Written Comments On

EXPOSURE DRAFT

Proposed Statement of Financial Accounting Standards
Measurements Fair Value

File Reference No. 1201-100

By

Humphrey Nash

September 7, 2004

The author of these comments is the author of Accounting For The Future (AFTF) and related essays and papers. The author believes that the AFTF accounting model is simpler and more relevant than existing accounting implementations. Many of the comments made are from the AFTF perspective. Little attempt is to explain the operation of the AFTF accounting model and some comments may seem unsupported. Interested parties may wish to read the AFTF draft proposal or the many relevant essays on my website at: http://home.sprintmail.com/~humphreynash/

These comments include Comments on Statement of Financial Accounting Concepts No.7: Using Cash Flow Information and Present Value in Accounting Measurements which addresses similar issues or lays a foundation for this exposure draft.
Definition of Fair Value

*Issue 1:* This proposed Statement would define fair value as “the price at which an asset or liability could be exchanged in a current transaction between knowledgeable, unrelated willing parties” (paragraph 4). The objective of the measurement is to estimate the price for an asset or liability in the absence of an actual exchange transaction for that asset or liability. Will entities be able to consistently apply the fair value measurement objective using the guidance provided by this proposed Statement together with other applicable valuation standards and generally accepted valuation practices? If not, what additional guidance is needed? (Specific aspects of the guidance provided by this proposed Statement are considered below.)

The definition of fair value is a decision point for FASB and accounting practice in the United States. The importance of fair value goes far beyond assigning values to assets and liabilities. This definition will determine the direction of accounting theory and practice for decades to come. It is vital for accounting and the for U.S. economy that the right direction be chosen. It is my position that the above definition is the wrong path and will do major damage to FASB, accounting and the U.S. economy. It will do so because it perpetuates the cost-based accounting of the past and impedes or precludes consideration of value-based accounting. A major problem for accounting today is that it lacks relevance (decision utility) for its primary users. They are interested in values not costs.

There can be no pretense that fair value in the above definition represents value when the definition start off with “fair value” as “the price at ...”. Price is a cost concept not a value concept. This is a disastrous start for fair value. Of course, accounting often doesn’t mean what it says or say what it means. Why should “fair value” break with this unfortunate tradition? For one, we have an opportunity to correct that failing. We can define fair value to be a value. Second, we can attach a relevant and useful meaning to fair value. The candidate for the value attribute is shareholder value. This is useful for financial reporting to shareholders.

It will be difficult to establish that parties to the transaction are unrelated or knowledgeable in controversial situations. Enron’s use of SPEs illustrates the difficulty in defining or enforcing “related parties”. In controversial situations, at least one party is insufficiently informed or knowledgeable. This definition is a convenient but hollow tautology in the sense that if the price is misjudged or misused then there was a lack of knowledge.

Limiting fair value measurements to transactions essentially precludes intangible or internal developed values. These are increasing important values. For example, such intangibles account for about $250,000,000,000 of the economic value missing from the Microsoft GAAP balance sheet.
Accounting must serve more than itself or it will wither. In fact, this has happened. The reality of accounting practice is far ahead of accounting theory. Forward-looking value-based accounting has to a large degree superceded GAAP accounting. But it still would be useful to unify accounting models and to bring the theory, practice and disciplines of formal accounting to forward-looking accounting.

"The price at which an asset or liability could be exchanged in a current transaction between knowledgeable, unrelated willing parties" in better labeled “fair price” or “fair market value”. This price is the cost of the asset to the buyer (or the charge to the buyer of a liability). It is a serious mistake to call or define this to be the seller’s “fair value”. Of course, in the event of a liquid short-term investment with an established market, the price and value happen to coincide. But it is a wild and a dangerous leap to generally equate buyer value to seller price or cost.

Assets are generally acquired for a purpose other than short-term trade, unless the company is a trading company. Acquired assets are almost always worth more to the buyer than the purchase price. The purchaser has a comparative advantage ... a utility and value-in-use greater than the price. Similarly, the (negative) value of a retained liability is almost always less than the cost of selling that liability, in part because of the comparative advantage the entity enjoys in discharging that liability and in part because of markup and risk charges the buyer imposes, especially under liquidation conditions. The entity-specific value or value-in-use is the value to the shareholder. This is the value required for relevant financial reporting. "Fair value" as defined by FASB is liquidation value but not the value to an ongoing enterprise. It might be conservative to assign a liquidation value but conservative values will not produce optimal decisions. In fact, they will generally produce the wrong decision.

One could claim that a liquidation value involves a sacrifice of comparative advantage and hence an unwilling party, so that the definition may default to entity-specific value-in-use, but I don’t think this is the intent or will be the interpretation of “fair value”. In any event, this interpretation would eviscerate the definition except in moot cases (actively traded short-term financial instruments).

The proposed definition of “fair value” essential continues the cost basis of GAAP accounting. This basis lacks relevance. GAAP and “fair value” do not represent economic value and are unsuitable for decisions. This leaves the question as to what “fair value” is suitable for. It does provide a conservative floor on value but companies and economies can’t progress when glued to the floor.

FASB has changed its definition of “fair value”. It is instructive to examine the changes. FASB’s definition of “fair value” in CON7 was,

The amount at which that 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.
FASB's new definition is,

"The price at which an asset or liability could be exchanged in a current transaction between knowledgeable, unrelated willing parties."

The old definition defined “fair value” as an amount, which, at least, allowed the possibility of a value, for example an economic or shareholder value interpretation. The new definition declares that “fair value” is a price, similar, if not identical to “fair market value”.

The old definition excluded forced liquidation values. Value-in-use was at least a possibility. The new definition, as discussed, “presumes the absence of compulsion (duress)” but it is still the liquidation market, even though voluntary, that forms the basis of value. It seems “fair value” is now explicitly being interpreted as the liquidation value.

“A going-concern or in-use valuation premise presumes that marketplace participants would continue to use (a) a business that is a going concern or (b) an asset that is configured for use by an entity. In those situations, a going-concern or in-use valuation premise is generally appropriate.”

The above quote, as nearly as I can interpret the context, permits the liquidation price to be based on the buyer’s use (market inputs) of the liquidated asset but does not permit the seller to make a similar judgment. The financial reporting perspective is misplaced.

FASB must back up a step or two. What is the purpose of accounting? Who are the end-users of accounting information. What kind of information do the end-users need and want? Does “fair value”, as defined, lead to accounting relevant to end-users? Is “fair value” internally consistent? What is the “fair value” of a publicly traded company? Do the “fair value” pieces add up to a “fair value” whole? Is fair value complete?

The purpose of financial accounting is to support decisions by management, creditors, analysts, advisors, mutual funds and individual shareholders. The individual investor is the core; others are representatives for the individual shareholder. Individual investors want a decision criterion, a single measure that indicates how the current price of the stock is related to the economic value of the stock. A company valuation based on the Present Value of Expected Cash Flows (PVECF) provides that value and a simple decision criterion when compared to price. “Fair value”, as defined, does not lead to accounting relevant to end-users.

Ultimately any accounting model must reconcile to cash flows; it makes sense to tie the model as closely as possible to cash flows. AFTF is based directly on cash flows. In contrast, the GAAP income statement is based on revenues (selected current cash flows) and the balance sheet is based selected future cash flows. GAAP accounting has repeatedly failed in its selections, exclusions and allocations.
Fair value of an asset is defined by the IASB as being the larger of value-in-use and liquidation value ("fair value"). This normally recognizes the intended use of the asset which would be the larger of the two values, given a rational management seeking to maximize shareholder value. There may, however, be a disconnect between the maximal strategy and management expectations, decisions and actions. If so, the IASB definition is liberal.

The FASB formulations is conservative and the IASB formulation is liberal. Both formulations are wrong and misguided.

Obviously conservatism and liberality confess to inaccuracy. Both destroy information and cannot support optimal capital allocation decisions. The only fair value formulation that is expected to be optimal is fair value based on the expected use.

Both FASB and IASB formulations are misguided. The goal of financial reporting to shareholders is to support their capital allocation decisions. Shareholders want to know the economic value of their company's shares (PVACF). This is based, in large part, on intangibles; these cannot be valued using traditional accounting methods. Intangibles are not fictions; they are real factors, structures or causes which have real cash flow manifestations, albeit in the future.

Even traditional accounting tangibles are impossible to assemble in a complete, non-duplicative and properly scaled manner. Another problem with conservative or liberal rules is inconsistency. One asset or liability may be assigned a liquidation value and another a value-in-use. The answer is to bypass both individual tangibles and individual intangibles and consider company level PVECF directly. AFTF provides technology to do this is an easy, relevant and reliable manner. AFTF measures are scaled to the company and disciplined by the capital markets.

Valuation Techniques

Issue 2: This proposed Statement would clarify and incorporate the guidance in FASB Concepts Statement No. 7, Using Cash Flow Information and Present Value in Accounting Measurements, for using present value techniques to estimate fair value (Appendix A). Is that guidance sufficient? If not, what additional guidance is needed?

Concepts Statement No. 7 is a most welcome introduction to the concepts of present values. Many of the ideas developed or explicated are needed to provide a theoretical foundation to present value theory. Present values provide a true foundation for a more

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1 AFTF generally deals with company level cash flow. However, new cash flows must be valued individually and incorporated into a revised cash flow model. For example, when a patent is purchased the cost/benefit (a prerequisite analysis) must be reflected as new information in PVECF.
relevant forward-looking accounting model. However, additional theory is needed to make present values practical. Two examples are cited.

Example 1. Concept Statement 7 defines present values from the probability weighted sum of all outcomes. Of course, some outcomes are so unlikely as to be properly ignored. For example, nuclear war is always possible and would significantly disturb cash flows. There are myriad such outcomes the total expected effect of which is insignificant. Ignoring these still leaves scores of important factors and hundreds of probable scenarios. While it is possible to stochastically model major factors and their inter-relationships and probably cover the likely scenarios, this is by no means guaranteed and is a very complex endeavor. I believe that this approach is a dead end. I also believe that it does not improve the quality (simplicity, comprehensibility, accuracy, completeness) of the resulting valuation.

Instead the much easier expected value approach should be used. To illustrate: With this approach with 100 flips of a coin would be expected to give rise to 50 heads, even though this exact outcome is unlikely. With the probability weighted outcome approach we would assign a probability to: exactly 0 heads, exactly 1 head, exactly 2 heads, exactly 3 heads, ..., exactly 99 head and finally exact 100 heads. We would then multiply the probabilities times the numbers of heads and add all such products. The sum will be the expected number of heads and again equals 50. The advantage of this more complex approach is that it permits the individual outcomes to be analyzed; this is handy if the number of heads is not the whole story as when the payoff varies with the number of heads in a non-linear fashion. In a business setting many patterns are discontinuous or non-linear such as bankruptcy or exponential growth. As a practical matter, it is often sufficient to assume linear patterns or to deal with secondary outcomes like payoffs rather than basic outcomes such as the number of heads. The expected value approach is widely and successfully used. Probability weighted outcomes or stochastic scenarios are less frequently used with present values for financial reporting. Financial reporting is designed to support decisions which are difficult enough when expected values are provided. Scenarios do not provide a clear cut decision. Scenarios or multiple outcomes do provide more information about risk (variance). In practice, the risk cost is a minor consideration (see the essay Accounting Control for further discussion).

The second problem with Concept Statement 7 is that it is practically impossible to develop an appropriate discount rate. Partially to cope with this difficulty the discount rate is defined to be a risk free rate. This means that the risk cost (which is determined by capital market prices) must be somehow associated in each scenario with the cash flow components. For example, a sales estimate must be assigned a probability and a risk cost associated with that level of sales. For each scenario or level of sales a risk cost must be subtracted (or perhaps added) which represents the penalty the market applies for the variability of results. This is impossible. There are no procedures for doing this. Even the risk free discount rate presents major problems.
I'll repeat that Concept Statement 7 is educational and may be preferred from a theoretical perspective. But the all outcomes/risk cost approach is impractical. The approach illustrated will be a disaster for FASB and all who attempt to follow it.

There is a way out for accounting. AFTF provides very simple, natural, proven, failsafe procedures for measuring values. It is regrettable that the AFTF model is not more widely understood. This represents accounting failure at many levels: academics and researchers, FASB, the SEC, the AICPA, and others. I realize that new ideas take time to assimilate, accept, refine and promote, but I have little evidence of even the first step. Little comment on the ideas, no questions, no feedback, no criticism, no praise. Giving my efforts to communicate this is disappointing.

"The marketplace is the final arbiter of asset and liability values". For publicly traded companies the capital markets determine the "current economic value" of a company. The underlying economic value of a company must be closely related to the price the company receives for its stock because the final arbiter is the marketplace. Financial reporting must, at least, use the same general scale of measurement as the capital markets. FASB, as a standard setter, must endorse a relevant measurement standard.

Active Markets

Issue 3: This proposed Statement would clarify that valuation techniques used to estimate fair value should emphasize market inputs, including those derived from active markets. In this proposed Statement, active markets are those in which quoted prices are readily and regularly available; readily available means that pricing information is currently accessible and regularly available means that transactions occur with sufficient frequency to provide pricing information on an ongoing basis. Is that guidance sufficient? If not, what additional guidance is needed?

Certainly values and prices correspond for liquid invested assets (stocks, bonds, etc) held for the short-term. But expected value-in-use would then also match market or liquidation price. A problem develops when liquidation is not the expected use. One answer, that espoused by AFTF, is to employ capital market pricing at the company level in financial reporting. The capital market is the paragon of active markets and prices are readily available for publicly traded companies. Capital market pricing is an ideal attribute for financial reporting.

The AFTF answer is "Yes, market prices provide sufficient guidance. But the marketplace should be the capital markets." See the essay Disciplining Prospective Accounting for an explanation of how capital market prices are used to produce relevant value-based economic information. Valuations based on observed or imputed liquidation prices ("fair values") are not relevant valuations.

Valuation Premise

Issue 4: This proposed Statement would provide general guidance for selecting the
valuation premise that should be used for estimates of fair value. Appendix B illustrates the application of that guidance (Example 3). Is that guidance sufficient? If not, what additional guidance is needed?

The guidance provided in Appendix B is insufficient, not in terms of detail but in terms of simplicity. Accounting needs simple goals and uniform procedures. Detailed rules or examples cannot substitute for the underlying principle. It is clear from the varied examples that there is no underlying principle. The use of multiple valuation techniques is an admission of failure and will not satisfy the intent of the "fair value" effort. FASB needs to examine the purpose of accounting before promulgating rules. AFTF has a single feasible technique with a single goal. Complexities and judgments still exist but they are not part of the AFTF accounting model.

**Fair Value Hierarchy**

*Issue 5:* This proposed Statement would establish a hierarchy for selecting the inputs that should be used in valuation techniques used to estimate fair value. Those inputs differ depending on whether assets and liabilities are identical, similar, or otherwise comparable. Appendix B provides general guidance for making those assessments (Example 4). Is that guidance sufficient? If not, what additional guidance is needed?

A decision hierarchy adds a layer of procedural formality which compounds the difficulties and doesn't address the basic question as to what fair value should be. The definition of fair value offers an opportunity to simplify and unify accounting. Instead rules and procedures have been substituted for the principle. Shareholder value is a necessary and sufficient guide for valuation; "fair value", as defined, is neither necessary nor sufficient. The "fair value" hierarchy in consequently insufficient.

AFTF provides simple uniform guidance and no hierarchy.

**Level 1 Reference Market**

*Issue 6:* In this proposed Statement, the Level 1 reference market is the active market to which an entity has immediate access or, if the entity has immediate access to multiple active markets, the most advantageous market. Appendix B provides general guidance for selecting the appropriate reference market (Example 5). Is that guidance sufficient? If not, what additional guidance is needed?

Appendix B provides guidance to "fair price" which is generally different from the value to the buyer of an asset or to the seller of a liability. Only in the case of short-term invested assets will value equal price. It is a mistake to extrapolate price to value. The most advantageous market may be the internal market (value-in-use). Is this dismissed?

AFTF defines fair value on the company scale as defined by the capital markets. Has this been considered as alternative guidance?
Pricing in Active Dealer Markets

Issue 7: This proposed Statement would require that the fair value of financial instruments traded in active dealer markets where bid and asked prices are more readily and regularly available than closing prices be estimated using bid prices for long positions (assets) and asked prices for short positions (liabilities), except as otherwise specified for offsetting positions. Do you agree? If not, what alternative approaches should the Board consider?

This is a relatively minor issue which pales in comparison to major issues apparently already decided or assumed.

Measurement of Blocks

Issue 8: For unrestricted securities with quoted prices in active markets, many FASB pronouncements (including FASB Statement No. 107, Disclosures about Fair Value of Financial Instruments) require that fair value be estimated as the product of a quoted price for an individual trading unit times the quantity held. In all cases, the unit of account is the individual trading unit. For large positions of such securities (blocks) held by broker-dealers and certain investment companies, the AICPA Audit and Accounting Guides for those industries (the Guides) permit fair value to be estimated using blockage factors (adjustments to quoted prices) in limited circumstances. In those cases, the unit of account is a block.

The Board initially decided to address that inconsistency in this proposed Statement as it relates to broker-dealers and investment companies. The Board agreed that the threshold issue is one of determining the appropriate unit of account. However, the Board disagreed on whether the appropriate unit of account is the individual trading unit (requiring the use of quoted prices) or a block (permitting the use of blockage factors). The majority of the Board believes that the appropriate unit of account is a block.

However, the Board was unable to define that unit or otherwise establish a threshold criterion for determining when a block exists as a basis for using a blockage factor. The Board subsequently decided that for measurement of blocks held by broker-dealers and certain investment companies, current practice as permitted under the Guides should remain unchanged until such time as the Board fully considers those issues.

For those measurements, do you agree with the Board's decision? If applicable, what approaches should the Board consider for defining a block? What, if any, additional guidance is needed for measuring a block?

The guidance is postponed on this issue. The AFTF unit of account is the company and valuations are based on expected company cash flows. Nothing else is needed.

Level 3 Estimates
**Issue 9:** This proposed Statement would require that in the absence of quoted prices for identical or similar assets or liabilities in active markets, fair value be estimated using multiple valuation techniques consistent with the market approach, income approach, and cost approach whenever the information necessary to apply those techniques is available without undue cost and effort (Level 3 estimates). Appendix B provides general guidance for applying multiple valuation techniques (Examples 6-8). Is that guidance sufficient? If not, what additional guidance is needed?

Practical considerations determine the approach used. These are important exceptions to the general liquidation value approach. They seem to apply only to the asset buyer’s price within the liquidation market.

AFTF suggests simple uniform procedure which essentially eliminate uncertain valuation choices. Under AFTF, management reporting and decisions are based on the same technologies and measures as financial reporting to shareholders and their decisions. This insures that management represents shareholder interests and that shareholders communicate their needs (via the cost of capital). GAAP and “fair value” information is unsuitable for either management or shareholder decisions.

**Restricted Securities**

**Issue 10:** This proposed Statement would require that the fair value of restricted securities be estimated using the quoted price of an otherwise identical unrestricted security, adjusted for the effect of the restriction. Appendix B provides general guidance for developing those estimates, which incorporates the relevant guidance in SEC ASR No. 113, Statement Regarding “Restricted Securities.” Is that guidance sufficient? If not, what additional guidance is needed?

This seems to correspond to expected cash flows and is sufficient. No additional guidance needed.

**Fair Value Disclosures**

**Issue 11:** This proposed Statement would require expanded disclosures about the use of fair value to remeasure assets and liabilities recognized in the statement of financial position. Appendix B illustrates those disclosures. This proposed Statement also would encourage disclosures about other similar remeasurements that, like fair value, represent current amounts. The Board concluded that those disclosures would improve the quality of information provided to users of financial statements. Do you agree? If not, why not?

Disclosures of this type are a necessity to encourage timely and candid information and to prevent or discourage managed earnings. Agree.
Effective Date

Issue 12: This proposed Statement would be effective for financial statements issued for fiscal years beginning after June 15, 2005, and interim periods within those fiscal years. The Board believes that the effective date provides sufficient time for entities to make the changes necessary to implement this proposed Statement. Do you agree? If not, please explain the types of changes that would be required and indicate the additional time that would be needed to make those changes.

It may prove difficult to implement “fair value” within the current GAAP model. For example, it may be difficult to transition from current capitalized, amortized or depreciated values to “fair values”. Generally accepted valuation practice may conflict with “fair value”, for example for insurance or pension liabilities. The extent of “fair values” may differ from the current scope of assets and liabilities. Liabilities may be especially troublesome.

“Fair values” are doubly conservative. This may create resistance.

More time may be needed to explore the ramifications and alternatives. The time frame is not the principal problem, however.

Other Issues

Issue 13: This proposed Statement represents the completion of the initial phase of this project. In subsequent phases, the Board expects to address other issues, including issues relating to the relevance and reliability of fair value measurements and the unit of account that should be used for those measurements. What, if any, other issues should the Board address? How should the Board prioritize those issues?

Investigations into relevance and reliability should precede not follow implementation. The Board should address the concerns of dissenters within FASB, develop a more complete and consistent valuation model within a value-based accounting model, and look more carefully at the AFTF implementation.

Public Roundtable Meeting

Issue 14: The Board plans to hold a public roundtable meeting with respondents to the Exposure Draft on September 21, 2004, at the FASB offices in Norwalk. Please indicate whether you are interested in participating in the meeting. If so, comments should be submitted before that meeting.
General Comments

Some of the goals of the "fair value" effort were to improve the consistency, reliability, comparability and to simplify the accounting model. As defined "fair value" is based on actual or imputed liquidation prices. When prices exist these goals are met. Liquidation is generally not the expected outcome so "fair value" generally lacks relevance. Consistency, reliability and comparability are desirable but are empty if relevance is absent.

"Certainly financial analysts desire information that is both relevant and reliable, but their bias is towards relevance. In a phrase, analysts prefer information that is equivocally right rather than precisely wrong. Inexact measures of contemporaneous economic value generally are more useful than fastidious historic records of past exchanges"  

The 1993 AIMR Report: Financial Reporting in the 1990's and Beyond

It is not impossible to have relevance and reliability within the same accounting model. AFTF suggests how this might be accomplished. AFTF is simple, consistent, and unparalleled for comparability. In addition, AFTF is an outgrowth of traditional accounting principles and current accounting practice. In particular, AFTF supports PVECF and a useful definition of fair value. This definition is almost the same but with the scale of measurement being the company level and the marketplace being the capital markets (stock market). More important this definition is encapsulated within a relevant accounting model.

It is my hope that FASB's call for comments is not just a formality and that change is still possible. PVECF holds great promise as a fundamental accounting technology and it would be a shame to see it misguided. It would be a shame to see accounting go down the wrong path, which it will do with the proposed "fair value" approach.
The following paper was provided to FASB some 4 years ago and was designed to steer FASB away from the direction and perspectives adopted in the exposure draft. It failed.

Fair Value
by Humphrey Nash

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</td>
<td>The entity’s labor costs, regardless of whether others would incur similar costs</td>
</tr>
<tr>
<td>those that others would incur</td>
<td></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
They further hold that, "Using fair value to measure non-financial assets and liabilities has troublesome recognition implications." (for example, recognizing non-existent liabilities)

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

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

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

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

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

An Alternative View

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

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

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

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

**Suggestion**

Interpret fair value to be,

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

The fair value of the company is the market capitalization. The total price of the company stock is the total value to the company because the company is the seller.

**Indictment of Fair Value**

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

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

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

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

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

5. Fair market value is unsuitable for decisions. Decisions (for a publicly traded company) are made with the goal of adding value. Measuring cost or liquidation values is not oriented towards this goal.
6. The fair value concept is more strained for liabilities than for assets. "Buying liabilities" even sounds perverse. For an ongoing enterprise it is doubtful that liabilities can be fully discharged to a third party.

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

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

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

10. Fair value does not provide procedures, discipline, or uniformity. Fair value provides no guidance in determining expected cash flows or discount rates. Unless a fair market value is observable there will be no discipline on "value" assignments. Interest rates, risk and uncertainty premiums, projected cash flows may vary with each asset or liability.
\[1\text{ See } \textit{Statement of Financial Concepts No. 7}\]
Comments on

Statement of Financial Accounting Concepts No. 7
Using Cash Flow Information and Present Value
in Accounting Measurements

Submitted by
Humphrey Nash
September 7, 2004

Part of Comments on

Proposed Statement of Financial Accounting Standards

Fair Value Measurements
File Reference No. 1201-100
Introduction

These comments on Statement of Financial Accounting Concepts No. 7: Using Cash Flow Information and Present Value in Accounting Measurements, hereinafter referred to as CON7, are part of comments solicited in connection with Proposed Statement of Financial Accounting Standards: Fair Value Measurements. It is not possible to comment on fair value without reference to CON7 which introduces the concept of "fair value" and discusses methods for determining "fair value".

CON7 is a most welcome addition to accounting literature and formalizes earlier studies of Present Values of Expected Cash Flows (PVECF), published by FASB. In general, CON7 presents a balanced and informative basis for understanding PVECF. It provides guidance for the purpose and use of PVECF in an accounting setting. The comments below are not meant to detract from FASB's overall achievement. They are meant to help FASB steer PVECF in the most useful direction, as I see it.

Some of the comments below are directed at the language, phrasing or emphasis of the CON7 document. These comments are supplied to illuminate possible current or future problems that may arise and to provide an opportunity to explore related issues. Most of the comments are aimed at fundamental difficulties, flaws or inconsistencies in CON7. To understand fundamental problems, it may be necessary examine fundamental meanings and purposes, but this cannot be bypassed.

The author of these comments is the author of Accounting For The Future (AFTF) and related essays and papers. The author believes that the AFTF accounting model is simpler and more relevant than existing accounting implementations.
Accounting must serve a useful external purpose. It cannot thrive or even survive by serving only itself. Accounting serves its own purposes best by serving others. This applies to accounting theory, professional practice, and to standard setting. FASB, as a standard setter, is charged with the responsibility of developing principles and standards to guide the theory and practice of financial reporting for publicly traded corporations. Such financial reporting is one aspect of accounting ... a very important one.

Financial reporting for public corporations is reporting to the shareholders and it is the shareholders' needs which are paramount. Shareholders supply capital in exchange for future returns, either through dividends or through later sale of stock, which are, in turn, present value assessments of future dividends or sale proceeds. The value of a stock resides in the expected cash flows to the shareholder. These cash flows are ultimately related to cash flows from company operations.

An informed decision to invest or divest must be based on the amount and timing of cash flows to the company and on the shareholder's discount of possible future returns compared to his certain current sacrifice. This assessment (of amount, timing and discount) is embodied in the price that he and other investors are willing to pay. In active, liquid capital markets this current purchase price is current value of the stock since the investor can immediately sell his shares. In this sense the current price of a stock is the "current economic value" of that stock. However, at any particular instant, for a particular company, in a particular economic and political environment, this "current economic value" or price may differ from the long-term or underlying economic value.

This economic value is the Present Value of Actual Cash Flows (PVACF). Actual cash flows cannot be known in advance and can only be approximated using expected cash flows. Prospectively, PVECF provides the only method that can be expected to approximate economic value. Other methods not based on expectations cannot be expected to approximate economic value. In practice, economic value must be based on expectations. If a company is viable those expectations must be based on that viability, i.e., cash flows must assume that the entity continues to use its assets and satisfy its liabilities. If and only if a company becomes bankrupt does the expected use of assets involve liquidation to satisfy its creditors.

There may be a misty area between viability and bankruptcy. If assets and liabilities are valued at their overly conservative “fair value” rather than their value-in-use then an unnecessary bankruptcy may be created. This results from asset liquidation values generally being lower than value-in-use and liability liquidation values generally being higher than value-in-use. Curiously, bankruptcy can also result from overly liberal assumptions. For example, if liabilities are discounted for the entity's (poor) credit rating then the company may look healthy even when approaching bankruptcy. We may even create the situation where, the worse the company's position, the better it appears from financial reports. These kinds of backwards accounting are perversions of the purpose of accounting. How can accounting even contemplate such perspectives?
This may be, in part, an occupational hazard. Accounting is based on bookkeeping which depends on the powerful idea of double-entry bookkeeping and balance of the asset and liability accounts. Each transaction within a company has a dual aspect: a source and a use or destination for all cash flows. This works because the entries are simultaneous cash flows within the same company. In a sense the company is the buyer and seller of a short-term liquid asset: cash. However such a dual aspect can't be applied without regard to time and space. If the frame of reference changes then measures and values change. Three examples are cited:

1. If a corporation has a portfolio of risky investments, for example loans or corporate bonds, then it is prudent to discount those loans to reflect likely defaults. Some individual loans will eventually default, but we don't know which ones, so we assume each has a probability of default and the portfolio will payoff proportionately. However, from the perspective of individual borrower, the loan is usually repaid in full or not repaid at all (although partial repayment is possible). The laws of probability don't operate for the individual borrower. Company liabilities are not impaired from the Company's perspective but must be fully discharged. If the borrower is a public corporation, the stockholder generally has last call on corporate assets. As far as the shareholder is concerned there is no benefit from partial repayment. That only occurs after bankruptcy. For financial reporting to shareholders, discounting liabilities disguises deteriorating situations and may even invite bankruptcy. There is little reason for borrower and lender values to match. There are good reasons why they should not match. The prices are the same but economic values are not; trying to equate values is a fundamental error. There are good reasons for the lack of consensus at FASB regarding discounted liabilities.

2. The income statement is essentially retrospective whereas the balance sheet is essentially prospective. Accounting attempts to equate them and does so with artificial balancing items. This damages both the income statement and the balance sheet and leads to substantial deviations from economic results and values. Applying the dual aspect to income and balance sheet is a fundamental error.

3. "Fair value" of an acquired asset is defined in terms of price, which is the value to the seller. The value to the buyer may be quite different. That value depends on the entity's future use of the asset. Equating values and price is a fundamental error. "Fair Value" as defined by FASB is conservative. This matches or offsets the liberality of discounted liabilities only by coincidence.

In each of the above cases FASB wants to equate value measures within different frames of reference. FASB should do the opposite: insist that values are measured relative to the time and place (company), as FASB once did for measures subject to general price changes (inflation). Another general problem that FASB has created for itself is lack of a fundamental cohesive approach to standard setting. To some degree this is an outgrowth of limited resources; it would take a great commitment of time and personnel to make basic accounting model changes. It is also the result of a natural desire for continuity with gradual and manageable change and then only when necessary. Unfortunately, the pace of structural economic and business change has far outstripped accounting
structure change. For example, the Board's decision to consider only measurement issues and not to consider recognition issues\(^6\) may not lead to optimal measurement issues decisions and may prejudice later consideration of recognition issues, which will have to conform to prior decisions (or be inconsistent). In the same vein, the Board's decision to not specify when fresh start measurements are appropriate and to decide on a project-by-project basis, raises fundamental questions.\(^7\) More likely, fundamental questions forced the Board's decision. This represents a failure to produce workable general theory and may represent confusion or lack of agreement within FASB. This is not standard setting. In any event, a broader and more fundamental analysis is suggested.

FASB's stated objective for present value measurement is to capture the economic difference between sets of estimated future cash flows. This objective is weaker than the objective to capture economic value through present value measures. There is a reason for and a result from this weakness, namely, a deficient accounting model. This weakness leaves open such fundamental questions as: What is the PVECF or “fair value” of a company?\(^8\)

**PVECF Theory**

I have some minor quibbles with the emphasis of PVECF concepts in Con7.

First, Con7 refers to uncertainty in the amount and timing of cash flows and suggests that this creates risk and risk charges. This is true, but the uncertain timing can be and should be subsumed within uncertain amounts. For example, if a certain cash flow or an expected cash flow is possible at different points in time, we can apply the timing probabilities to the cash flows to arrive at new expected cash flows, i.e., uncertain timing can be incorporated into uncertain expected amounts. This gives equivalent answers but is conceptually easier.

Second, Con7 introduces the expected cash flow approach, which differs from the traditional approach by focusing on explicit assumptions about the range of possible estimated cash flows and their respective probabilities. This is good theory but bad practice. We need to give the theory of practicality some weight. The traditional approach treats those uncertainties implicitly in the selection of an interest rate. This is a simplicity that is commonly used and understood. I doubt that the more sophisticated theory will have many adherents. The “range of values” approach is difficult and is not needed to produce a useful result. If we simplify case 23(e) by limiting outcomes to exactly $8,000, $10,000 and $12,000 each with a probability of 1/3. The expected value is the same as case (d). How can we make use of the added information about the variation in outcomes? We must somehow assess the risk cost of the uncertainty. It's not likely to be large since the expected value is the same and the chance of a $12,000 return equals that for the $8,000 return. Also the range is reasonably narrow. Perhaps $200 would be a reasonable risk premium. But it is impossible to say that this amount is correct or incorrect. It depends on the risk preference of the investor and his diversification. The risk premium might be $200 for an individual with this single investment but it might be substantially less for the diversified investor or the corporation; it can even be negative. Accounting should recognize that risk cannot be objectively quantified. Accounting should also understand that risk need not be
quantified because: a. most investors are reasonably diversified, b. risk premiums are generally relatively unimportant c. investors understand and willingly accept risk and would not be surprised if actual results differ from expectations. d. capital markets do a good job of pricing for uncertain outcomes and don't need to be told what to do.

In any event, AFTF easily solves many of the difficulties in a reliable manner producing a relevant result. Sophisticated theory is not required and generally will not produce better results. A typical application might be a forward (say 5 years out) estimate of sales. While it is true that projecting many sales levels and assigning a probability of each sales level will often produce a similar expected value to a point estimate there may be little gain in expected accuracy. In fact, complexity is dangerous and may give a false sense of security or obscure the obvious. As mentioned in the first point above, it is not necessary to use a range of values to accommodate the use of present values when the timing of cash flows is uncertain. Uncertain timing is not a good reason for using all possible or even a range of possible values. Another reason for using a range of values is to capture the variance of outcome for which there is often a risk charge. While it is true that such variance may give rise to risk charges, it is nearly impossible to determine explicit risk charges that might be added or subtracted from cash values. In any event, those risk charges are those judged and assessed by the capital markets. The theoretical risk charges to individual cash flow must ultimately reconcile to capital market risk charges. AFTF uses the historic cost of capital (derived from prices) to directly and easily use capital market assessments. The historic cost of capital also automatically handles the time value of money, inflation, quality of management, and the scaling of values.

Con7 suggest that the time value of money, represented by a risk free rate of interest, should be used. Although Con7 later retreats from this position, it should be pointed out that a risk-free rate of interest may be difficult to understand or determine. For example, does it include provision for expected inflation? Is time preference generally positive? What if risk preference is negative, as it is for lotteries and may be for the stock market? A total expected yield rate may be more easily understood than a decomposed rate of return (part risk free yield, part built in absolute risk charges, part positive present value, part other factors). A risk free rate may not be stable and may create wild income statement swings. Other factors, such as illiquidity or market imperfections, if they are to be reflected at all, are difficult to quantify except within AFTF where they are naturally and automatically incorporated within the historic cost of capital. The historic cost of capital is aligned with economic value and with company scaled fair value reporting.

As suggested above, direct point estimates (of expected cash flows) are often more practical than a range of values each assigned a probability, multiplied and then added. Such point estimates -must be made for various cash flow components (with interrelationships) at various points in time then discounted and summed. This is difficult enough. Admittedly this does not provide information beyond the expectation whereas a range of values could. But information about risk (standard deviations) is very difficult to assess. Proposals to add or subtract a risk premium (the market cost of undertaking a risky investment compared with a risk free investment with the same expected value) are much too complex to be used. Such sophistication is quicksand. Perhaps more to the point is that it is not necessary to assess risk since the capital markets do an excellent and unequivocal job of assessing and measuring risk. AFTF makes use of capital markets prices to measure, value, and report risk within a simple,
natural, relevant, and reliable accounting model. AFTF also suggests simple methods for explicit reporting of risk in addition to the implicit costs of risk "subtracted" within financial reports.

Interest rate yields have traditionally incorporated provision for risk. Investors are experienced with the risk/reward tradeoffs inherent in higher yields. It might be more difficult to make judgments about risk and its cost if discounting were done at a risk free rate. This would require a more detailed analysis and assessment of individual cash flow components and their respective risk cost subtractions. There is no such market assessment capacity and, as mentioned above, no capacity to measure or produce risk costs. The risk free rate itself is problematic. A current rate could produce massive valuation swings under inflationary conditions. These swings would increase markets instability and would not take into account the varying effects of inflation on individual companies. For example, some companies may benefit from inflation but their valuations would reflect a decrease. If a real risk free discount rate were used then, to be consistent, real cash flows should be projected. This would involve an equivalent but much more difficult discounting mechanism. Perhaps more to the point is that it not necessary to determine the appropriate discount rate for the financial environment or the specific company's characteristics or position. AFTF has an unequivocal mechanism for determining the historic cost of capital based on capital market prices. This discount rate produces a meaningful and relevant end result, namely economic value. See the essays *Disciplining Prospective Accounting* and *The Historic Cost of Capital* for more details.

Third, it is stated that observable marketplace amounts (prices) are more reliable than measurements that employ estimates of future cash flows. This seems clear and unassailable, but may not be so. If we are trying to measure economic value then PVECF is the universal proven technology; historical cost or liquidation price (fair value) is not. If we are trying to measure economic value in a reliable and auditable manner, then AFTF provides the disciplined technology needed. In the case of intangibles, prices don't exist but PVECF always does. Prices are perfectly reliable measures of value to the asset seller or liability buyer but not necessarily to the asset buyer or the liability seller.

Accounting income statements are representative to the extent that they represent the past accounting period; the historical cost perspective serves this purpose well. Value statements, on the other hand, are designed to represent a complete future, not a single past period. Estimates of future cash flows are needed. Such "estimates" may be more representative and reliable than actual past results.10

Fourth, PVECF is "not an end in itself" but must have some observable and purposeful attribute. The indicated purpose of PVECF is to reflect the "economic differences" using "fair value" as the attribute. Unfortunately "economic value" and "fair value" are not the same, any more than "economic value" and price are the same. It is stated that both "fair value" and "value-in-use" or "entity-specific measurements" attempt to capture the five identified economic elements of PVECF but that "value-in-use" would substitute the entity's assumptions for those of the marketplace. AFTF does not do this and value-in-use may not necessarily do this; AFTF uses capital marketplace prices and assumptions to scale PVECF. The capital marketplace is the most powerful and ubiquitous pricing system available. Unlike "fair values", these prices are always
observable. Unlike "fair value", these prices reflect economic value to the company and its shareholders. ¹³ Value-in-use is the proper perspective for management of an ongoing entity and for the shareholders. If expected values are to be used, the expected use should be used. To use liquidation "fair value" may be a self-fulfilling prophecy since it doesn't support optimal economic decisions.

Fifth, FASB struggled to justify using expected value based on the probability of an event, especially where the probable outcome was not even a possible outcome, e.g., .5 expected heads from a coin flip. The best supporting argument is that, in the normal scale of corporate endeavor, many trials (coin flips, investments, drilled oil holes) are the norm, more like 100 coin flips rather than a single trial. The chance of an appreciable deviation from 50 heads from 100 flips is remote. For example, the chance of less than 45 heads is only 13.6%. Most corporations are large and diverse enough for the law of large numbers to operate effectively. But even if they are not their investors may be sufficiently diversified, i.e., shareholders may invest in many companies so that any residual outcome variance is diversified away.

Item 65 makes the point that investors are risk adverse and that, given a choice of two investments with identical expected gains, the investor will select the one with less outcome variance. This is not true for gamblers or market speculators and may not be true for the stock market as a whole. Consider a $1.00 lottery ticket with an expected payoff of $0.50. Not many people would buy the ticket if immediately upon purchase the clerk immediately provides a sure $0.50 payoff. The lottery ticket is purchased because of the huge risk element or the belief in the ability to pick a winning number. In the stock market, greed may exceed fear or the investor may believe that he has some ability to pick a winning stock. The evidence (stock market volatility, IPOs, Dot Com bubble, penny stocks, high P/E ratios, technical analysis, hedge funds, etc.) seems to support this observation. The risk adverse may gravitate to bonds or bond funds. In any event, risk preference is relative to the psychology and diversification of the investor. It cannot be generally assessed using general market characteristics or CAPM. ¹⁴

In Item 73 it is stated that

"Any measurement based on estimates is inherently imprecise, whether that measurement portrays the sum of cash flows or their present value. Estimates of the future usually turn out to have been incorrect"

Not necessarily imprecise or incorrect. It may be the outcomes which vary. For example we can say unequivocally that the expected number of heads from 100 flips of a fair coin is 50. This is a precise and correct statement. Outcomes will vary even under simple ideal conditions. What's the difference? The difference is that shareholders understand and accept the risk that financial outcomes will vary due to random statistical variation, random local events (a strike, lawsuit, plant explosion) and environmental conditions (political, economic, natural). Pension funds, mutual funds, and individual investors are often diversified and don't need to be protected against randomly variable outcomes. What they do need to be protected from is an accounting system which lacks relevance or produces systematically wrong information. In the words of the Association for Investment and Management Research (AIMR), ¹⁵

"Certainly financial analysts desire information that is both relevant and reliable, but their bias is towards relevance. In a phrase, analysts prefer
information that is equivocally right rather than precisely wrong. Inexact measures of contemporaneous economic value generally are more useful than fastidious historic records of past exchanges.

Item 74 admits the possibility that PVECF may not be free of judgment or bias and that judgments may differ but points out that not using PVECF may be less representative. PVECF based on expected use of assets has this same advantage over “fair value”. AFTF has the great advantage that bias is essentially filtered out, unrewarded and/or punished. Another advantage is that the accountant makes no judgments and has a well defined audit role. Two AFTF auditors will agree to the penny.

Item 75 discusses liabilities and espouses the same “fair value” definition as for assets, i.e., the price that paid (received) to liquidate the liability (asset) in an arms-length transaction. In both cases “fair values” are generally conservative making the implementation doubly conservative and violating FASB’s own guideline.16

Item 78. “The most relevant measure of a liability always reflects the credit standing of the entity obligated to pay.” Why? To match the price? To satisfying FASB’s definition of “fair value”?

“Those who hold the entity’s obligations as assets incorporate the entity’s credit standing in determining the prices they are willing to pay.” True. Hence, such a measure is a fair price and a liquidation value but not generally an expected value.

The example provided compares apples ($374 received) to oranges ($284 received).

“When an entity incurs a liability in exchange for cash, the role of its credit standing is easy to observe. An entity with a strong credit standing will receive more cash, relative to a fixed promise to pay, than an entity with a weak credit standing. For example, if 2 entities both promise to pay $500 in 5 years, the entity with a strong credit standing may receive about $374 in exchange for its promise (a 6 percent interest rate). The entity with a weak credit standing may receive about $284 in exchange for its promise (a 12 percent interest rate). Each entity initially records its respective liability at fair value, which is the amount of proceeds received—an amount that incorporates that entity’s credit standing.”

This only makes sense if the value to the buyer and seller are equated. These values are not the same. It is not reasonable that the entity with the larger interest cost should record the smaller liability. Part of the problem is that the loans are of different size ($374 versus $284). This confuses the issue. For example, if 2 entities both borrow $373.63 to be paid in 5 years, the entity with a strong credit standing must pay back $500.00 (a 6 percent interest rate). The entity with a weak credit standing must pay back $658.46 (a 12 percent interest rate). The liability on the loan date is the SAME in both cases, namely $373.63. At any later date the accumulated loan value is the original loan amount plus earned compensation for risk assumed. After one year the 6% percent has been earned and is due along with the principal from the stronger debtor. Similarly for the weaker debtor but the liability is 12% plus the principal. The weaker debtor has a LARGER liability. The same applies in every year.
Even if we consider loan portfolios from the lender perspective the loan assets are not smaller for the riskier loans. If the extra 6% paid by the riskier debtor represents a fair compensation, then the expected asset values with defaults from both loan portfolios will be identical. In fact, even with a single pair of loans, the expected values will be identical, although the actual value will be may be different. It’s easier to imagine a portfolio of loans operating probabilistically than a single loan. Unless we compare apples and oranges, the value of the riskier loan is NEVER LESS than the value of the less risky loan. There is a more important issue. If accounting does not fully recognize the liabilities of a viable entity, the entity may soon not be viable. Permitting the discounting of liabilities will be a temptation for the worst accounting abuses. Discounting liabilities is bad accounting theory and worse accounting practice. I doubt that my observations are unique.

PVECF and “Fair Value”

There are major problems for PVECF when coupled with “fair value” as defined.

First, the concept is applicable at the individual asset or liability level whereas financial reporting is generally at the company level. So what? The problem is that the sum of the parts will not equal the whole. The company as a whole has a fair value which is the company’s capitalization (market price). The “fair values” of individual assets are liquidation values, which don’t add up to the capital market’s assessment of the company as an ongoing enterprise. The same assets or liabilities may have different economic values in different companies. Comparability may be enhanced but lacks economic meaning.

Second, assigning “fair value” or any value to individual assets or liabilities is impractical; there are too many of them. It becomes too difficult to assemble the values of every asset and liability. This is much like trying to value a car by looking up the replacement and assembly costs of all the separate parts of the car. The answer will be difficult and wrong. AFTF easily provides a cohesive, complete and non-duplicative PVECF at the company financial reporting level, using the capital market scale and satisfying user needs.

Third, there are generally many intangible assets which are excluded under the current accounting implementation. Intangible assets are increasingly important and are often dominant assets. “Fair value” accounting is massively incomplete without intangibles. Intangibles are labeled as such because they do not have a current manifestation or a “fair value”, but all intangibles have future cash flow manifestations, at least in AFTF\(^7\). It is clearly necessary to include all future cash flows when using PVECF.

Fourth, the fair value of the company is what shareholders are interested in, not liquidation values of individual assets. FASB has not answered the crucial question, has not asked the crucial question, and seems not be aware of the crucial question. What is the economic or fair value of the company? FASB seems to readily accept capital market values for individual assets yet not for the company as a whole.
Fifth, many if not most assets will not have observable prices. Assigning “fair value” places a heavy and unnecessary burden on accounting. If fair value is defined in terms of the capital marketplace, prices are always observable and economic value assignments relatively easy.

Some arguments are presented that are critical of alternatives to “fair value” as defined by FASB. These need to be examined. Item 31 or CON7 states,

“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, (b) inserts assumptions made by the entity’s management in the place of those that the market (not the capital market) would make, and/or (c) excludes factors that would be contemplated in the price of a market transaction but do not apply to the value-in-use. 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.”

(a). Value-in-use and AFTF do add factors not contemplated in “fair value” prices. The factors are important economic factors that should not be ignored. For AFTF, and probably for value-in-use as contemplated by its proponents, only those factors which enter into capital market prices are added. Hence pricing information is used, at least as an attribute or goal. In the case of AFTF capital market pricing is used directly.

(b). Assumptions made by the entity’s management are not unimportant. It is the prerogative and responsibility of management to make such assumptions. In theory and in practice, nobody is better equipped. Such assumptions do not substitute for capital market assumptions, although they may substitute for assumption inherent in “fair value” (liquidation value). One of the basic management assumptions is that the entity will not go into bankruptcy and be forced to liquidate but will be able to make use of its assets. Management assumptions will be closely aligned with those of the capital markets and both are directed at economic value. Within AFTF management assumptions assume an additional role. They, together with the resulting expected cash flows, become the standard by which management is judged and held accountable.16

(c). Value-in-use and AFTF do exclude certain charges that the liquidation market for individual assets or liabilities would make. Unless liquidation is the planned or expected outcome, those charges will not be incurred. AFTF always uses an entity specific view, in part because AFTF is reporting on the specific entity. AFTF generally uses an expected value-in-use perspective unless liquidation is the expectation; this is appropriate for Present Value of Expected Cash Flows.

Any accounting system ignoring management assumptions will lack relevance. AFTF makes direct use of management assumptions but applies very strong disciplines so that such assumptions add disciplined and relevant information. It is “fair value”, as
defined by FASB, which is substituting assumptions which management and the capital market would naturally use.

In item 32, reasons are given for why management's PVECF might differ from "fair value". Each of these reasons support the use of an expected value-in-use but in item 33 it is pointed out that using these or similar reasons would produce an immediate recognition of the comparative advantage (current measure of future profit) at initial measurement. This is not in accord with GAAP or accounting tradition, is not conservative, and could be abused.

If accounting is failing, perhaps a break from GAAP and/or accounting tradition is overdue. Actually, cost/benefit analyses are techniques are well within relevant accounting practice. In practice, accountants recognize the decision utility of measuring all future benefits. It is not a large jump to report such economic measures. "Fair value" is conservative both for assets and liabilities. Conservatism, like liberalism, destroys information and cannot support optimal decisions.

Any accounting system can be abused. The GAAP record is not an exemplar. Using AFTF recognition of value is disciplined ... much more so than GAAP revenues.

Immediate recognition is not necessarily a flaw; delayed recognition always is. It doesn't conform to economic or capital market fair value. FASB's position is contradictory: on one hand FASB espouse the use of PVECF, on the other hand FASB shies away from immediate recognition. FASB is shackled to the current GAAP implementation which generally recognizes profit only to the extent of expenditure, and sometimes not even then.¹⁹ This is conservative and cannot optimally support decisions.²⁰ In the past, there may have been prudent reasons for conservatism. With AFTF and its disciplines those reasons no longer exist. The AFTF dual validation reduces or eliminates bias and the motive for bias. AFTF also insures that any residual bias comes back to haunt management.

Con7 cites (from CON1) three objectives of Financial Reporting:

a. That is useful to present and potential investors and creditors and other users in making rational investment, credit, and similar decisions (paragraph 34).
b. That helps present and potential investors and creditors and other users in assessing the amounts, timing, and uncertainty of prospective cash receipts from dividends or interest and the proceeds from the sale, redemption, or maturity of securities or loans (paragraph 37).
c. That tells about the economic resources of an enterprise, the claims to those resources (obligations of the enterprise to transfer resources to other entities and owners' equity), and the effects of transactions, events, and circumstances that change resources and claims to those resources (paragraph 40).

PVECF with "fair value" provides some information but fails to provide the most relevant information for meeting these objectives. AFTF (disciplined value-in-use) is more relevant. For example, while it is true that management's best estimate fail to communicate risk and uncertainty in cash flows, the historic cost of capital applies an
appropriate discount, as judged by the capital markets, to those cash flows. "Fair values" are liquidation values not measures of economic resources. "Fair Values" and PVECF are defined from different perspectives and are contradictory when used together. As promoted by FASB both are sub-optimal as decision criteria. With relatively minor modification both fair value and PVECF can be coordinated and can be made to support decisions. The basic concepts are fine, the implementation misses the mark.

Item 37 states that "fair value represents a price and, as such, provides an unambiguous objective for the development of the cash flows". This is correct. But the liquidation price represents the value to the buyer of the asset not the seller. The price forms a basis for PVECF for the buyer. This is OK for a liquid asset held short term, such as a stock or bond; prices and values will be the same. But in general, the buyer and seller perspective are not the same, the asset use is not the same and the values, including PVECF, are not the same. The capital market price does form a basis for the disciplined recognition of value using PVECF. There is little or no arbitrariness in the selection of cash flows or the interest rate using AFTF.²¹

"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."

The acquisition cost is in the past. Value, including PVECF, is in the future. We can define them to be equal but this is self-defeating. If "fair value" is equated to unintended liquidation value we are no longer dealing with expectations or PVECF.

Item 38 suggests that the entity's assumptions may be appropriate when market prices or the assumptions of the marketplace are not available. But this is directed at entity assumption for the marketplace not for the entity itself, i.e., liquidation assumptions not value-in-use assumptions.

FASB's position on "fair value" ignores or dismisses the AFTF developments, the IASB position and the dissenting position of some FASB staff members. FASB's position also seems to ignore inconsistencies and contradiction within its own interpretations. FASB's position seems to give short shrift to economic value and end-user needs. FASB cannot have two wives; it cannot cling to an antiquated cost-based model, yet embrace forward-looking value-based accounting model. It won't work.
Recognition

"Concept 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. Recognition includes depiction of an item in both words and numbers, with the amount included in the totals of the financial statements. For an asset or liability, recognition involves recording not only acquisition or incurrence of the item but also later changes in it, including changes that result in removal from the financial statements."

This definition of recognition is formalized. Generally a recognized item appears explicitly, perhaps in combination, in accounting records and/or statements. Hence assets and liabilities acquire existence or non-existence by virtue of defining and recording. This is an open door to discretion, artificiality, duplication, incompleteness, and lack of relevance. Recognition must be defined in terms of some external reality. Recognition must have some purpose and relevance, not just be a term of art. AFTF defines recognition of value as the two step process of recognizing expected cash flows and their measurement as present values. This anchors recognition to a useful reality and provides general guidance. For example, accounting allocations, which are not cash flows (accrual adjustments, deferrals, amortization, capitalized expenses, depreciation, goodwill, etc.), do not have a purpose, existence or recognition within AFTF. Allocations are distortions, or at best poor approximations and at worst a cause of bankruptcy. Without artificial allocations it is easier for initial recognition and subsequent measurements to be on the same basis and for that basis to be economic value. One objective of PVECF should be the elimination of all allocations including amortization.

Cash flows and present values must be used within a meaningful and relevant accounting model. The AFTF accounting model recognizes the primacy of cash flows and present values and maximizes their relevance and reliability. Recognition of value is a superior concept within a superior AFTF accounting model. FASB should not defer consideration of recognition issues when considering cash flows and present values.

"Appendix B outlines 21 instances in which the Board and its predecessors have used present value techniques in measuring assets and liabilities recognized in financial statements. A review of other accounting guidance reveals many more, along with situations in which present value techniques could have been used but were not."

Many, if not most, FASB statements are forward-looking value-based fixes for a retrospective cost-based accounting model. It would be more consistent and far easier to fix the basic model than to perpetually add value-based fixes after the need arises. AFTF is a forward-looking decision-useful accounting model directly based on PVECF. It does not require repetitious and detailed guidance such as is present in FASB's 150 statements and 26 interpretations. Fireproofing the accounting model is easier than constantly putting out accounting fires.
It is stated that

“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. The marketplace assessment of present value is already embodied in such prices.”

The assessment of PV for the seller is embodied in the price. It would be convenient to have buyer and seller values match, but this will only happen for short-term liquid assets. It would be convenient to have values match prices but this is only true for the seller who realizes a current positive cash flow. The asset buyer generally realizes a current negative cash flow (costs) and later generally realizes positive cash flows (benefits) from his investment.

The economic value of a company is or is approximated by its market capitalization. If measuring and reporting economic value is the accounting goal then the capital market value should be used, not liquidation value, i.e., the observable attribute of PVECF should the market capitalization. If economic value is not the accounting goal then reporting to shareholders will remain deficient. Accounting should not just pay lip service to economic value. “Present value is not an end in itself.”

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1 For AFI'F the liabilities are not directly discounted for credit rating. For less creditworthy companies the **historic cost of capital** be higher which discounts liabilities but the same applies to assets. Since assets generally exceed liabilities a higher **historic cost of capital** will reduce the shareholder value, as expected

2 At least to the extent that balance sheet changes are matched to the income statement or vice-versa.

3 AFI'F has a unified **Statement of Values** in which the progress of the company (value added) is naturally coordinated with the statuses of the company (valuations).

4 AFI'F is prospective. All AFI'F values resides in the future so that purchase price is not a factor. Purchase price is sunk cost not useful for decisions. Selling price is only used in conjunction with an expected sale otherwise the expected use determines the value. “Fair value” as currently defined is liquidation value and is not used within AFI'F

5 AFI'F uses the **historic cost of capital** which incorporates provisions for risk, time value of money, inflation as assessed by the capital markets.

6 AFI'F defines **recognition of value** as the two step process of recognizing expected cash flows and the disciplined measurement of those cash flows using present values. Measurement and recognition are related in a natural and disciplined manner by the **dual validation**. See the paper **Disciplining Prospective Accounting** for details.

7 AFI'F requires continuous fresh-start measurement at least quarterly or whenever it is reasonably expected that new measurement would affect shareholder or management decisions. This provide uniform and general guidance.

8 AFI'F is scaled to company level value measurement and the attribute of the measure being PVACF or economic value. AFI'F disciplined PVECF is the practical approximation.

9 See the essay **Disciplining Prospective Accounting** for details.

10 Actual annual past cash flows may not be as reliable as expected annual past cash flows. This is due to,

1. year-to-year fluctuations in reported results due to extraordinary items and to extraordinary experience
2. year-end fluctuations in accounts due or receivable
3. the greater reliability inherent in the longer base period (5 years) used in the model
4. the addition of knowledge, understanding, structures, and relationships to the model
5. the fact that the cash flow model is specifically designed to reliably represent the underlying patterns.

In a very real sense the expected cash flows become the standard by which the actual cash flow are judged, not the reverse. If a past or future year's actual net cash flow is higher than the modeled net cash flow, then we would probably conclude that actual result was better than expected. We would probably not conclude that the model was unreliable for that year. Expected cash flow are perfectly reliable in that they are exactly what they purport to be. Within AFTF expected cash flow are disciplined in several ways, making them more reliable than revenues.

11 In practice, "value-in-use" may be equivalent to the cost-accumulation or cost-accrual approach.
12 See CON7 item 23
13 "fair values" reflect liquidation values which are economic values to others.
14 CAPM determines the risk component independent of market prices, which represent the capital market's assessment of risk and other similar factors. AFTF uses market prices.
15 The 1993 AIMR Report: Financial Reporting in the 1990's and Beyond
16 "The Board emphasizes that any attempt to understated 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."
17 AFTF defines accounting broadly and supports that broad definition. AFTF is the core of a uniform financial decision support system that includes management accounting, financial analysis, capital allocation decisions, pricing, and financial reporting to shareholders.
18 A major component of AFTF financial reports is the actual to expected cash flow exhibit.
19 An exception is made when a company is acquired when capital market realities intrude.
20 "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." This contradicts the conservative definition of "fair value" and the unavoidable omission of intangible assets.
21 Using the dual validation and explained in the paper Disciplining Prospective Accounting.
22 AFTF defines accounting broadly and supports that broad definition. AFTF is the core of a uniform financial decision support system that includes management accounting, financial analysis, capital allocation decisions, pricing, and financial reporting to shareholders.
23 See Accounting For The Future: Appendix 4: Summary of Unnecessary FASB Statements for a enumeration of those statements which would not be needed within a prospective accounting model, such as, AFTF.