Comments on

Status of Trustees' Strategy Review

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By
Humphrey Nash
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Introductory Comments

The opportunity to comment of the IFRS strategy and its review of that strategy is most welcome and appreciated. The openness of the comment procedure is much appreciated. It is especially gratifying

1. to see comments solicited from the "general public",
2. to be involved at "a very preliminary stage",
3. to note that the Trustees have "not reached any conclusions"
4. to note that the review will be "comprehensive".

However, my past experience with standard setters is that they are set in their ways and not at all open to new ideas or comprehensive reviews. In fact, most documents out for public comment have already settled on conclusions and are essentially carved in stone. In fact, FASB (and probably the IASB) has abandoned all pretense of fundamental or comprehensive review and have restricted their formerly general and fundamental efforts to "convergence and improvements" of the current FASB/IASB accounting and financial reporting models.

I hope the IFRS review will be more productive or lead to more productive results.

Context for the Review

It is stated that the new IASB would "be focused on creating standards aimed at investor protection." This seems a reasonable goal but in fact it may be suboptimal from the standpoint of capital market efficiency AND investor protection. The current FASB/IASB accounting and reporting models are conservative in several areas. While such conservatism MAY reduce insolvencies by understating financial results, status or values, it does so at the cost of accuracy, neutrality, disclosure, transparency, capital market efficiency and investor safety.

For example, by not valuing certain assets like intangibles, by immediately recognizing all future negative cash flows (liabilities) and not recognizing all future positive cash flows (assets), by using irrelevant or inappropriate "fair value" measures, by using a cost basis, by using a retrospective income approach, etc., the investor is given a very poor idea of the economic value of his shares. Conservatism distorts and hides information which is always sub-optimal. As a simple illustration, suppose all income statements and balance sheets were divided by two. This would be conservative from an accounting perspective but users would soon multiply by two defeating the original intent. Unfortunately, in practice, the investor can't actually identify the many sources of conservatism and has no hope of accurately correcting financial reports. Lack of disclosure and lack of transparency does not protect the individual investor and does significant damage to capital market efficiency generally.

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 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.

I suspect that the goal of "investor protection" actually means protection of investors in the aggregate not the individual investor and stock. However such slogans as "investor protection" has a good chance of becoming grounds or justification for conservatism which would not positively contribute to overall or aggregate investor protection.

I prefer a focus "on creating standards aimed at efficient and productive capital allocation." Or alternatively, "on creating standards aimed at providing relevant (decision useful) information to the general investor." Or even, "on creating standards aimed at maximizing expected investor returns." I think the gist of my comments is clear and this may suggest some refinement of the Trustee's stated focus.

I wholeheartedly approve of the emphasis on the investor. Other interested parties (lenders, suppliers, regulators, etc.) have lesser needs which are, in any event, primarily satisfied by investor information.

I fully support, perhaps more than fully support, the goal of an IASB "not beholden to national or special parochial interests." But this, to me, represents a major departure from past standard setting. For example, almost every single FASB statement is of extremely limited application often applying to a single situation within a single industry. Such statements are not standards … in fact they are non-standards. A standard must have some general applicability and must be supported by some underlying principle or directly be a principle. Standards must also be complete and internally consistent. It seemed at one time that the FASB/IASB had decided to develop and enunciate principles as replacements for specific parochial statements and rules, but I haven't heard much about this recently. I would prefer that the professional accounting bodies, e.g., AICPA, be responsible for all industry or situation specific accounting/reporting practice guides. Of course it would be up to the profession (teachers, accounting firms, professional bodies, staff accountants and independent auditors) to insure that such FASB/IASB principles were followed in practice. Final oversight and enforcement could be a responsibility and authority of FASB/IASB and SEC (or like body), respectively.

As mentioned above, FASB has now restricted its efforts to improvement and convergence. The problem I see is that the current accounting and reporting models are fundamentally flawed. I don't agree, for example, with the following characterization.

"Much of the <u>success</u> of IFRSs to date is the result of three factors: 1) the IASB's ability to produce a full set of standards of high quality …"

This characterization also does not sit comfortably with its opening statements (cited as points 2-4 on the first page of these comments. Are we again going through the motions?

I apologize in advance for the length of what follows. But, unless some attention is focused on these critical deficiencies and limitations, they will remain. Unless that attention is made specific and cogent (within my ability), that attention will be cursory and dismissive.

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.

Complexity

Part of the complexity results 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 model: the current models employ 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 can't decide whether revenue should be transaction based (retrospective) or balance sheet based (prospective). Obviously such indecision results from fundamental flaws. The need for arbitrary 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 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 modification 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 classic example is the spontaneous creation of value when a company is acquired. A company may have a "net worth" or a "book value" far below its market value or acquisition price. After acquisition the value of the company is suddenly and mysteriously increased by its "goodwill". Such blatant inconsistencies create complexity. Note: 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 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 <u>relationships and their measures</u>. 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.

I think the Boards intuitively understand that the accounting model is much too complex. They also understand that such complexity may 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 <u>economic decisions</u>. 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 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 and reports, 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 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.

GAAP earnings are often negatively correlated with the creation of economic value.

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

Discipline

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

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

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

Transparency

It is hard to imagine that an undisciplined, inconsistent and complex accounting/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 do 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% 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. 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.

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 may be both necessary and sufficient to provide 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).

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 value depends on the future. Intangible assets are not imaginary: they are real, identifiable and significant factors which emerge as cash flows over time. They are just as real and significant as liabilities. Over the sweep of time, “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 the “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 by recoverability. Hence a basic tenant of GAAP is that profitable endeavors that add economic value are never recognized in a timely manner. Of course such gains are measured later, but this hardly suits the purpose of financial reporting to investors. Just this one aspect alone casts serious doubt on the appropriateness of the current accounting/reporting model.

Another aspect of incompleteness is the failure of accounting to produce quality high level information. Accounting theory and practice does not meaningfully process information so that 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.

Comparability

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

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

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

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

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

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

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

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 strive to reduce complexity, adopt well defined accounting elements, simplify identification, rationalize and standardize measurement, strengthen and extend summarization, and improve disclosure.

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 or punishes bad judgment. In fact, experienced subjectivity and informed judgment is a vital ingredient for businesses. As previously discussed shareholders understand and willingly assume risk. They 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 neutral, unbiased, representative, informative and useful.

Relevance

Financial reports today typically contain a surfeit of complex material. The traditional income statement and balance sheet are increasing 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 approachable, transparent and digestible and 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 more of a systematic distortional representation and force. In any event, an incomplete report is not a faithful representation. In fact, current reports are not representations at all.

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 like this information.

Comparisons are a relevant activity and limited comparability limits relevance.

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 an unreliable and irrelevant model.

The multiplicity of accounting models multiplies costs.

The current accounting/reporting models clearly deliver more positive benefits than negative benefits (such as recent accounting failures), but the benefits, at best, are limited and the costs are high. We should and can do better.

Purpose

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 responsibility and do the work needed to achieve that purpose. It is ludicrous 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, are mixed with some Toyota parts, and are the wrong Cadillac model.

The IFRS Foundation 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.

IFRS: Four Strategic Fronts and Questions

Q1a. Mission: How should the organization best define the public interest to which it is committed?

In general the current mission statement seems reasonably general, on target and concise. I am concerned about interpretations, which may suggest some fine tuning.

First, there is no mention of faithful representation which would support or require that the accounting/reporting be complete (see my comments in the **Completeness** section). Hence we could have the situation where the financial statement reports only on the number of pencils in the company. This would be reliable, objective and verifiable information (high quality?). It would be simple, meaningful, easily understood and approachable information (transparent?). It would be easily and universally comparable. Barring "pencil manipulation" it might be somewhat correlated with the value of the company and with its growth or economic progress. It would "help" investors "make economic decisions". This ludicrous example serves to illustrate that completeness is a necessary characteristic. I suggest adding the word "complete" or "faithful representation" or some other phrasing to require "the whole truth".

Much to the same point the phrase " help investors … make economic decisions" is too weak and does little to encourage optimized or even improved accounting/reporting. A much more proactive phrasing might be "<u>enable</u> investors to make economic decisions" or even "to <u>best</u> help investors… make economic decisions". Or even "… high quality, transparent, comparable and <u>optimized</u> information …". I don't especially like my phrasings but you get the gist.

As previously commented on, I didn't like the goal of "investor protection" which I argued would be counterproductive for the individual investor as well as the capital markets generally. For similar reasons, the emphasis on the investor (although on target) leaves the broad capital markets without a champion. Perhaps standards should also give a nod to smooth and efficient operation of capital markets, markets where risk is a necessary and desirable ingredient but where the individual investor in an individual company is at risk (because of lack of diversification, time horizon, leverage, risk capacity, emotions etc.). Does the IFRS feel any obligation to the general economic welfare?

"High quality information" sounds great, almost as good as "fair value". But there should be some discussion or explication of its meaning and intent. Does it mean complete, processed and refined, relational, disciplined, verifiable, relevant, accurate, summarized, concise, having economic substance (value oriented), important to the investor, actionable, etc.?

Similarly does “transparent” mean simple, tightly defined, easily understood, verifiable, commonly understood, easy to interpret, unequivocal, full and complete disclosure, whole truthful, etc.?

There is some advantage in not tightly defining such terms since they can then be broadly applied but the disadvantage is that they can also be misunderstood or misapplied.

Q1b. Should this objective be subject to revision?

A: Yes

Q2. To what extent can and should the two perspectives be reconciled?

As discussed above the efficient operation of the capital markets should be a goal of reporting standards, in addition to informing the individual investor about an individual company. The latter will accomplish the former but only if the accounting/reporting model is neutral. There is no better mechanism for financial stability that efficient operation.

A conservative model that serves to protect the individual or a model that avoids risk will ill serve the capital markets generally. Efficient capital markets require innovation, risk taking, and natural selection to be healthy and to evolve. It is not the job of accounting to tilt the scales. It will backfire in any event.

There are legislative, regulatory or monetary steps that can be taken to increase financial stability, such as the elimination of nationally chartered banks to avoid “to big to fail”. But these steps are not accounting. Having said that, it is most regrettable that legislative steps had to be imposed on accounting to encourage disclosure and accountability. Accounting should solve its own problems.

Q3. Does this three tier structure remain appropriate?

I don’t think the IFRS should contain its own monitoring board. It would seem that an independent outside board would be more effective and more capable of representing end-user interests. I like the SEC/FASB structure and relationship, even though it hasn’t been that effective.

If FASB and IASB are consolidated perhaps ASB rather than IASB would be more appropriate name.

Q4. Are further steps required to bolster the legitimacy of the governance arrangements, including in the areas of representation of and linkages to public authorities?

As an international accounting body and authority it will be difficult to make arrangements with public authorities since they are so varied and dispersed. Perhaps a governing council (major players plus rotating minor representation a la UN) could be considered. As mentioned in Q3, any monitoring board should be independent to provide checks. Political endorsement would be superfluous with an independent governing council.

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 accountants) what they can have, with little regard to what they 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 no developed accounting or reporting structures or standards.

Q5. Is the standard-setting process currently in place structured in such a way to ensure the quality of the standards and appropriate priorities for the IASB work programme?

Given the fundamental flaws in the current FASB/IASB standards and resulting accounting and reporting models, the answer has to be "no". I don't see how the current Boards or their successors can easily break away from inherited standards. In fact the goal seems to be to maintain the current models concentrating all efforts on "improvements and convergence" of those inherited 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 structure is to have investor representation and working participation at least equal to that of the standard setters. They should not be accountants.

Q6. Will the IASB need to pay greater attention to issues related to the consistent application and implementation issues as the standards are adopted and implemented on a global basis.

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. This would permit, for example, a degree of regional variation. For example, accrual adjustments, fair value of liabilities or intangibles might be treated differently but still conform to the constitutional principles. I would hope that global application and implementation issues could be passed down the line.

Financing: how should the organization best ensure forms of financing that permit it to operate effectively and efficiently?

Q7. Is there a way, possible as part of a governance reform, to ensure more automaticity of financing?

Financial reporting is (or should be) designed to benefit investors. They should pay for their reports whenever they trade shares. I suggest a .01% (.0001) tax on all purchase or sales of stock (including mutual funds, options, ETFs, hedge funds, etc.) or bonds. This would fund at least $100,000,000 or $200,000 for each of 500 standard-setter employees.

However, a major goal would be give some increased voice to investor needs.

Q8. Are there other issues that the Trustees should consider?

It is stated that IFRS Foundation standards are to be "based upon clearly articulated principles". Where are these principles articulated? Those I've seen are sparse and impotent.

The trustees should consider the fundamental flaws I've identified in the **Context For Review** section of these comments.

My criticisms of the current accounting/reporting model are meant to be constructive. To that end I have developed 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, 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 a solution, such as AFTF, is considered and understood the limitations of the current accounting/reporting implementations become, by contrast, crystal clear.