual assets or liabilities, although there could be functional breakdowns.

48. "The use of probabilities is an essential element of the expected cash flow approach, and one that may trouble accountants. They may question whether assigning probabilities to highly subjective estimates suggests greater precision than, in fact exists." I don't believe that expected cash flows will be troublesome to accountants under a model like AFTF. First, expected cash flows are management expected cash flows. The accountant bears no responsibility. Second, the expected cash flow measures that are reported are discounted where the implicit discount offsets the cash flows, so that the exact expected cash flows are almost immaterial. Third, the AFTF cash flow model is validated which restricts its range. There is little motive or opportunity for bias in the cash flow model. Fourth, the ongoing actual-to-expected cash flow ratios clearly reveal deviations to which the capital markets can and will react.

49. "Many estimates developed in current practice already incorporate the elements of expected cash flows informally." Accountants are already major users of PVECF.

51. AFTF or similar models can be quite crude and simple, reducing cost where benefits are minimal. In fact, a simple least squares fit (spreadsheet function) to past cash flows works remarkably well as a cash flow model and goal seek (spreadsheet function) can easily determine the implicit discount rate (*historic cost of capital*). Statement values then appear automatically. Generally though, an intelligent model reflecting management plans and expectations, non-linearities, interrelationships, technology, demographics, etc., would be more useful to management and shareholder decisions.

53. Expected outcomes may not be close to actual or possible outcomes for an asset or liability flow but the totality of such outcomes will converge on the expected as the law of averages asserts itself. For a diversified investor outcome variation is even less of an issue.

54 I have my doubts about pricing and risk analysis tools like Black-Scholes. Events like LCTM, AIG and JPMC do not inspire confidence. In any event they are beyond normal accounting or my competence.

56-61 It seems ironic that the PVECF technology of CON7 which produces present values is not directly identified with the values present, i.e., recognized. In AFTF *recognition of value* is the direct consequence of recognizing management expected cash flows and measuring them as present values. Admittedly GAAP recognition takes many accepted forms so CON7 recognition is naturally conflicted.

62 "... in many cases a reliable estimate of the market risk premium may not be obtainable or the amount may be small relative to potential measurement error in the estimated cash flows." These cases are frequent; it is the exception where reliable estimates can be made. AFTF automatically includes the capital market's assessment of risk and its cost (and other components) in the discount rate (*historic cost of capital*).

63. "That uncertainty has accounting implications because it has economic consequences." GAAP seems to be "a little bit pregnant" with the idea of economic value.

65-69. "In most situations, marketplace participants are said to be risk averse or perhaps loss averse." Given that natural aversion, does accounting also need to incorporate conservatism into its accounting model? I don't believe that deliberate conservatism serves the company, the individual investor, or the capital market efficiency.

"The Board emphasizes that any attempt to understate results consistently is likely to raise questions about the reliability and the integrity of information about those results and will probably be self-defeating in the long run."

"Portfolio theory suggests that, in an efficient market, the amount attached to the risk premium would be expected to be small relative to expected cash flows, except to the extent of systematic risk." We seem to be talking about the capital marketplace here not a liquidation market for individual assets. This is the relevant marketplace for the "fair value" attribute.

70-71 FASB is apparently arguing against attempting to use sophisticated explicit models, which I agree with. Management, accountants, auditors and investors would have difficulty with them in any event. They are however not needed in AFTF which implicitly incorporates risk premiums.

72. "The Board expects that accountants will continue to use observed amounts, when available, to determine the fair value of an asset or liability. However, many assets and liabilities do not have readily observable values derived from marketplace transactions." AFTF does not attempt to inventory or determine market or carrying values of hard assets, financial instruments, intangibles, contracts, inventory, leases, liabilities and other commitments. This is impossible to do in a complete and non-duplicative manner that reflects their economic or shareholder value. AFTF adopts a more holistic view which accomplishes a relevant purpose.

73. "The Concepts Statements acknowledge that neither relevance nor reliability is the paramount characteristic of accounting information. The two must be balanced against one another ..." Not so, AFTF is both relevant and reliable. See the essay *AFTF Reliability* in Appendix E.

75. " ... the measurement of liabilities sometimes involves problems different from those encountered in the measurement of assets and may require different techniques in arriving at fair value." The same technique is used to arrive at economic value for all assets AND liabilities in AFTF or similar model.

77. Generally liabilities are paired or can be associated with matching assets. It makes sense to apply the same discount to each so that the PVs are matched, leaving equity on a net discounted basis. Using different discount rates would not produce the expected return on equity (ROE).

78.-88 "CREDIT STANDING AND LIABILITY MEASUREMENT ... they ask, can a bad thing (declining credit standing) produce a good thing (increased owners' equity)?" I asked this same question but now understand that using the same discount for assets and liabilities generally decreases shareholder equity because it has a greater affect on assets which are generally greater than liabilities, i.e. equity will shrink overall. This

produces the same result as looking at net expected cash flows and discounting at the same cost of capital rate. (Note we are somewhat conflating credit standing and cost of capital but they are at least related if not identical.) This works with AFTF but not under GAAP where missing assets can't produce the commensurate offset to discounted liabilities.

89-100 ACCOUNTING ALLOCATIONS THAT EMPLOY PRESENT VALUE

All allocations are distortions which affect economic values.. Changing timing changes PVECF. CON7 could be used to eliminate all allocations and the problems they cause. AFTF, for example, avoids all allocations; they are not needed, not possible. See the essay *Simplicity* in Appendix D for the extent of the benefits.

The idea of spreading expenses over the useful life of an asset is a misleading and unfortunate interpretation. Such expenses are deferrable or amortizable only if recoverable, i.e. there is a stream of associated revenue. It is this stream of revenue which is being immediately recognized. It is patently absurd to consider expenses paid an asset (expense asset). However recognizing future income is not part of GAAP so accounting creates a disguising interpretation and language.

"The selection of a particular allocation method and the underlying assumptions always involve a degree of arbitrariness. As a result, no allocation method can be demonstrated to be superior to others in all circumstances." In fact, they are all inferior to no allocations (the AFTF approach and potentially the CON7 approach).

101-109. "The wide range of interest rate conventions and cash flow conventions used in existing accounting pronouncements was one of the factors that prompted the Board to add a present value project to its agenda. Many accounting pronouncements simply specify "an appropriate rate" with little or no additional guidance. The appropriate rate of interest, however, does not exist in a vacuum. Without a specific objective of the measurement, such as a price, the selection of an interest rate necessarily includes an element of arbitrariness."

AFTF relates expected cash flows and the interest rate to observed capital market pricing (as the objective source and target); there is no vacuum.

"An entity's borrowing rate is rarely, if ever, appropriate for the measurement of that entity's assets. ... Some have suggested that asset-earning rates are appropriate if a legal or contractual funding arrangement exists... expected-earning rates are not consistent with the present value concepts described in this Statement."

There is a vacuum here. There is no FASB rationale or guidance given for selecting an interest rate. AFTF does better. For reporting to shareholders, the shareholder cost of capital is the natural choice. AFTF provides an easy and unequivocal method for determining this discount rate (*historic cost of capital*). It has several advantages: stability, economic value, natural meaning, customized, comprehensive (include risk, inflation, real rate of return, market liquidity, etc.).[18] The *historic cost of capital* is sufficient and also necessary (anything else does not reflect capital market pricing).

[18] see the essay *The Historic Cost of Capital* available in the <u>*AFTF Analyis*</u> section of the flacct.com website

Appendix H

Dissent

> "Messrs. Larson and Trott dissent from this Statement because of its adoption of fair value as the sole objective of using cash flow information and present value in accounting measurements at initial recognition and fresh-start measurements."
>
> From the end of CON7

I believe some of their concerns are similar to mine. However, my interpretations and solutions may differ. On the simplest level interpreting the "fair value" marketplace to be or include the capital marketplace starts the ball rolling. Better yet would be changing the new definition of fair value to be more in line with the old definition or not using "fair value" as the PVECF attribute in the first place. The ultimate solution, in my opinion, is an implementation similar to AFTF and a new CON7 to encompass it.