Comments on

Conceptual Framework for Financial Reporting The Reporting Entity

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> By Humphrey Nash Submitted July 7, 2010

The author of these comments, Humphrey Nash, is the author and proponent of AFTF: *Accounting For The Future*, a value based accounting and reporting model. This model is based on the Present Value of Expected Cash Flows (PVECF). More information on the model is available at the website: http://home.sprintmail.com/~humphreynash/index.htm.

In the comments that follow, quotes from the FASB Exposure Draft are in the original Times Roman font. My comments use the Arial font. Underlining may have been added to quotes for reference clarity

Specific Questions

1. Do you agree that a reporting entity is a circumscribed area of economic activities whose financial information has the potential to be useful to existing and potential equity investors, lenders, and other creditors who cannot directly obtain the information they need in making decisions about providing resources to the entity and in assessing whether the management and the governing board of that entity have made efficient and effective use of the resources provided?

No, see below.

2. Do you agree that if an entity that controls one or more entities prepares financial reports, it should present consolidated financial statements?

No, see below.

Do you agree with the definition of control of an entity?

No, see below.

3. Do you agree that a portion of an entity could qualify as a reporting entity if the economic activities of that portion can be distinguished from the rest of the entity and financial information about that portion of the entity has the potential to be useful in making decisions about providing resources to that portion of the entity?

Yes

4. The FASB and the IASB are working together to develop common standards on consolidation that would apply to all types of entities. Do you agree that completion of the reporting entity concept should not be delayed until those standards have been issued?

Yes. However, I believe that there are more fundamental and more pressing issues that should be considered first. Resolution of these issues might produce a very different definition of the reporting entity and consolidation standards.

General Comments

Developing the Common Conceptual Framework

P5. The Boards concluded that a comprehensive reconsideration of all concepts would not be an efficient use of their resources.

FASB and the IASB are rightly concerned about efficient use of their resources. They have limited personnel, financial resources and limited time. In my opinion, time is the most limiting factor as the past has demonstrated. Many Board projects die of old age before they are born. Inflation accounting, MOBR and fair value are examples of projects passing their expiration dates. I believe that the Boards correctly determined that a comprehensive or fundamental reconsideration of the conceptual basis of the current accounting and reporting models would be expensive and time consuming (and probably outlive the current Board members).

However some important points need to be made.

First, it is not primarily the Boards' resources that are at stake but the broader interests of reporting entities, shareholders, creditors, regulators, suppliers, etc. Capital market efficiency and the general economic welfare should be the dominant consideration. The Boards' focus should be on how best to serve broader interests. To focus on FASB or IASB efficiency is penny wise and pound foolish. I acknowledge that there is a conflict between the noble goals of a perfect accounting and reporting model and the real and pressing necessity to accomplish something. It seems that "must do's" always take precedence over "should do's" even though the "should do's" are ultimately more important and the "must do's" are ultimately less important. This leads to my second point.

Second, it is patently incongruous and self-serving to not consider all concepts when reexamining the "conceptual framework" of the financial reporting model. Cherry-picking certain concepts while ignoring, dismissing or discarding others may achieve the desired result but may not achieve a desirable result. Selecting concepts may, for example, support the current GAAP/FASB/IASB models but this is hardly a fundamental reconsideration and may not produce needed improvement. In my opinion, it is not worthwhile approaching the "conceptual framework" unless basic concepts are examined and examined first.

Third, the "conceptual framework" project itself provides a clue. This is not a new project. The Boards have repeatedly examined, in one way or another, reporting concepts and practices. There is a reason for this. The current conceptual framework is fundamentally flawed. It is outdated, obscure, arbitrary, inconsistent, and too complex. The current framework lacks rigor, discipline, moral backbone and, most damning, relevance. It is generally inadequate. Empirical proof of inadequacy is very close at hand.

I think the Boards intuitively understand that there is something wrong with the current model. The increasing complexity of the current model threatens to collapse under its own weight crushing the Boards in the process. This doesn't particularly worry me. But capital market efficiency and economic health depend on the effectiveness of financial reporting information ... that worries me. Properly or usefully defining a reporting entity is not unimportant but there are more fundamental issues that must be settled first. This is not just a matter of sequence; the foundation determines the shape of the whole structure, including appropriate definitions.

Fourth, there are "alternatives the Boards should consider". One alternative is a value approach to financial reporting. One example of a value approach to financial reporting is provided by the "Accounting For The Future" model outlined and espoused (in great detail) by yours truly. This model is simpler, consistent, relevant and disciplined. The AFTF model should be at least compared with the current model. AFTF is completely described and examined in the AFTF draft proposal and supporting essays at my website (also available in the FASB library). A Chinese version is available.

Many aspects of their frameworks are consistent with each other and do not seem to need fundamental revision. (FASB and IASB frameworks)

Agreed, they may not need fundamental revision to achieve consistency. But the frameworks may need fundamental revision to achieve other goals.

Instead, the Boards adopted an approach that focuses mainly on the improvement and convergence of their existing frameworks, giving priority to issues that are likely to yield standard-setting benefits in the near term.

Improvement and convergence of the existing frameworks may give the appearance of progress but this is like pouring concrete before the basic forms are built. It just makes genuine fundamental improvements that much harder.

P6. The Boards decided to focus initially on concepts applicable to business entities in the private sector.

This is an appropriate focus since the purpose and nature of not-for-profits and government entities is quite different. Perhaps the focus could be narrowed to publicly traded business since the privately held reporting environment is so small and so different. The tail shouldn't wag the dog.

Authoritative Status of the Framework

P10. Neither FASB Concepts Statements nor the IASB's *Framework for the Preparation and Presentation of Financial Statements* overrides authoritative standards, even though some standards may be inconsistent with them.

This seems to eviscerate the concepts. Hopefully new conforming standards will eventually be developed.

P11. ... Although there is currently no firm plan, the FASB expects to reconsider the authoritative status of the FASB Concepts Statements at completion of the Conceptual Framework project, which could result in elevating its status to authoritative.

This provides a welcome path to fundamental change not necessarily anchored to historic GAAP.

The Reporting Entity

S1. A reporting entity is a circumscribed area of economic activities whose financial information has the potential to be useful to existing and potential equity investors, lenders, and other creditors who cannot directly obtain the information they need in making decisions about providing resources to the entity and in assessing whether the management and the governing board of that entity have made efficient and effective use of the resources provided.

The reporting entities being considered are for-profit non-public (non-governmental) organizations. The overwhelming majority of these are publicly traded corporations. The published financial reports these entities produce are directed foursquare at owners (shareholders) and are labeled as "reports to shareholders". It is the shareholders who have the greatest need for information since it is primary their capital contributions which are at risk. Creditors or lenders have a lesser need since they are often secured and their claims to assets take precedence over shareholders. If the shareholder is informed and thus protected then the lender will be protected. Furthermore, "unsecured" creditors such as bondholders generally have access to all information and can require, in advance, financial reports customized to their interests. Bondholders are also ostensibly informed and protected by rating organizations. I don't think that lenders or creditors should be equated to shareholders. Hence the repeated phrase "existing and potential equity investors, lenders, and other creditors" would be better phased as simply "existing and potential equity investors".

In contrast to creditors, shareholders provide RISK capital with only a reasonable expectation of some return from their investment. They fully understand that returns are not guaranteed. Indeed they don't want guarantees but rather the expected rewards from risk assumption. Equity investors generally enjoy the protection that diversification and a long investment horizon fosters.

The point of this discussion is that the financial reporting entity should be defined in terms of the shareholder. To design reports to fit an entity definition and then supply whatever financial information that results to shareholders is backwards. Currently all financial reports of publicly traded entities have well defined bodies of shareholders. If the goal is to serve those shareholders then the entity must take its meaning from the interests of those shareholders.

A more on-target definition might be:

"The entity for shareholder reporting purposes consists of the organizations and organs receiving and returning shareholder provided capital. The financial reports provided by such entities should contain information useful to current shareholders."

Note that lenders are not mentioned. The fox that chases two rabbits will catch neither.

Note also that potential equity investors are not mentioned. Two examples of potential investors that should not determine the financial information provided include acquiring entities and future shareholders. The acquirer is not a simple investor but expects the acquisition to increase value (because of synergies, reduced competition, patents, economies of scale, etc.) over that the independent entity could produce. The potential improved value should generally not be part of shareholder reporting. Future shareholders should also not govern or influence shareholder reporting. For example, management may double the outstanding share for its own benefit. There is no loss to the new shareholder group but existing shareholders take it on the chin, to be polite.

Reporting's primary responsibility is to the current owners. Financial reporting information should support the current owners' hold or sell decision. This same information should also reasonably support the buy decision for potential investors.

A useful definition of an entity will be very difficult to achieve within a retrospective accounting and reporting model. That's because the economic significance of the entity resides in the future. AFTF is prospective and it ultimately becomes easy to define the entity. Under AFTF the economic entity is totality of all resources and obligations that affect expected cash flows. This would be the corporate structure, the buildings and equipment, human capital, patents, agreements, market share, the economic environment, hedge funds, suppliers, customers, competition, flood, oil prices, taxes, SPEs, bird flu, blowout preventers and inflation, among other things. The point is that is difficult to dissect or demarcate the entity. It is much easier to reasonably estimate the total (monetary) effect on the entity than to assemble and measure the individual components, even if they could be completely identified. For measurement and reporting purposes the entity can be equated to its cash flows.

S2. An entity controls another entity when it has the power to direct the activities of that other entity to generate benefits for (or limit losses to) itself. If an entity that controls one or more entities prepares financial reports, it should present consolidated financial statements.

The power to control is different from the exercise of control. I recently bought a company which was 60% purchased (with cash and a subsidiary) by another company but the intent and expectation was the purchase was to be hands off. The acquisition actually went the other way and so did the consolidation. There may be tax, political or other reasons why the power to control is not exercised and the investment or other control mechanism doesn't reasonably suggest consolidation.

This brings up an important general point about the definition of entity and financial reporting. The shareholder willingly and gladly assumes risk. He or she is well aware that there are no guarantees, only an expectation. The only financial reporting measure that optimally supports the shareholder's expectation is **expected value**. All other values are inappropriate, except by coincidence. The entity should be defined to correspond to those expected structures, activities, behaviors, plans, environment, and boundaries that relate to or impinge on expected value.

RE1. The objective of general purpose financial reporting is to provide financial information about the reporting entity that is useful in making decisions about providing resources to the entity and in assessing whether the management and the governing board of that entity have made efficient and effective use of the resources provided. The reporting entity concept is intended to further this objective.

The shareholder is interested in the "efficient and effective use of the resources". The lender or creditor is only marginally concerned about this (barring bankruptcy). As mentioned above it is the lender or creditor reference which should be deleted or at least demoted.

RE2. A reporting entity is a circumscribed area of economic activities whose financial information has the potential to be useful to existing and potential equity investors, lenders, and other creditors who cannot directly obtain the information they need in making decisions about providing resources to the entity and in assessing whether management and the governing board of that entity have made efficient and effective use of the resources provided.

The efficient and effective use of resources raises another issue, namely that management (managerial) reporting is currently different from shareholder reports. Managerial reports directly support efficient and effective resource utilization. Shareholder reports currently support formal GAAP requirements. This difference shouldn't exist since management interests and shareholder interests should be the same. With the AFTF model management and shareholder reports are fundamentally similar (AFTF shareholder reports reflect management expectations).

RE3. A reporting entity has three features:

- a. Economic activities of an entity are being conducted, have been conducted, or will be conducted
- b. Those economic activities can be objectively distinguished from those of other entities and from the economic environment in which the entity exists

Tax policies, competition, recession, inflation, lawsuits, cost of capital, natural disasters, civil unrest, strikes, etc. are all part of the economic environment. This economic environment may significant affect company results, value or expectations. How can they possibly be ignored in reporting values to shareholders? The answer unfortunately is that values, including shareholder values, are not part of the current financial reporting model. AFTF uses expected values which incorporates the economic environment not a narrow and myopic entity perspective.

c. Financial information about the economic activities of that entity has the potential to be useful in making decisions about providing resources to the entity and in assessing whether the

management and the governing board have made efficient and effective use of the resources provided.

GAAP has the potential to be useful. However this is damning with faint praise. AFTF is not merely potentially useful, it is optimally useful in making decisions. In fact, AFTF reports shareholder values to shareholders thus providing a direct decision criterion. AFTF uses expected cash flows; there is no need to formally define the entity. Within AFTF the **entity** may be simply and usefully defined as the totality of cash flows (available or realizable to the shareholder).

These features are necessary but not always sufficient to identify a reporting entity.

A definition must provide necessary and sufficient criteria to be complete.

RE4. Identifying a reporting entity in a specific situation requires consideration of the boundary of the economic activities that are being conducted, have been conducted, or will be conducted. The existence of a legal entity is neither necessary nor sufficient to identify a reporting entity. A reporting entity can include more than one entity or it can be a portion of a single entity.

How can the current reporting model or the definition of entity incorporate economic activities that "will be conducted"? Does the pending acquisition, the decision to close a plant, or the creation of SPEs (Special Purpose Entities) define the reporting entity? Should the future be ignored?

RE5. A single legal entity that conducts economic activities and does not control any other entity is likely to qualify as a reporting entity. Most, if not all, legal entities have the potential to be reporting entities. However, a single legal entity may not qualify as a reporting entity if, for example, its economic activities are commingled with the economic activities of another entity and there is no basis for objectively distinguishing their activities. In some jurisdictions, there may be questions about whether those entities are separate entities under the law.

The potential difference between legal and economic entities essentially evaporates if the entity takes its meaning from the shareholders to which the reporting is directed. (see my previous comments). Ownership is rigorously defined and it is complex, capricious, and unnecessary to start at the wrong end to define the entity.

Consolidated Financial Statements

RE7. An entity controls another entity when it has the power to direct the activities of that other entity to generate benefits for (or limit losses to) itself.

The power to control should not be equated so quickly to actually exercised control. For example, Blackrock may have the ownership power to control an investment but may not do so. Should the financial reports be consolidated other than as a listed asset? There should be no consolidation where control is not expected to be exercised. This is in keeping with the desire of shareholders to know expected outcomes.

RE8. If one entity controls another entity, the cash flows and other benefits flowing from the controlling entity to its equity investors, lenders, and other creditors often depend significantly on the cash flows and other benefits obtained from the entities it controls, which in turn depend on those entities' activities and the controlling entity's direction of those activities. Accordingly, if an entity that controls one or more entities prepares financial reports, it should present consolidated financial statements. Consolidated financial statements are most likely to provide useful information to the greatest number of users.

I agree with this if control is exercised, but not simply if the power to control is present.

RE10. If one entity has *significant influence* over another entity, it does not control that other entity. The entity's ability to influence the activities of another entity without actually being able to direct those activities does not constitute power over that other entity.

This might apply to the Blackrock example.

Combined Financial Statements

RE12. Combined financial statements include information about two or more commonly controlled entities. Combined financial statements do not include information about the controlling entity and are often prepared when the controlling entity does not prepare financial reports. Combined financial statements might provide useful information about the commonly controlled entities as a group.

The more common situation may be company under a corporate umbrella. Here consolidation and reporting is done by the corporation. The consolidation and reporting generally takes its cue from the pattern of ownership.