Agenda Request

Concerning

Statement of Financial Accounting Concepts No. 7

Using Cash Flow Information and Present Value in Accounting Measurements

Submitted by

Humphrey Nash

June 23, 2012

Note: Humphrey Nash is a retired actuary. In March of 1998 he published the draft proposal Accounting For The Future (AFTF) as a value based or forward-looking accounting and reporting model. This model is based on the Present Value of Expected Cash Flows (PVECF), the same technology behind Concept 7 (2000) and earlier FASB publications. He maintains a website flacct.com dedicated to promoting the use of cash flow information and present value in accounting measurements. For brevity the AFTF model is not described in this agenda request. Hard copies of the AFTF draft proposal are available at FASB. The flacct.com website has a complete copy.
Structure of this Request

Introduction

Events, Circumstances and Issues Arising

Economic and Social Environment

How is CON7 Tied to GAAP?

The Accounting Environment

Proposed Solutions

Appendix A: A Critical View of GAAP

Appendix B: An Alternative to GAAP

Appendix C: A Context for AFTF

Appendix D: Simplicity

Appendix E: AFTF Reliability

Appendix F: Fair Value

Appendix G: Specific CON7 Comments

Appendix H: Dissent
Agenda Request

Introduction

It is requested that FASB review and examine the Statement of Financial Accounting Concepts No. 7 (Using Cash Flow Information and Present Value in Accounting Measurements). The purpose of such a review is to make Concept 7 more directly suitable for the development of new improved accounting and reporting standards.

Concept 7 is a valuable addition to the Statements of Financial Accounting Concepts. It formally introduces and explicates the concept of present values. Present Values of Expected Cash Flows (PVECF) are widely and successfully used in many contexts: pricing, valuations, acquisitions or mergers, stock analysis, legal settlements, capital investment analysis, insurance and pension funding, tax calculations, and whenever and wherever the future must be quantitatively assessed. Accountants and auditors are leading users of PVECF; the publication of Concept 7 provides clarity, support and purpose to PVECF.

Unfortunately the stated purpose is not ideal for management reports to shareholders. In addition, Concept 7 is a potential basis for new and improved accounting and reporting models and should not be forced to conform to the current GAAP implementation. Concepts should be general and independent of any particular implementation.¹

Events, Circumstances and Issues Arising

There are several new and evolving factors which impinge of CON7 and suggest review and revision may be useful.

¹ the FASB board "will use this Statement (CON7) in developing future accounting standards as issues arise and are added to the Board’s technical agenda."
Economic and Social Environment

GAAP was developed by auditors for auditors. It was designed to meet the needs and capabilities of its time. Those needs and capabilities have changed over time so that GAAP has become less relevant over time.\(^2\) It is unfortunate that CON7 is tied itself to any specific accounting/reporting implementation but especially so for an implementation which is increasing less relevant, like GAAP. This is not useful for "developing future accounting standards". CON7, as it is currently applied, actually prevents the development of new standards. This may be the intent but it shouldn't be.

There are many current needs within our economic and social environment that can be satisfied with an improved accounting and reporting model. The following extract from flacct.com summarizes some of these that should have attention now.

"Now is the time:
1. to provide relevant, clear and complete economic information to investors.
2. to more closely align the interests of management and shareholders.
3. for management and the capital markets to focus on long-term values.
4. to make management visibly responsible for their business judgments.
5. for investors to have an effective voice in the companies they own.

Now is the time:
6. for accountants to formally adopt a single unified approach to all financial decisions.
7. for new accounting technology to provide structure and guidance to prospective financial statements.
8. for accountants and auditors to employ and enforce unequivocal disciplines to forward looking financial statements.

Now is the time:
9. to rationalize and simplify accounting and reporting theory.
10. for standard setters and professional accounting organizations to significantly improve the accounting and reporting models.
11. for the SEC and PCAOB to actively promote capital market stability and efficiency as accounting and reporting goals."

These goals can be met using PVECF (CON7) technology. AFTF provides an example of how PVECF can be used to produce a complete accounting and financial reporting model. It provides simple concepts, explicit basic principles, advanced technology,

\(^2\) See the essay A Critical View of GAAP for a discussions of GAAP deficiencies including its decreasing relevance. See the essay An Alternative to GAAP for an explanation of how changing technologies can support new and improved accounting and reporting. These essays are appended.
robust structures, effective disciplines and meaningful presentations to accomplish the above goals.

How is CON7 tied to GAAP?

1. CON7 assumes that reports to shareholders are “financial reports” and that “financial reports” contain "financial statements" and that "financial statements" contain an "income statement" and a "balance sheet". This has become so ingrained that accountants and standard setters can’t even imagine financial reports that do not contain an income statement and balance sheet. But there could be other reporting structures or formats not using the income statement/balance sheet approach. In fact, AFTF is one. An additional problem is that there is an unstated assumption that the income statement and balance sheet are both based on GAAP. The result is that CON7, with this perspective, closes the door to its avowed purpose of "developing future accounting standards".

2. A related problem is that CON7 assumes that the GAAP implementation is the only and best expression of financial reports. It is my belief that GAAP is too complex, inconsistent, not disciplined, not transparent, massively incomplete, not comparable, subjective (in a biased sense), irrelevant, costly, outdated and purposeless. See the appended essay *A Critical View of GAAP* in Appendix A for detailed arguments. Also, see the essays *An Alternative to GAAP* (Appendix B) and *Simplification* (Appendix D) to fully appreciate GAAP’s deficiencies. CON7 should be reviewed and amended to eliminate GAAP references or presumptions.

3. A second related problem is that CON7 "adopts fair value as the measurement objective". Fair value is a GAAP concept and lacks the generality one expects from a basic concept. Furthermore, the fair value concept has changed over time and since CON7 was promulgated. This raises question as to whether the changes are intended for or suitable to CON7. At the time CON7 was developed the definition of fair value was

   *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.*

   This definition at least allowed "fair value" to be a value. This is no longer the case since "fair value" is now defined as a price as follows,
"The price that would be received to sell an asset paid to transfer a liability in an orderly transaction between market participants at the measurement date."

Furthermore the old definition included the phrase "other than in a forced or liquidation sale" which at least allowed the "highest and best" use to determine the amount. In addition the phrase "willing parties" implies that management selects the most advantageous market. This market could be the internal market, i.e., the entity specific "value in use". Another interpretation, equivalent to "value in use", is to allow the most advantageous market (highest and best use) to include the capital markets. Admittedly this market does not value individual assets (only whole companies) but this market is clearly always present (for publically traded companies) and is the most liquid and reliable. What another investor or an acquirer is willing to pay for company shares is certainly germane to shareholder value and represents a true fair value. 3

The old "fair value" definition seems to be closely related to the concept of economic value where the new definition is close, if not identical, to liquidation value. The problem is that PVECF is a powerful general economic concept and tool; it's self-defeating to have it shackled to a specific implementation (GAAP) or misguided by an inappropriate attribute (like the new "fair value" definition).

The Accounting Environment

There is a accounting context for CON7. That context supports the use of PVECF and strongly suggests its application to forward-looking financial statements. This context also suggests that standards for forward-looking financial statements are needed and overdue. CON7 can be helpful in developing such standards but only if CON7 is not tied to historic GAAP. The essay A Context for AFTF (see Appendix C) provides my view of the accounting context for forward-looking standards. Although phrased in AFTF terms (the only known forward-looking accounting/reporting model), this essay provide a general context. Changing "needs and capabilities" have made review and amendment of CON7 more important.

Accounting, standard setting, auditing and understanding financial reports have become more complex at an increasing rate. CON7 has the potential to vastly simplify if it can break away from the patterns of the past. The current accounting implementation is so

3 In AFTF capital market prices are only used to scale company measurements. They are not used to value individual assets. In fact, under AFTF there are no individual assets only expected cash flows.
complex that accounting may collapse from its own weight. Years of time and effort have been expended considering such things as the MOBR, leases, fair value, revenue recognition under contracts, etc. These Herculean efforts have produced little positive gain but lots of complexity. The PVECF technology can cut the Gordian knot of complexity. AFTF provides an example of a PVECF-based accounting and reporting model which simplifies. Appendix D (Simplicity) summarizes some of the complexities that are completely eliminated or easily handled using the present value of expected cash flows.

One problem for accountant, auditors and standard setters is that they can't imagine forward-looking reports that have any semblance of reliability. Forward-looking reports (and standards) are a non-starter if unreliable. Case closed.

But wait! It can be argued that forward-looking reports are more reliable than the GAAP implementation, for whatever that's worth. See the Appendix E (AFTF Reliability) for an example and explanation of a reliable forward-looking accounting and reporting model. If a reliable forward-looking accounting model is possible (and exists) it may be useful to amend CON7 to at least encompass that possibility.

### Proposed Solutions

There are many problems with current accounting standards and implementation. One solution that solves most such problems is AFTF or a similar model.

In regard to CON7 there are several problems with corresponding solutions.

**Problem 1.** The "fair value" attribute for PVECF has changed.

**Solution 1.** Update the attribute to conform to the new definition. This is the worst solution. Using the new "fair value" definition produces liquidation values which are not shareholder values. This defeats the purpose of reports to shareholders. The old definition at least could be interpreted as supporting economic value. Another half-baked solution is to retain the old definition but specifically interpret it to include or refer to capital markets. Perhaps "best and highest use" can imply this.

**Problem 2.** The "fair value" definition is fundamentally flawed. This is problem for CON7 since those flaws are inherited.

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4 See the essay *Fair Value* in Appendix F. Note that this essay was written in about 1999 when the old definition of "fair value" was in force. The new definition opens up another can of worms.
Solution 2. Don't make "fair value" the PVECF attribute. Another solution (proposed in 1999 before CON7) was to change the observed market to the capital markets. This has many advantages over liquidation markets but only applies to total assets and liabilities.

Problem 3. CON7, as it's presently constituted, stands in the way of improved or alternative reporting models. It usurps and perverts the PVECF technology. If CON7 stands as a fundamental concept it will prevent improvements to GAAP and forestall the development or standards for forward-looking statements.

Solution 3. Leave GAAP alone and develop forward-looking accounting as a separate-principled accounting and reporting model. CON7 would not have to be changed, just ignored. PVECF would have a different attribute for forward-looking statements. AFTF is an example (perhaps the only example) of a forward-looking accounting and reporting model. It has the advantage of reliability, relevance and simplicity compared to GAAP.\(^5\)

\(^5\)“It may be difficult to abruptly scrap GAAP. I suggest that forward-looking statements be classified as conforming (to AFTF or its standard setter reincarnation) and non-conforming which includes forward-looking statements as currently provided. Initially conforming statements would be voluntary and supplementary (to GAAP). After a period of exposure and refinement they would be made mandatory and supplemental. After a further period they would be mandatory with GAAP becoming supplementary and non-mandated. It is expected that GAAP will die a natural death as it becomes clear that forward-looking accounting and reporting is simpler, more disciplined and more useful.” From the Introduction to the flacct.com website.
Appendix A

A Critical View of GAAP

Unsolicited Comments Submitted to the
Financial Accounting Standards Board

By
Humphrey Nash
January 30, 2011
Introductory Comments

GAAP was intended to provide decision useful information primarily to current and potential investors. Such information was intended to help users assess the amount, timing and uncertainty of prospective cash receipts. In addition, GAAP was intended to provide information about economic resources (assets and liabilities) and changes therein. GAAP is useful and helpful … to a limited degree.

It is my belief that the current GAAP accounting/reporting model is fundamentally flawed and that capital market efficiency and the general economic welfare has been incalculably damaged as a result. The primary purpose of these comments is to briefly summarize some of the deficiencies and limitations of GAAP in order to encourage some interest in improvements or change. A secondary purpose of these comments is to reference an alternative model, which is done on the last page of these comments.

The current accounting/reporting model is too complex, inconsistent, not disciplined, not transparent, massively incomplete, not comparable, subjective (in a biased sense), irrelevant, costly, outdated and purposeless.
Complexity

Part of the complexity arises from the multiplicity of accounting/reporting models in effect. There are models ostensibly for shareholders, for example, US GAAP and similar. There are accounting/reporting models for regulators, for example, insurance company statutory accounting and cash flow testing, or for SEC filings. There are models for management decisions or for forward looking statements for investor guidance. There are models for tax accounting. There are models for stock analysts or potential acquirers. There are models for bondholders or bond rating organizations. It might be noted, parenthetically, that a common interest of all parties is cash flows.

Part of the complexity arises from choice. Many times the accountant has a choice and a judgment to make. This can be good (to cope with different or changing circumstances or situations). But it often facilitates manipulation. It is a sign of a weak accounting foundation.

Part of the complexity results from the schizophrenic accounting model; the current model employs uncoordinated income statements and balance sheets. The income statement is primarily retrospective whereas the balance sheet is primarily prospective. There is little reason for the historic past to coordinate with the anticipated future, yet the income statement is “reconciled” to the balance sheet. Of course this reconciliation is artificial which is to say they are not really reconciled at all. The problem with this is that the model is chasing two rabbits ... too different rabbits. And it catches neither. For example, the Boards (FASB/IASB) can’t decide whether revenue should be transaction based (retrospective) or balance sheet based (prospective). Such indecision results from fundamental flaws. The need for any income/balance sheet reconciliations themselves provides another clue of fundamental weakness.

Part of the complexity results from the piecemeal approach to accounting problems. Instead of examining and fixing the basic model, the approach has been to paper over the flaws, repeatedly deferring structural change to the future.

Part of the complexity results from ill considered changes. A classic example is the “fair value” concept and its implementation. This concept is inappropriate and should never have been adopted. The values it provides are wrong except in those cases where it’s not needed. I objected strenuously and repeatedly (starting in 1999) to its adoption as did many others. I provided well reasoned arguments against the concept ... to no avail. Recently there have been fixes and modifications to patch-up or paper-over some deficiencies but the basic concept remains flawed. This will produce continuing complexity well into the future.

Part of the complexity results from attempts to bridge the gap between accounting measures or accounting “values” and obvious economic values. A glaring 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. Note that it is the normal (pre-acquisition) accounting “values” which miss the mark; the acquisition price is the obvious economic value.

Part of the complexity results from the form and nature of financial reports. Annual reports are massive. They are full of data and more data. This produces overwhelming complexity. It is the rare individual who reads an entire annual statement. Rarer still is the individual that has the time, energy or expertise to assimilate and process this data to create decision useful information. Admittedly some processed data is provided in GAAP reports but even this information misses the mark.

For example, the internal auditor might assert that the accounting net worth of a company is CU 52,137,355,914. Ignoring the fact that net worth may be a small fraction or large multiple of the capital market or economic value of that company, what does the figure mean? Its real significance depends on many things. It must be related to such things as: the number of shares outstanding, the type of Currency Unit and its point in time, the capital market price of those shares, the prior period net worth of the company, prior period expected net worth, the expectation for the future net worth, the risk profile for the company, the size of its assets and liabilities, the company’s use of its assets, the relationship of its accounting assets (net worth) to total assets, etc.. The significant items are not absolute measures like CU 52,137,355,914 but rather the foregoing and similar relationships and their measures. A dividend yield, for example, conveys an “Essential Truth”, a decision-useful measure that traditional absolute accounting measures generally fail to provide. The traditional income statement may report total dividends paid of CU 43,122,754.21. This absolute fact may comply with accounting rules, may be accurate to the penny, and may be conveniently auditable. So what? Accounting does not exist for itself. It must have meaning and context and serve an external purpose.

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 minutia. Accountants will be overwhelmed by complexity or conflicted with detailed prescriptions which don’t quite fit their particular situations. New basic principles and concepts need to be developed. Old principles and concepts need to be re-examined, improved or scrapped, and coordinated with new. True general standards need to be developed. The problem with only addressing specifics, apart from complexity, is that the basic shareholder reporting model is flawed and needs updating: FASB/IASB can no longer afford to be “penny wise and pound foolish”.


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.

I think the FASB intuitively understands that the accounting model is much too complex. They also understand that such complexity will cause problems for standard setters as well as those who produce and use accounting reports.
Consistency

The current model is internally inconsistent. Inconsistency is intertwined with complexity. Already cited is the inconsistency of the semi-retrospective income statement with the partially prospective balance sheet. Also cited was the inconsistency of radical value changes upon acquisition. FASB readily admits to inconsistency between and among statements, concepts and principles. There are also inconsistent applications to differing companies and industries. The judgments and choices the accountant must make creates inconsistency over time, between companies and between countries. One particularly irksome source of inconsistency is the election to restate prior periods.

Another source of inconsistency is the inability of the Boards to identify end user needs. There is no bright beacon to guide accounting and reporting. The IASC constitution has clearly phrased its objectives but defines the ultimate purpose as financial information for economic decisions. While I agree with this general goal, it’s more like a warm glow on the horizon than a bright beacon. This creates ambiguity and inconsistency. What is needed is some follow-up to the phrase “economic decisions”. This requires economic elements and measures, not just traditional accounting elements and measures. The accounting/reporting models must be made complete.

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.

The “fair value” concept of “discounted liabilities” for troubled companies is inconsistent with the decreased value of that troubled company. Discounted liabilities do not support value creation or investor protection. The “fair value” hierarchy itself produces inconsistency.

A basic tenant of GAAP is the “going concern” assumption which presumes that business operations will continue indefinitely. This is at odds with the liquidation values that “fair value” requires.

The “consistency principle” requires the use of the same accounting principles and methods from year to year. Unfortunately practices like prior period restatements, the spontaneous generation of goodwill, fresh start accounting, discounted liabilities, cliff treatments[1], and massive write-downs violate the principle.

GAAP earnings are often negatively correlated with the creation of economic value. Such perverse measures are not useful to investors.
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.

Many recent corporate failures show how inconsistent the current reporting model is to its professed purpose.

Inconsistency will cause problems for standard setters as well as those who produce and use accounting reports.
Discipline

These same corporate/accounting failures also show how undisciplined the current model has become. One day Enron is healthy from an accounting standpoint; the next day it’s bankrupt. Allowing Special Purpose Entities to assume liabilities with Enron stock as the matched asset may have satisfied the “fair value” concept but it failed a simple consolidation test. Were existing standards not enforced? Should the auditor (Anderson) have been crucified? Was Enron management the only villain? Were investors and analysts asleep? Or perhaps, the accounting principles, standards, elements, and measures lacked internal discipline and power to enforce?

The 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.

Undisciplined concepts like revenues and expenses also create opportunities for mistakes or fraud. Many of the recent corporate failures could and would have been avoided with disciplined cash flow accounting.

Accounting 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. Value, especially economic or capital market value, provides a meaningful standard scale. For example, price/earnings ratios are highly variable over time, between companies and between industries. The price is an economic measure with great credibility. It is the undisciplined earnings that lack economic significance and produce the variation. A similar situation applies to accounting “net worth” or “book values” which are often a fraction or multiple of capital market values.

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).

Forward looking statements have an undeveloped theoretical foundation and little discipline. Admittedly, these are new kids on the block, but they are increasingly important. In fact they may already be more important that traditional financial statements. Often I have noticed stocks plunging, despite better than expected earnings, when guidance is less than optimistic… and the reverse. This simply reflects
the fact that all share value resides in the future … a fact essentially overlooked by traditional income statements and balance sheets.

Another aspect of discipline is holding management responsible for the statements they produce or sanction. Until recently there was no such accountability. It is only with forced outside legislation (Sarbanes-Oxley) that accountability has been introduced. Accountability is just one of the fundamental accounting principles missing from the vocabulary of accounting/reporting.

The recently required separation of accounting services and auditing functions is an overdue discipline also not supported by accounting principle.

In the prior discussion of complexity, the surfeit of absolute data and the dearth of processed information were cited. Also cited was the lack of information in context, i.e., relational information. To be useful information must be meaningful and digestible, i.e., processed high level, refined and condensed information. Such information is its own discipline, while disciplining management and the shareholder.

Verification is a discipline but only the dead past can be verified which limits its utility. It may be convenient for auditors to limit accounting to the objective evidence of the past, but we pay the price in completeness and relevance.

I think FASB understands that the accounting model lacks discipline. They also understand that this has caused and will cause problems for standard setters as well as those who produce and use accounting reports.
Transparency

It is hard to imagine that an undisciplined, inconsistent and complex reporting model can be transparent. Other factors also contribute. One very misleading term used in accounting/reporting is the term “value”. Seldom do accounting “values” correspond to the common or natural use of the term. For example, “fair values” would much more accurately be described as fair or market prices; they bear little resemblance to the values that shareholders or management understand or use for decisions. Values in use or going concern values are more relevant; “fair values” are liquidation values.

Similarly, the terms “net worth”, “stockholder equity”, “revenues”, “expenses”, “depreciation”, “goodwill”, “liabilities”, “assets”, etc., are not tightly defined within accounting and may not correspond to natural or commonly understood meanings. This is obfuscation not transparency. Accountants may understand their terms of art but financial reports should be understandable to users, especially to the average or less sophisticated investor. In many cases, such as Enron, WorldCom, AIG, Lehman, etc., even the most sophisticated investors, analysts and auditors could not or did not understand. Such lack of transparency is not in the public interest.

For example, for Google the accounting/reporting “stockholder equity” is less than 25% of Google’s market capitalization. Most of Google’s economic value (assets in common terminology) lies in accounting intangibles which are not measured in the current accounting model. What good is the accounting which reveals only a glimpse of the whole picture? Even worse are those Enron-like situations where we only have a glimpse of liabilities. Such partial measures cannot be reliable representations.

Transparency also requires timely disclosures. Long delays in publishing financial statements and closing the books well before or well after period-end hinders transparency. The GAAP time-period principle assumes that an artificial past time period (quarter, fiscal year, calendar year, etc.) is appropriate for reporting economic activities. One hint to its inappropriateness is the word “artificial”. Another problem is that economic values of a going concern reside in the future.

Practices like prior period restatements may reveal a truth but do not constitute transparency; in fact, they are admission of lack of transparency. So called “fresh start accounting”, like GM, make a mockery of the capital markets. More generally, accounting allocations of any type distort and interfere with transparency (see WorldCom). Accrual adjustments are a fertile ground for distortion, misrepresentation or fraud. The matching principle requires expenses and revenues be artificially matched in time, which creates almost insurmountable problems with time values (of money) and economic values.
Again it fell to outside legislation (Sarbanes-Oxley) to mandate or impose increased transparency in accounting.

Transparency must involve more than accounting for past transactions and current status. Some attention must be paid to the future, especially future costs and risks, and some provision must be made. The recent banking and mortgage crises show how little risk was understood, hedged, provisioned for, or disclosed. The future is not merely important, it is all important. Since all shareholder value resides in the future, it is both necessary and sufficient to provide timely guidance (forward looking statements), dispensing with the retrospective income statement and balance sheet.

Transparency should be present for auditors as well as users of reports. I don’t know if the accountants/auditors of Stanford and Madoff securities were dishonest but they certainly let transparency pass them by. It may not be sufficient to require report and audit transparency. The accounting and reporting models themselves may have to incorporate new transparent and unequivocal elements and measures (like cash flows).

The accounting model lacks transparency; this causes problems for those who use accounting reports.
Completeness

Accounting must tell the truth and nothing but the truth. It must also tell the whole truth. A partial picture may be just as misleading as a lie.

Assuming we are focusing on investors in publicly traded companies, it would seem that the most useful measure would be the economic (going concern) value of a share. When compared with the share price this would provide an easy decision criterion. While accounting pays lip service to such economic values, it does little to measure or report them. Instead it restricts its attention only to current or past accounting tangibles. This is convenient for the auditor who can categorize and tally past transactions and inventory tangible assets but it ill serves the investor whose share value depends on the future.

Intangible assets are not imaginary: they are real, identifiable and significant factors which emerge as cash flows over time. They are just as real and significant as liabilities. Over the sweep of time, as the economy evolved from primarily industrial/mercantile to primarily service/information related, “intangibles” have become increasingly important to the point that today they may be the dominant values of most companies. How much value is “accounted for” in companies like McDonalds, Microsoft, Coca-Cola, Goldman Sachs, Walmart, Ford, or Google? Where is the value of Google’s products, structures, people, knowledge, reputation, patents, market share, dominant size, etc.? Using only accounting tangibles and concepts like “fair value” we arrive at an accounting “net worth” which is closer to a liquidation value than a going concern or economic value …conservative but more counterproductive than useful.

It’s not just assets which are incompletely accounted for. Liability values, such as “fair values”, may be discounted for troubled companies. General Motors has large unfunded pension liabilities which have been discounted to improve appearances. GM also has plans to reduce its pension liabilities by $6,000,000,000 by transferring stock to the pension accounts. How this is different from Enron’s SPE scheme is beyond me.

Accounting measures the cost of capital from debt service but the cost of equity capital goes unrecognized and unmeasured. This is of interest to investors.

In addition, the income statement can be distorted thru incomplete accounting. A case in point is WorldCom which capitalized ongoing expenses, thus understating expenses and overstating net income. 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 or gain. However, such positive net gains are NEVER measured under GAAP. The expenditure is either expensed currently or capitalized. If capitalized no net gain is measured since capitalization is limited to the expense. Hence a basic tenant of GAAP is that profitable endeavors that add economic value are never recognized in a timely manner. Of course such gains are measured later, but this hardly suits the purpose of financial reporting to
investors. Just this one aspect alone casts serious doubt on the appropriateness of the current accounting/reporting model.

Another aspect of incompleteness is the failure of 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.

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 professes 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. They need to assume the responsibility and complete the work.

I’m not sure FASB fully understands that the accounting/reporting model is so incomplete. Incomplete reporting can’t be a fair or useful representation.
Comparability

It would be useful if investors could meaningfully compare alternative investments in order to maximize their expected returns and, collaterally, capital market efficiency. Unfortunately, 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. I’ll cite two common examples.

Investors often seek to compare companies’ Price/Earnings ratios (P/E). These are highly unreliable: they vary substantially from company to company, from industry to industry, from country to country, and over time. The Price part of the ratio is not the problem. Capital market values (Prices) are well defined, meaningful and unequivocal. The less well defined, less meaningful and more equivocal part is earnings. It is difficult to support comparability with such shaky elements as “earnings”.

Another example is Return On Equity (ROE). Here the problems of comparability are compounded by the fact that both returns and equity have meanings or measures that vary substantially from company to company, from industry to industry, from country to country, and over time.

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, if the capital market scale were adopted, i.e., if economic value was the purpose, then measures would at least be in the same ballpark.

Financial reports and comparability could be improved simply by providing some key statistics such as those provided online at Yahoo Finance. More fundamental improvements would require new perspectives, structures and measures that only a new accounting/reporting model can provide.

Two more problems that interfere with comparisons relate to changing monetary units. Distortions can result from exchange rates between countries or by real currency units changing over time. Inflation is currently very low and so is the interest in inflation accounting but, when inflation picks up, inter-period comparisons may be misleading. Actually, in a low interest rate environment even modest inflation may be more significant.  

There is also the problem of risk adjustments. Risky investments should yield more or equivalently their expected future should be discounted more. The current model doesn’t factor risk into measures or comparisons.
I don’t think FASB fully understands that the GAAP measures are relatively poor at providing comparable information or that more comparable measures are possible.
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. Earnings, for example, are the end result of many subjective judgments so that they often “manage” to produce an expected or desired result. So problematic were “managed earnings” that the US Congress passed legislation to discourage it. Accounting should adopt well defined accounting elements with standardized measures.

Because of complexity, uncertainty, variable situations and conditions, there will always be a need for judgments, a necessary and irreducible subjectivity. Accounting needs to find ways to reduce or eliminate intentionally deceptive judgments or bias. This can best be done, not by legislation, but by suitable principles or by an accounting/reporting model which discourages, discounts and punishes bad judgment.

In fact, experienced subjectivity and informed judgment is a normal and vital ingredient in the face of omnipresent uncertainty. The investor in stocks understands the risks involved and will generally diversify across stocks, as well as other investment classes, to reduce or eliminate individual company risk. Indeed the stock investor willingly assumes such risks and the more than commensurate rewards that result. The typical investor does not want conservative accounting which hides rewards as well as risks. To insure that no investor ever loses money on any stock investment would require so much conservatism in accounting, management and capital allocation that the financial system would soon collapse. Investors delegate to management the task of assuming risk in the face of current and future uncertainties; this requires subjective judgment. This is a strength that should be encouraged, even harnessed, within the accounting model.

Judgment and subjectivity are not synonymous with bias. For example, under uncertainty, expected values may be subjective yet unbiased, representative, informative and useful.
Relevance

Financial reports today typically contain a surfeit of complex material. The traditional income statement and balance sheet are increasingly treated like footnotes in accordance to their decreasing importance. Management discussions and guidance, cash flow statements, forward looking statements, risk disclosures, discussion of accounting treatments, all attempt to provide context for understanding financial statement data. It would be more useful if financial statements themselves provided more processed information and more context. Perhaps a more abbreviated financial report would be more relevant to those investors without “a reasonable knowledge of business and economic activities and accounting and who are willing to study the information diligently.”

Relevance is also impaired by inconsistencies, especially internal consistencies that cast doubt on reliability and even on the theoretical foundations of accounting. Subjectivity (possible bias) may also impinge on reliability and relevance. Relevance and reliability are also questionable in the face of limited disciplines. Checks and balances, defined and fixed standards of measurement, a beacon of purpose, external inputs, adjustment for risks, are all disciplines essentially missing from the current model.

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

The current accounting model 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. This type of incompleteness is not like a neutral random sample which might be good enough but a more systematic distortion. In any event, an incomplete report is not a faithful representation. GAAP reports are not representations at all.

Reporting based on the cost principle and to a lesser extent based on fair value is less relevant to economic values than value in use (as well as being antithetical to the going concern assumption).

GAAP obviously has some utility. However, it is not generally relevant for management or business decisions. 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. Investors also would prefer this information.
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.
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.

The lack of high level processed report information means that each investor must reinvent the wheel and must pay the price: time, energy, expertise, diligence.

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.

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. Management and investors need to consider the longer term future. The cost of not doing so may be large.

The multiplicity of accounting models multiplies costs. Basing shareholder reports on management measures, for example, would reduce costs, with the added bonus of more closely aligning management decisions with shareholder interests.

The current accounting/reporting models clearly deliver more positive 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.
Outdated

The current 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.

The current shareholder accounting/reporting implementation is essentially retrospective. It reports on assets with past or, at best, current values. It reports on the results of past transactions. The theory is that the past is either directly relevant or indirectly relevant to the future. Since all shareholder value resides in the future the latter is the fallback position. There is some merit to this view in that often what happens tomorrow resembles what happen yesterday. A retrospective implementation, however, lacks intelligence. A true and faithful representation requires an actual model. Current financial reports are not even representations: they make no attempt to model the economic value, behavior or ongoing operations of the organization. They are of limited use to management or investor decisions.

There is another aspect of the current accounting implementation that needs attention. That is the technological aspect. It's difficult for those involved with accounting to imagine or understand a new more technologically advanced accounting/reporting model, so I will approach it by a weather analogy.

At one time weather forecasting was little more than uneducated guessing. The Farmer's Almanac, for example, would use the past to "predict" the future. Only the crudest predicted weather patterns (like seasons) had any reliability or utility. The best guess for today's weather was yesterday's. Over the years the collection of current weather data, the building of intelligent weather representations (models), the use of computers, and real time reporting has advanced weather forecasting from crude guess to astonishingly accurate prediction. Not only can today's weather be predicted but even 10 day forecasts are reasonably reliable ... certainly reliable enough to support most weather related decisions. Weather forecasting is now a technologically advanced and proven science.

Likewise it is possible to advance accounting/reporting from the realm of crude extrapolative guessing into a smarter, more prospective and more useful decision support system. This can be done in a scientific manner that is more disciplined and reliable than the current accounting/reporting model. We have massive stored data, powerful computers and programs, expert management, accountants, auditors, risk assessors, feedback mechanisms, legislation, etc. that facilitate forward looking statements. There is also technology that ensures both auditability and reliability. All that is needed to make use of existing technologies is a willingness to change.

Like weather forecasting, financial reporting can be made more useful through technology.
Purpose

Of course GAAP has a stated purpose and strictly speaking is not purposeless. The problem I see is that its avowed purpose is at odds with its implementation. Not only is GAAP fundamentally flawed but GAAP, in my opinion, has neglected the end user in favor of the auditor. Auditing convenience and expedience are a poor foundation for financial reporting. Financial reporting is serving the wrong master.

One main purpose of GAAP is to provide information to assess prospective cash receipts. A retrospective accounting/reporting model only does this in the most tenuous and backward manner. A second main purpose is to present information about economic resources and changes therein. It is difficult to even pretend that GAAP accomplishes this. Only in the sense that there is a stated purpose does GAAP have a purpose. Effectively GAAP is purposeless.

I was glad to see investors listed as the primary target of financial reporting. This focus gives hope that a purpose, an external accounting purpose, can be identified. The investor or potential investor is primarily concerned with a sell, hold or buy decision. He may base his decision on many factors but ultimately he seeks to compare share value with share price. Share value is nothing but the value present or present value of the shareholder’s expected returns. This, in turn, is closely related to the per share present value of returns to the company so that value-based company reports provide the simplest and most relevant decision criterion. Why is value not the primary direct reporting goal?

Given the time, money and energy expended, the accounting/reporting process should add value to the capital markets. Despite limitations, the process does add value, but, because of those limitations, the value added is also limited. Accounting needs to identify a useful purpose, assume its responsibility and do the work needed to achieve that purpose. It is naive and hypocritical to assume that the individual investor will assemble and process data from financial reports in a meaningful way when the accounting model itself refuses the task as “too difficult”. What financial reports deliver is like a truckload of Cadillac parts to be assembled by the consumer. The poor consumer doesn’t have the time, energy, tools or expertise to complete the assembly. In any event, the Cadillac parts are incomplete, don’t fit together, and are mixed with some Oldsmobile parts.

The FASB/IASB has identified its external purpose to “help investors make economic decisions”. It now needs to consider specifically how to best satisfy that purpose, i.e. how to give purpose to financial reporting.
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 accounting standards.

The current accounting/reporting model is too complex, inconsistent, not disciplined, not transparent, massively incomplete, not comparable, subjective (in a biased sense), irrelevant, costly, and purposeless. Does the IASB/FASB have the time, resources, or inclination to consider these fundamental problems or their solution? The answers, in my view are: yes, yes and no.

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.

I would like to see the FASB/IASB formulate general constitutional principles that transcend company, industry, time and place. Within this general constitutional framework it would be the responsibility of accounting education, accountants, auditors, accounting firms and professional societies (like the AICPA) to insure that the general principles are followed.
My criticisms of the current accounting/reporting model are meant to be constructive. To that end I have developed (in 1998) a complete value-based accounting/reporting implementation, Accounting For The Future (AFTF). It solves all the problems discussed above. This accounting/reporting model is simple, consistent, disciplined, transparent, complete, comparable, objective (in a non-biased sense), relevant, auditable, less costly, technological and purposeful. It exemplifies and articulates many, more general, principles than available in current IASB/FASB models. The website below contains ample descriptive materials.

http://flacct.com

Once an alternative solution, such as AFTF, is considered and understood the limitations of the current accounting/reporting implementations become, by contrast, crystal clear.

[1] 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

[2] If we look at the Wikipedia History of GAAP the first sentence reads “Auditors took the leading role in developing GAAP for Business enterprises”. No wonder auditing convenience trumps investor interests.

[3] Capitalized expenditures may be viewed as future income capped at the expenditure.

[4] For example, even a 2% inflation rate may be burdensome if only 1% is available from bonds or CDs

[5] The “prudence principle” requires the use of accounting treatments least likely to overstate assets and income be chosen. Unfortunately this too easily facilitates understatement of assets and income or overstatement of expense and liabilities
Appendix B

An Alternative to GAAP

Unsolicited Comments Submitted to the
Financial Accounting Standards Board

By
Humphrey Nash
January 31, 2011
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
replaces 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[^1], 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.

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-seek 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.
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 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.
Completeness

GAAP conveniently[^3] 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”[^4].

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 or net gain. However such positive net gains are NEVER measured under GAAP. 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.
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$^{[6]}$ 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.
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. 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.
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. \[8\]

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.
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).

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.
Purpose

GAAP has two main stated purposes: to provide information to assess \textit{prospective cash receipts} and to provide information about \textit{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 \textit{prospective cash flows} measured \textit{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 \textit{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 cast 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 a 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 flacct.com contains ample descriptive AFTF materials

[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]
“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*

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

Joke

gains are immediately recognized under GAAP but limited to the associated expense.

The *historic cast of capital* is the capital market’s best assessment of this discounting factor.

SFAC #1  The objective of financial reporting is to provide information useful to business and economic decisions.

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

These technological breakthroughs are not new. The breakthrough is their implementation.
Appendix C

A Context for AFTF

By Humphrey Nash

Accounting For The Future (AFTF) is a “new” value-based accounting and reporting model developed by Humphrey Nash in 1997. Like most such developments it is a product of the times and an outgrowth of existing technological advancements[1]. It arises from and exists in a context; this essay describes that context, or at least my limited view.

AFTF is a value-based model. Value-based models have been explored many times, especially outside the United States. AFTF was developed (independently) in 1997, some 21 years after the classic 1976 paper by Harvey Kapnick (AICPA council member) in which he presented an impassioned plea for a value-based accounting and reporting model. His essay starts:

“Accounting based on values has been discussed more during the last forty years by accountants as providing more useful data based on economic facts than any other subject. Yet, what results in practice do we have to show for all these speeches, articles, papers, and books? Almost nothing! Why has there been so little real progress when an obvious need for change has become increasingly evident for many years?”[2]

Another nearly 40 years have again passed and the “need for change has become increasingly evident”. AFTF provides feasible and disciplined technology to fulfill Mr. Kapnick’s vision. To do this AFTF uses present values, a technology in use for at least 100 years. Present values are the aqua regia of financial decisions, able to dissolve expectations into economic values. Present values are widely used by management, accountants, investors, lenders, analysts, and wherever the future must be assessed and financial decisions made.

FASB has laid the foundation for a present value-based accounting and reporting model in a series of papers: FASB’s Present Value Measurements in Accounting, 1990 or The FASB Project on Present Value Measurements, Wayne Upton 1996 or Future Events: A Conceptual Study of their Significance for Recognition or Measurement, L Todd Johnson 1994. FASB also published (February 2000) Concept #7 which laid a
In addition FASB has two working groups, at least partially involved in value-based accounting and reporting. The first group, the Investors Technical Advisory Committee (ITAC), seems predisposed to a value-based model. For example, in regard to “revenue” recognition under contracts, ITAC’s position is:

“At inception of the contract:

(1) Recognize and record all assets associated with the contract by the nature of the asset (completeness);

(2) Recognize and record all liabilities/obligations associated with the contract by the nature of the obligation and by the term of the transfer of the goods or services if more than one transfer is included in the contract (completeness);

(3) Measure all assets and liabilities/obligations by either (i) the contract price or by the (ii) estimated fair values of the assets and liabilities/obligations if the fair values of the components differ from the amounts implied by the contract price (accuracy)”

The second FASB group is the Valuation Resource Group (VRG) “tasked with assisting the (FASB) Board in matters involving valuation for financial reporting purposes.”

The Private Securities Litigation Reform Act of 1995 provides a "safe harbor" for forward-looking statements. This reflect congress's belief that capital markets will benefit from an increased flow of forward-looking information. As stated in the AICPA Guide (see below): “The Securities Exchange Commission (SEC) permits the publication of prospective financial information under certain conditions and has adopted the general policy of encouraging such publication.” There is no legal or mandate impediment to a prospective accounting and reporting model. Quite the opposite.

In April 2002 Robert Herz was appointed FASB chairman and served until Oct 1, 2010. He is the co-author of The ValueReporting Revolution (2001) which was critical of the current GAAP reporting implementation and espoused a more complete and value-oriented approach. Unfortunately the value-based revolution didn’t ignite under his tenure.
The AICPA has many publications and references for valuation technology. In addition to the CPA designation the AICPA supports the Accredited for Business Valuation (ABV) designation, which is increasingly relevant and popular. The AICPA has also published the Prospective Financial Information Guide which provides professional guidance and standards for forward-looking statements. Valuation and prospective statements are the essence of the AFTF implementation, although the AICPA doesn't explicitly support AFTF.

GAAP provides a context for AFTF. Although, in practice, AFTF and GAAP are antagonistic implementations, many of the basic ideas, principles and purposes of GAAP are present in or satisfied by AFTF. In a sense the AFTF implementation is an extension or completion of the GAAP implementation.

There is another context for AFTF: the logical context. For relevant management reports to shareholders, AFTF is necessary and sufficient. See the essays The Future of Accounting For The Future and How AFTF Came To Be as quoted from below.

“There is no better:

1. information about prospective cash receipts than forecasted cash flows
2. way to forecast cash flows than to use management expectations
3. information about economic resources (value) than using the present value of expected cash flows
4. present value discount than the shareholder cost of capital
5. way to determine the cost of capital than to use capital market pricing
6. way to report economic progress to shareholders than to report value added
7. way to define value added than the period change in value (adjusted for the cost of capital)."

A related context for the assertion that AFTF (or its descendants) is necessary and sufficient is needs and capabilities.

Management needs to be freed from the shackles of GAAP financial reporting. GAAP is essentially retrospective constraining management reports, thinking and actions to the short term. This is not conducive to shareholder value creation, especially in an
economy where intangible values dominate. GAAP is also complex and convoluted absorbing resources and muddying the waters.

Management is perfectly capable of fulfilling its responsibilities under AFTF. In the main, AFTF adopts the existing management accounting and measurement perspective. AFTF only requires what good management also requires, namely a forward-looking view and quantification of the future.

The investor needs relevant information, information useful in deciding whether to buy, sell, or hold shares. This requires a comparison of price and value. Value-based financial reports can do this; GAAP reports cannot. Current GAAP reports provide very poor information on existing shareholder value and no guidance about the future.

The investor is perfectly capable of coping with the inevitable uncertainties of the future. The investor willingly assumes the risks and commensurate reward of ownership. In fact, the diversified equity investor (not trader) may ultimately be more secure than alternative “safer” investments like bonds or commodities. The investor does not want or require certainty but he does require a reasonable expectation, which management can provide. [5]

The accountant or auditor ultimately needs to fulfill a useful function. AFTF provides a more useful role for the accountant but it also provides an easier and safer role. GAAP is convoluted, inconsistent and complex, threatening to collapse of its own weight. This makes accounting and financial reporting difficult for the practicing accountant. GAAP complexity seems to be increasing exponentially (fair value, revenue recognition under contracts, lease accounting, etc., are examples). In addition, accountants face grave dangers when forced to make judgments or opine. Recent corporate failures have not enhanced accounting’s image, in some cases (Enron, for example) destroying whole accounting firms. This could be repeated.

The AFTF model places the burden and responsibility for business judgments squarely on management. AFTF requires management to express its own expectations. Accountants and auditors have precise, limited and unequivocal AFTF roles. They don’t need to stick their necks out. Their capacity to survive is enhanced. The accountant, internal or external auditors have well developed skills to support a value-based accounting or reporting model. In fact, accountants already use most of the tools and technology of AFTF, whether it’s supporting capital allocation decisions with cash flow analyses, budgeting and monitoring actual-to-expected cash flows, or providing shareholder guidance to the capital markets. The AICPA has well developed support for valuation functions and professional guidance for prospective financial statements. AFTF does not drastically disturb the traditional accounting role and is well within the capabilities of the practicing accountant.
Standard setters are delegated and charged with the responsibility of developing standards for accounting and reporting that satisfy primarily the needs of the capital markets. Currently there is nobody, apart from the standard setters (FASB, IASB, IFRS) who can undertake this role (legally the SEC can but does not have the capacity and willingly delegates to the standard setters). As the needs of the capital markets change it is up to the standard setters to adapt. It is not sufficient to maintain, codify, electrify or converge the status quo. To be relevant in the new economy requires a new purpose, new measures, new procedures and a new perspective. In addition, standard setters must cope with a multitude of precursors to relevance: simplicity, universality, transparency, consistency, discipline, completeness, comparability, cost, reliability, and adaptability. Many of these needs have been investigated in the papers: A Critical View of GAAP and An Alternative to GAAP and the conclusion, or at least my conclusion, is that AFTF is the more relevant model. Of these precursors to relevance, I think that complexity (lack of simplicity) is the most threatening to standard setters. GAAP may collapse of its own weight damaging capital markets in the process.

Standard setters have the responsibility, authority, knowledge and skills to develop a value-based model. In particular, FASB has laid a good foundation, as discussed above, for a forward-looking accounting and reporting model. The simplicity of AFTF or its standard setter reincarnation should facilitate that development.

The principal interested parties (standard setters, management, accountants, and investors) have a need for a value-based model. They also have sufficient capacity to develop, produce, guide and use such a model.

All the pieces of the puzzle are present. Now is the time for standard setters to fit them together.

For more information on AFTF see the website flacct.com.

[1] A major goal of AFTF “is to facilitate, accelerate and formalize an accounting evolution already in progress.” From the preface to Accounting For The Future (March 1998)
This essay is quoted very extensively in the paper entitled *Harvey Kapnick* in the *Miscellaneous Essays* category in the *flacct.com* website. Mr. Kapnick’s entire essay (VALUE-BASED ACCOUNTING EVOLUTION OR REVOLUTION) is available at: [http://newman.baruch.cuny.edu/digital/saxe/saxe_1975/kapnick_76.htm](http://newman.baruch.cuny.edu/digital/saxe/saxe_1975/kapnick_76.htm)

See ITAC comment letter on: Exposure Draft – Topic 605 - Revenue Recognition – Revenue from Contracts with Customers – File Reference No. 1820-100

GAAP concepts, ideas, or principles such as: matching concept, entity concept, time period principle, going concern principle, full disclosure principle, completeness, fair representation, override principle, materiality, consistency. On the other hand AFTF does not employ the objectivity principle (report only objective evidence), the monetary unit (ignore inflation), conservatism principle, revenue concept (“earned” not economic based), historical cost (not shareholder value). There are many AFTF principles not present in GAAP.

At this point it must be emphasized that, under AFTF, all management expected cash flows are strongly disciplined (recalibrated to the capital market or economic scale, among other things).

See the essay *Simplicity* on *flacct.com* for a rundown of GAAP complexities eliminated in AFTF.

I’m aware that FASB has limited capability or desire for the abrupt and disruptive change that a new accounting model entails. I quote from the introductory page of *flacct.com*. “It may be difficult to abruptly scrap GAAP. I suggest that forward-looking statements be classified as conforming (to AFTF or its standard setter reincarnation) and non-conforming which includes forward-looking statements as currently provided. Initially conforming statements would be voluntary and supplementary (to GAAP). After a period of exposure and refinement they would be made mandatory and supplemental. After a further period they would be mandatory with GAAP becoming supplementary and non-mandated. It is expected that GAAP will die a natural death as it becomes clear that forward-looking accounting and reporting is simpler, more disciplined and more useful.”

This need has increased dramatically as the economy shifted from agrarian/manufacturing/mercantile to a more technological/service/information basis where GAAP accounting intangibles dominate.
Appendix D

Simplicity

A Fable

Some years ago my friend Archie suggested a blind date with Betty volunteering that she had “a pleasant personality”. She was “damned with faint praise” and, to be on the safe side, I declined the date. The next week he suggested a date with Veronica. I asked him to tell me more about her than he did about Betty. He replied that she doesn’t have leprosy, is not depressed, has an absence of physical deformities and no mental deficiencies. Again I declined the date. My ex-friend Bill and his beautiful and vivacious wife Veronica now have three happy, beautiful, brilliant children. As far as I know they don’t have leprosy. Looking back on my lonely life I wonder what went wrong. Clearly Bill’s disclosure and reporting systems were inadequate. For Betty they were incomplete. For Veronica they were incomplete, convoluted, perverse, not representative, unnecessary and silly.

It has been repeatedly claimed by me that AFTF simplifies. The purpose of this paper is to enumerate some of the simplifications. Most are self-explanatory or discussed elsewhere.

GAAP is generally based on immediately recognizing possible losses but waiting for actual profits. This conservative approach is so far removed from economic reality that some fix was needed. One fix was to defer expenses. This produced results more in line with economic measures and so was somewhat useful. But, like the negative but true descriptions of Veronica, GAAP is also incomplete, convoluted, perverse, not representative, unnecessary and silly. How can expenses already paid be deferred? How can an expense asset even be considered an asset? This is convoluted at best, like calling profit a negative expense. It can be done but why do it? Expenses are deferred only if they are recoverable, i.e., there is an associated stream of future income. It is this future income stream which is the real asset but, in accord with the pretense of delaying any profit recognition, we call it an expense asset not an income asset. Another motive for this convoluted approach is to arbitrarily cap or limit income recognition to the level of the expense which makes it easy to audit. But this does great damage to economic values. It is inconsistent with the treatment of liabilities. It introduces a conservative bias which is suboptimal for management or
investor decisions. It is not the path to capital market efficiency. It is a prime example of the tangled web that accounting finds itself trapped in..

AFTF avoids such silliness. In fact it avoids most of the troublesome items that plague accounting including:

1. Income (gain) and expense (loss) recognition issues. AFTF management expected cash flows completely eliminate these perennial problems. AFTF simply bypasses the troublesome income and expense concepts.
2. Accruals. Under AFTF there is no need for accruals. Value added simply and directly incorporates the purpose for accruals.
3. Allocations generally are avoided under AFTF. There is no need for arbitrary lease accounting, depletion, depreciation or amortization schemes. The idea of deferral has no purpose or existence in AFTF.
4. The matching concept is automatic with AFTF. It is not necessary to arbitrarily manufacture and shift money flows.
5. There in no need to choose inventory valuation methods. AFTF expected cash flows accurately captures what inventory valuations attempt. There is no choice or bias.
6. Under AFTF there is no need to have separate cash flow accounts and presentations or to reconcile to GAAP.
7. The going concern assumption is inherent in expected cash flows which visibly support (or fail to support) the assumption.
8. There in no need for the epiphany of goodwill. AFTF anticipates and measures the economic value or lack thereof of an acquisition (including economies, synergies, better management, financial resources, patents, market share, etc.).
9. As discussed elsewhere AFTF unifies all decision technologies (managerial accounting, pricing, shareholder decisions, budgeting, management planning, oversight and control, independent investment analysis, acquisitions or mergers, etc.). This simplifies.
10. There is no need to report massive amounts of data in shareholder reports to help users assess the amount, timing and uncertainty of prospective cash receipts or to provide information about economic resources (assets and liabilities) and changes therein. AFTF does this explicitly. This simplifies, especially for users.
11. There is no need for inflation accounting, risk adjustments, risk-free interest or opportunity-cost assumptions. The AFTF cost of capital (discount) provides unequivocal and customized measures. This improves and simplifies.
12. AFTF has a unified and coordinated statement of values showing the status (value) and progress (value added) in a single presentation. GAAP, in contrast, shows an essentially retrospective income statement and an independent essentially prospective balance sheet which are then artificially reconciled.
13. Auditors under AFTF have a more limited and simpler role. They are not required to be experts in the industry, the company, its environment, management plans, or complex GAAP machinations. Their AFTF role is more useful and restricted to enforcing unequivocal disciplines (simpler). This limits their liability but not their importance.

14. If we survey FASB’s statements we find that most are fixes to a fundamentally flawed accounting model. They are simply unnecessary under AFTF.

15. AFTF handles derivatives, hedging, options, fair value, contingencies, intangibles, impairment, and many other GAAP-difficult items with relative ease. Generally, expected cash flows and only expected cash flows can be expected to provide optimal economic representations.[1]

It might be thought that the universal power of expected values is a ruse, merely transferring or delegating difficult accounting issues to management. It explicitly does this but anticipating and quantifying the future is the management function and responsibility. The reality is that GAAP accounting has unnecessarily created the difficult problems it faces. As enumerated above, AFTF simplifies and makes management’s accounting and reporting responsibilities much easier. In fact there is very little beyond existing management functions to be done. AFTF requires what management already uses. AFTF has substantial overlap with managerial accounting.

1. The basic decision technology used in managerial accounting is the same as AFTF, namely the present value of expected cash flows. This is the way management prices products, evaluates capital expenditures, measure future profits, establishes budgets, decides on mergers or acquisitions, and generally chooses courses of action. If, by chance, management doesn’t routinely “run the numbers” then AFTF will force the issue. This will require management to consider the long term future and quantitatively measure it. This will improve the management product.

2. AFTF uses the historic cost of capital as a discount, similar to a shareholder required rate of return or hurdle rate. However, the historic cost of capital has some advantages. First, it is unequivocally determined by the capital markets and customized to the company. Second, industry standard hurdle rates like 15% or 12% are arbitrary and highly variable. Third, such “standard” rates are not comprehensive (they may not reflect company risk characteristics, inflation expectations, perceived management quality, or other factors).

3. The actual-to-expected cash flow exhibits which are so integral and important to AFTF are very similar to common budgeting technology employed by management and accounting staffs.

4. Management’s Discussion and Analysis provides a non-quantitative view of the future containing the same factors which enter into expected cash flows. Management also provides long-term future outlooks and more formal
short-term guidance. Formalizing and quantifying its outlook should come naturally to management.

5. Management’s cash flow expectations are a forecast based on good faith (unbiased) estimates. They are not expected to be exactly realized and many factors can produce variations. There is no burden on management to be precise … only reasonable. Shareholders willingly delegate such judgments to management, understanding the risks they assume in the face of irreducible uncertainties. Managements not willing to confront and quantify the future and share their vision should not be management.

6. AFTF is relevant and disciplined. This protects management, the auditor and the investor. AFTF provides little opportunity and very little motive for management to be biased. This should comfort.

7. Management expected cash flows do not directly enter progress reports (value added) or status (value) reports but are essentially recalibrated (tared\(^2\)), using the AFTF discount rate, to the capital market scale.

AFTF may require more from management but only what good management should do anyway. Management should embrace AFTF since it is simpler and eliminates the formalities of GAAP.

**Conclusion**

As mentioned above, it is GAAP which complicates; AFTF is simpler because it doesn’t. Although AFTF is vastly simpler than GAAP, which contributes to its effectiveness, the biggest advantage of AFTF is that it is fundamentally more rational and effective.

\(^1\) GAAP is incomplete and fails to provide a true or fair representation. It is a paradox that FASB promotes the fair value concept often where it doesn’t apply or is not needed yet FASB steadfastly refuses to recognize the fair value of the whole enterprise. The parts don’t add up to the whole. The capital market value of a company is very well established, although somewhat variable (AFTF would help stabilize).

\(^2\) See the essay *Disciplining Prospective Accounting*
Appendix E

AFTF Reliability

by Humphrey Nash

One barrier to understanding Accounting For The Future (AFTF) is the assumption and belief that a prospective accounting and reporting model can't be reliable. Every molecule of the accountant's (auditor or standard setter) instinct and training is oriented in one direction: the past. To the accountant (auditor or standard setter) reliable measures and representations of the past are difficult enough; they don't want to even think about the future. Can crystallized assumptions and catechismic beliefs be set aside long enough to give the prospective view fair consideration? The answer, so far, is no.

A measure or representation is said to be reliable if it accurately measures or represents what it purports to measure or represent. AFTF is intentionally and explicitly based on management expectations. The cash flow models developed and signatured by managements are their representations. There is no fundamental assumption or pretense that management expectations are unbiased or will be realized in the future. The present value measures reported to shareholders by management are unequivocally values present in current capital markets. There is no fundamental assumption that such values are unbiased or enduring. A question now arises. Is this definition of reliability too narrow? Or perhaps AFTF is so narrowly defined that it is trivially reliable?

Let's examine some other broader aspects of "reliability". On a fundamental level AFTF is based on cash flows which are inherently more reliable than GAAP "flows". For every circumstance, GAAP income and expenses must be carefully and separately defined. These definitions involve choices, judgments, interpretations, rules, principles and procedures that are highly variable. GAAP revenue recognition and expense treatments have been extremely troublesome for accountants and auditors, standard setters, management and investors for decades. There is no general external purpose, philosophical basis, explicit set of guiding principles, or consistent practice to produce reliable GAAP "flows".

In contrast cash flows, or at least past cash flows, are tightly defined and controlled. Cash flows are associated with a specific transaction, fixed in time and place. They are booked, subject to double entry and ledger balancing. They are relatively easily auditable. Expected cash flows

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6 This is the definition of reliability employed by standard setters.
7 See the essays Disciplining Prospective Accounting and The Historic Cost of Capital for further explanation.
8 In truth (or my perception of it) it is GAAP financial statements that are trivially reliable. GAAP statements make no pretense of measuring or reporting economic progress or shareholder value. They measure and report only accounting values. What are accounting values? That which is being measured and reported.
are still cash flows and still associated with a specific transaction, fixed in time and place. They are booked, subject to double entry and "non-ledger" balancing. Future cash flows are also tightly defined and controlled. They are defined unambiguously as management expected cash flows. Are they controlled? Certainly they are under management control, for whatever that's worth. It's not unreasonable to assume that management is in the best position to produce a cash flow model since this is their assumed role. A cash flow model will not have the detail of the ledger but will aggregate flows at a significant level. Aggregated flow may have a degree of stability, predictability and controllability not present in detailed accounts. Cash flow are controlled by management in another sense. Management makes decisions and takes ownership of those decisions. Management has oversight and control of R&D, production, sales, targets and results. If cash flows expectations are not being met management adjustments or changes may be implemented. Management has two weapons to control its actual-to-expected results.

Having control and exercising appropriate control may be two different things. AFTF has disciplines to encourage reasonable and appropriate expectations. The AFTF dual validation requires that the initial cash flow model fit the recent historic cash flows. This anchors the model. The dual validation also requires the historical company valuations to match the historical market values. This is done using the (goal seek) historical cost of capital. This implicit discount rate guarantees that, no matter what the expected cash flows are, the reported measures (value and value added) are scaled or tared to economic values. It does little or no good for management to, for example, exaggerate future expected cash flows. The opportunity and motivation for misrepresentation are controlled. This forcefully encourages the reliability of expected cash flows. There are two more aspects of AFTF which discipline management expectations. First, value added, for example by optimistic forecasts, will be soon followed by value lost, in spades. Second, AFTF reports actual-to-expected cash flows. If guidance is shortfalled the capital markets make adjustments, in spades.\(^9\)

Another facet of reliability is relevance. Can the investor rely on AFTF to support his capital investment decisions? AFTF reports value per share which can easily and meaningfully be compared to price to provide the ultimate decision criterion. In contrast, GAAP provides only partial and overwhelmingly complex information. GAAP is not unuseful, just minimally useful. It should not be relied upon.

The majority of recent corporate failures or frauds have been financial reporting failures. It is my belief that reporting cash flows, rather than GAAP revenues and expenses would have precluded or avoided most such problems. More important than sudden and visible corporate collapses is the gradual, invisible but pervasive damage from misguided or inefficient capital allocations. The losses from corporate failures are substantial but the insidious opportunity losses from inadequate financial reporting are immeasurably larger. The current GAAP implementation cannot and should not be relied on.

\(^9\) Falling market prices trigger dual validation increases in the historic cost of capital automatically negating spurious value added in prior periods.
Another aspect of reliability is accuracy. Management expected cash flows (and AFTF) will not be accurate. The future is uncertain and many factors may impinge on expectations. Economic factors, disasters, changing regulations or taxes, inflation, technological breakthroughs, social changes, wars, will all affect expectations. Some of these exogenous factors may be anticipated, hedged or disarmed but effects will be present. Internal factors like poor management (assumptions, judgments, modeling, execution, controls, responses) will affect accuracy. Shareholders will assess these factors and take any needed action. The shareholder, in contrast to the debt holder, is comfortable with variations. Indeed, the shareholder seeks out risk and the more than commensurate rewards. He does not require certainty only an informed and responsible expectation. Management expectations provide the only information expected to be optimally useful.\(^{10}\)

AFTF measures, technology and shareholder reports are very similar to existing management measures, technologies and reports. This seems appropriate for management reports to shareholders. This similarity simplifies management's job but it also tends to ensure that management represents and acts in shareholders' interests and that the investor is informed. GAAP cannot be relied upon to do this. Far too often GAAP measures are inversely related to shareholder values.\(^{11}\) GAAP measures discourage investment, R&D, employee training, long term thinking, and intangibles. GAAP cannot be relied upon to encourage the creation of shareholder value.

AFTF vastly simplifies accounting and financial reporting. It processes data and provides condensed and refined information. It does not overload management reports with raw data or myriad disclosures of unknown significance. It provide complete, completed and transparent information. GAAP statements, on the other hand, require the individual investor "to assess the amounts, timing, and uncertainty of the prospective cash flows". GAAP relies on the individual investor; in contrast the investor can rely on AFTF.

AFTF value added and the ongoing AFTF actual-to-expected cash flow ratios provide clear and current information about the success of the company and its management. This information can be relied upon if management or director changes are indicated. AFTF value added and the ongoing AFTF actual-to-expected cash flow ratios can provide a reliable basis for granting bonuses and their payout. AFTF permits capital markets to contribute (via the cost of capital) their risk assessments and tolerance, inflation expectations, assessment of management quality, and risk free real yield requirements. GAAP ignores capital market information which doesn't enhance reliability.

Another aspect of reliability is auditability. This involves the ability to audit accurately and the significance of the audit. It may be easy and accurate to verify "fastidious historic records of past exchanges" but does this satisfy shareholder needs? Stating an opinion that "financial statements present fairly, in

\(^{10}\)"Certainly financial analysts desire information that is both relevant and reliable, but the bias is towards relevance. In a phrase, analysts prefer information that is equivocally right rather than precisely wrong. Inexact measure of contemporaneous economic values are more useful than fastidious historic records of past exchanges." Financial Reporting in the 1990's and Beyond, AIMR 1993. AFTF is both relevant and reliable.

\(^{11}\)For example, capital expenditures are generally expected to be profitable but this is never measured. The best GAAP does is to occasionally permit expense deferral. This is not neutral, informative or conducive.
all material respects, the financial position of the company and the results of its operations and its cash flows in accordance with GAAP" seems 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.\textsuperscript{12} The second problem is "in accordance with GAAP".\textsuperscript{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 \textit{dual validation}).\textsuperscript{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 \textit{historic cost of capital}) that emerges from the \textit{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 \textit{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 \textit{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 \textit{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 \textit{Sarbanes–Oxley Act of 2002} makes it crystal clear that management is ultimately responsible for all financial reports; ignorance or delegation is no excuse. \textit{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 reproduciability, contributing to reliability.

\textsuperscript{12} The income statement and balance sheet are uncoordinated, c.f., AFTF Statement of Values.
\textsuperscript{13} GAAP, among other things, is incomplete and does not support or report economic or shareholder values. GAAP statements are not true representations
\textsuperscript{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.\textsuperscript{15} AFTF’s self-control contributes to reliability.

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

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

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.

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**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.

One 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

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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 they 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 they 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).
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 the 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 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 best 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.). 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 AFTF Analysis 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.