

# **A Critical View of GAAP**

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

By  
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## Introductory Comments

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

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

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disciplined, not transparent, massively incomplete, not comparable, subjective (in a biased sense), irrelevant, costly, outdated and purposeless.

## Complexity

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

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

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

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

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

Part of the complexity results from attempts to bridge the gap between accounting measures or accounting “values” and obvious economic values. A glaring example is the spontaneous creation of value when a company is acquired. A company may have a “net worth” or a “book value” far below its market value or acquisition price. After acquisition the value of the company is suddenly and magically increased by its “goodwill”. Such blatant inconsistencies create complexity. Note that it is the normal (pre-acquisition) accounting “values” which miss the mark; the acquisition price is the obvious economic value.

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

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

Complexity also results from the level of issues that FASB/IASB addresses. Most FASB statements, for example, address specific issues within specific industries. These are not standards: standards must have some general application, must involve basic concepts, and must conform to basic principles. Standard setters addressing specific issues will inevitably get bogged down since there is no end to minutia. Accountants will be overwhelmed by complexity or conflicted with detailed prescriptions which don't quite fit their particular situations. New basic principles and concepts need to be developed. Old principles and concepts need to be re-examined, improved or scrapped, and coordinated with new. True general standards need to be developed. The problem with only addressing specifics, apart from complexity, is that the basic shareholder reporting model is flawed and needs updating: FASB/IASB can no longer afford to be "penny wise and pound foolish".

The GAAP definition of revenue, its recognition and measurement had been a costly conundrum for decades. The fact that so many resources have been expended with so little result is an important clue.

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

## Consistency

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

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

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

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

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

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

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

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

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

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

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

## Discipline

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

The revenue and expense concepts are undisciplined. Both can be defined and manipulated to suit. There are too many choices and judgments in their measurement. By way of contrast, cash flows based on ledger entries are unequivocal: subject to double entry discipline, balanced and auditable to the penny. There is no comparison. Indeed, the discipline of the cash flow model is gradually replacing the more traditional revenue/expense model. Undisciplined concepts like revenues and expenses also create opportunities for mistakes or fraud. Many of the recent corporate failures could and would have been avoided with disciplined cash flow accounting.

Accounting often appeals to economic value to support its model but will not directly adopt economic values. There is no standard scale for accounting/reporting measures. They can be no quality control or discipline unless there is a standard measure. Reports will not be useful until that scale has some meaning and significance. Value, especially economic or capital market value, provides a meaningful standard scale. For example, price/earnings ratios are highly variable over time, between companies and between industries. The price is an economic measure with great credibility. It is the undisciplined earnings that lack economic significance and produce the variation. A similar situation applies to accounting "net worth" or "book values" which are often a fraction or multiple of capital market values.

Two companies with radically different risk profiles may report similar results yet have substantially different economic or capital market values. There is no capital market feedback mechanism to take into account risks assessments (shareholder cost of capital).

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

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

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

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

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

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



## Transparency

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

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

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

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

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

Again it fell to outside legislation (Sarbanes-Oxley) to mandate or impose increased transparency in accounting.

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

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

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

## Completeness

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

Assuming we are focusing on investors in publicly traded companies, it would seem that the most useful measure would be the economic (going concern) value of a share. When compared with the share price this would provide an easy decision criterion. While accounting pays lip service to such economic values, it does little to measure or report them. Instead it restricts its attention only to current or past accounting tangibles. This is convenient for the auditor who can categorize and tally past transactions and inventory tangible assets but it ill serves the investor whose share value depends on the future.<sup>2</sup>

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

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

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

In addition, the income statement can be distorted thru incomplete accounting. A case in point is WorldCom which capitalized ongoing expenses, thus understating expenses and overstating net income. The more common situation is the understatement of income. Almost all marginal capital expenditures are investments made with the purpose and expectation of some future net benefit or gain. However, such positive net gains are NEVER measured under GAAP. The expenditure is either expensed currently or capitalized. If capitalized no net gain is measured since capitalization is limited to the expense.<sup>3</sup> Hence a basic tenant of GAAP is that profitable endeavors that add economic value are never recognized in a timely manner. Of course such gains are measured later, but this hardly suits the purpose of financial reporting to investors. Just

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

<sup>3</sup> Capitalized expenditures may be viewed as future income capped at the expenditure.

this one aspect alone casts serious doubt on the appropriateness of the current accounting/reporting model.

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

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

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

## Comparability

It would be useful if investors could meaningfully compare alternative investments in order to maximize their expected returns and, collaterally, capital market efficiency. Unfortunately, GAAP accounting and reporting do not provide good measures for comparisons. As mentioned above, contextual or relational measures are preferred but even when provided they are based on shaky data or information. I'll cite two common examples.

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

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

Comparability is further impaired by lack of external purpose. Financial reports have become formalities whose purpose is to satisfy requirements (USGAAP and similar). What is being measured? "Accounting values". What are "accounting values"? That which is being measured. This creates the problem that there is no fixed scale, no standard measure that permits comparison. In contrast, if the capital market scale were adopted, i.e., if economic value was the purpose, then measures would at least be in the same ballpark.

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

Two more problems that interfere with comparisons relate to changing monetary units. Distortions can result from exchange rates between countries or by real currency units changing over time. Inflation is currently very low and so is the interest in *inflation accounting* but, when inflation picks up, inter-period comparisons may be misleading. Actually, in a low interest rate environment even modest inflation may be more significant.<sup>4</sup>

There is also the problem of risk adjustments. Risky investments should yield more or equivalently their expected future should be discounted more. The current model doesn't factor risk into measures or comparisons.

I don't think FASB fully understands that the GAAP measures are relatively poor at providing comparable information or that more comparable measures are possible.

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<sup>4</sup> For example, even a 2% inflation rate may be burdensome if only 1% is available from bonds or CDs

## Objectivity

Accounting is replete with subjective judgments. Revenues, expenses, earnings, assets, liabilities, goodwill, expense capitalization, depreciation, accrual adjustments, and many other accounting items require definition, identification, measurement, summarization and disclosure. At each stage subjective judgments are required of management, the accountant and auditor. Earnings, for example, are the end result of many subjective judgments so that they often “manage” to produce an expected or desired result. So problematic were “managed earnings” that the US Congress passed legislation to discourage it. Accounting should adopt well defined accounting elements with standardized measures.

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

In fact, experienced subjectivity and informed judgment is a normal and vital ingredient in the face of omnipresent uncertainty. The investor in stocks understands the risks involved and will generally diversify across stocks, as well as other investment classes, to reduce or eliminate individual company risk. Indeed the stock investor willingly assumes such risks and the more than commensurate rewards that result. The typical investor does not want conservative accounting which hides rewards as well as risks. To insure that no investor ever loses money on any stock investment would require so much conservatism in accounting, management and capital allocation that the financial system would soon collapse.<sup>5</sup> Investors delegate to management the task of assuming risk in the face of current and future uncertainties; this requires subjective judgment. This is a strength that should be encouraged, even harnessed, within the accounting model.

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

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

## Relevance

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

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

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

The current accounting model generally fails to account for intangibles which have become important if not dominant values. An incomplete picture limits the relevance of financial statements, especially since a biased view is generally produced. This type of incompleteness is not like a neutral random sample which might be good enough but a more systematic distortion. In any event, an incomplete report is not a faithful representation. GAAP reports are not representations at all.

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

GAAP obviously has some utility. However, it is not generally relevant for management or business decisions. Pricing, capital budgeting, mergers and acquisitions, profit studies, cost/benefit analyses, and business valuations, all use the present value of expected cash flows discounted at a shareholder cost of capital. Investors also would prefer this information.

Comparisons are a relevant activity and limited comparability limits relevance.

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

## Costs

A complex and inconsistent accounting/reporting model will be costly. It will be costly to standard setters who must continuously rationalize or repair the current model.

It will be costly to managements, accountants and auditors who struggle to understand and comply.

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

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

The current accounting model looks backward. For example, economically profitable investments are NEVER currently recognized. The GAAP implementation does not measure or encourage innovation, R&D, growth, human capital formation, or, more generally, a proactive perspective. GAAP is focused on and emphasizes the short term. Management and investors need to consider the longer term future. The cost of not doing so may be large.

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

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



## Outdated

The current accounting implementation is an artifact. It is based on concepts, elements, measures, and practices developed and useful in the past. These are less relevant in today's predominantly service/information economy where intangible values are dominant.

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

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

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

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

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

## Purpose

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

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

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

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

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

## Concluding Remarks

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

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

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

I would like to see the FASB/IASB formulate general constitutional principles that transcend company, industry, time and place. Within this general constitutional framework it would be the responsibility of accounting education, accountants, auditors, accounting firms and professional societies (like the AICPA) to insure that the general principles are followed.

My criticisms of the current accounting/reporting model are meant to be constructive. To that end I have developed (in 1998) a complete value-based accounting/reporting implementation, **Accounting For The Future (AFTF)**. It solves all the problems discussed above. This accounting/reporting model is simple, consistent, disciplined, transparent, complete, comparable, objective (in a non-biased sense), relevant, auditable, less costly, technological and purposeful. It exemplifies and articulates many, more general, principles than available in current IASB/FASB models. The website below contains ample descriptive materials.

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

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