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Comments on the "Progress Report of the Advisory Committee on Improvements to Financial Reporting to the United States Securities and Exchange Commission," dated February14, 2008

I have a number of comments, based on my book *Contemporary Issues in Financial Reporting: A User-Oriented Approach*, published by Routledge New York in 2006, which covers many of the issues discussed in the Report. In my comments, I refer to pages in the Report as, for example, (R24), to the book as (CF), and to pages in the book, for example, as (CF254).

1. Main Comment

One of the two tasks assigned by the SEC in its charter of the Committee to improve financial reporting is "reducing the complexity of the financial reporting system to investors, companies, and auditors." (R1) It makes several proposals to do so. However, it does not address the main cause of complexity, which is the design of financial reporting standards so as to achieve a ***relatively stable income reporting pattern***. (CF249-254)

(That feature of the standards also causes financial statements to violate the criterion of representational faithfulness. (CF88-90) It results, as discussed below, in amounts that not only fail to faithfully represent aspects of the reporting entity that exist, that existed, or that occurred, a requirement stated by the FASB in its Statement of Concepts No. 2, "Qualitative Characteristics of Accounting Information," but that do not even represent such aspects. [CF85])

2. Allocation

Currently, accounting is *defined* as a process of allocation, as stated by the AAA in 1936 and used as the cornerstone of financial reporting ever since:

> Accounting is . . . not essentially a process of valuation, but the allocation of [acquisition] costs and revenues to the current and succeeding fiscal periods. (American Accounting Association, "A Tentative Statement of Accounting Principles Affecting Corporate Reports," *The Accounting Review*, June 1936, 188) (CF229)

Allocation slices up amounts, taken from observing the reporting entity, in a systematic and rational manner, without regard to facts of the reporting entity, representing nothing about the entity, in order to stabilize income reporting. (CF237)

Examples of areas that depend on allocation are the following:

- Reporting on inventories (CF228)
- Depreciation (CF228)
- Depletion (CF228)
- Amortization (CF228)

- Reporting on income taxes (CF426-441)
- Reporting on pensions (CF479)
- Reporting on postretirement benefits other than pensions (CF495)
- Discounting (CF285)
- Reporting liabilities (CF337)

In all those area, comprising much of current financial reporting, allocation works to stabilize income and to make the reporting unnecessarily complex, in addition to not providing information. (CF239)

3. Academic Representation on the FASB

The Report concludes that academic representation should not be mandated on the FASB. (R#1 in summary of significant CIFIR recommendations) However, academics bring to the table independence of mind and curiosity that members from other areas do not bring to an equal extent. An academic should therefore be mandated.

4. Single Standard Setter

The Report concludes that the FASB should be the single standard setter for U.S. GAAP. (R#3 in summary of significant CIFIR recommendations) That ignores the movement to make the IASB the world's single standard setter. (CF20)

5. Alternatives

The Report recommends concludes that a stated objective should be to eliminate alternative accounting policies. (R21) While that is a commendable objective, the Committee should recognize that the source of most alternative accounting policies is the acquisition cost basis of reporting. (CF406) The most efficient way to eliminate them would be to eliminate the acquisition basis of reporting. (I know that the Committee does not consider that to be part of its assignment. It should bear in mind, however, that its other efforts to eliminate alternatives probably will not be fully successful.)

6. Economists

The Report recommends involving economists in the standard setting process. Their involvement has done much harm to financial reporting, (CF278-9) and so their involvement should not be mandated.

7. Summary of Significant Recommendations

The Report lists 12 significant recommendations to improve financial reporting and reduce complexity. (R6-10) (It ignores the most effective way to accomplish those results, which is to rectify the pervasive defects of GAAP. (Described throughout CF)

8. Appropriate Priorities and a Consistent Conceptual Framework

The Report mentions concerns about whether the FASB is following appropriate priorities within a consistent conceptual framework. (R3) The FASB is deficient in both areas:

- In 1978, the FASB promised to reexamine its pronouncements, pronouncements of predecessor standard-setting bodies, and existing financial reporting practice in the light of newly enunciated objectives and concepts. In the 30 years since then, it has not done so, and it has not given an indication that it ever will. (CF226-7) Doing so should be a priority. If it does so, it could benefit from considering the defects of GAAP described in CF.
- The current FASB conceptual framework is generally good, but it could be significantly improved. (CF84-98) The current project to revise the framework gives promise. The framework should be sound, not merely consistent.

9. Underlying Economic Substance

The Report refers to consistency with "the underlying economic substance" (R4) and implies that it is a necessary attribute of financial statements. That corresponds with the FASB's qualitative characteristic of representational faithfulness in its CON2. That characteristic requires amounts in financial statement to represent something outside the statements, outside the mere thoughts of the issuers of the statements, and about the reporting entity. Most amounts in financial statements are based on allocation, which represents nothing outside the statements, or on thoughts of the issuers about the future. So, most amounts do not conform to what the Report says is a necessary attribute.

For the same reasons, most amounts in financial statements cannot be verified, determined to correspond with the parts of the substance that are supposedly being represented. Therefore, because of the defects of current GAAP, the amounts in financial statements ***prevent successful auditing of amounts in financial statements***. (CF247-8)

10. Unnecessary Volatility

The Report refers to a view that increased use of fair value measurements will cause "unnecessary volatility." (R4) But volatility, defined as ups and downs in net income from period to period, must be represented as it is for financial statements to be representationally faithful.

11. Decreased Reliability

The Report refers to a view that the increased use of fair value measurements will decrease the reliability of financial statements. (R4) However, GAAP now is based largely on allocated acquisition cost. Allocated acquisition costs violate the user-oriented criterion of representativeness, as discussed above, because they don't purport to represent anything outside themselves, for example, they don't purport to represent anything about the reporting entity. Because the first requirement for items to be reliable is that they purport to represent something outside themselves, ***allocated acquisition costs are com-***

pletely unreliable. (CF237) Current financial statements therefore have little if any reliability to decrease.

12. Estimates of Value

The Report states that fair value involves estimates of value that may be less objectively determined than acquisition costs. (R4) However, the only kind of "fair value" reporting that is satisfactory is current selling price reporting, which does not involve "estimates" of value, that is, predictions. (CF303)

13. Optionality

The report suggests that alternative practices (optionality) can in rare circumstances be justified. (R6) However, with the most satisfactory kind of reporting, current selling price reporting, alternatives do not exist. They exist because of the acquisition cost basis of reporting, as discussed in item 5 above.

14. Management Intent

The Report takes no position on whether management intent should be incorporated in financial reporting standards. (R6n7, R23) However, management intent is a thought of a person about the future. Such thoughts should have no place in financial reporting standards. (CF175-8) The Report also indicates that management estimates of future amounts are similar to management intent. (R23) For that reason, such management estimates should also be excluded.

15. Investor Perspectives

The Report states that investor perspectives must be properly considered by all parties. (R7) However, investors will generally ask for what they have been receiving, thus stifling progress. (CF369)

16. Assessment of Existing Standards (R7)

See item 8 above.

17. PCAOB Auditing Standards

The Report extols the PCAOB auditing standards. (R9) Because item 9 above indicates that successful auditing of amounts in financial statements based on current GAAP is prevented by its defects, such standards are in vain.

18. Not Resulting in Useful Information

The Report includes as an area of inquiry whether there are current accounting and reporting standards that do not result in useful information. (R11) CF discusses innumerable such areas, including virtually all areas of financial statements.

19. Mixed Attribute Model

The Report correctly identifies the mixed attribute model as a cause of complexity. (R12) That is correct; it is also the cause of a number of other problems, such as violation of the rules of arithmetic. (CF9) Current selling price reporting avoids this problem.

20. Incomplete and Inconsistent Conceptual Framework

The Report refers to an incomplete and inconsistent conceptual framework. (R13) That properly describes two of the problems with the FASB's current conceptual framework. CF describes all of the problems.

21. Clear and Consistent Guidance

The Report emphasizes the need for GAAP to provide clear and consistent guidance. (R17) A more important criterion is the need for <u>sound</u> guidance. Most of GAAP provides <u>unsound</u> guidance, as described throughout CF.

22. Patent Conundrum

The Report describes a conundrum concerning a newly-developed patent under current GAAP. (R16) Current selling price reporting avoids that conundrum.

23. Lease Reporting and Bright Lines

The Report rightly condemns bright lines separating similar items in GAAP, and gives lease reporting as an example. (R17) The solution to the lease problem is to change GAAP so that all active leases result in the acquisition of assets and all active noncancelable leases result in the incurrence of liabilities unless all the rent is paid at the inception of the lease. (CF496-8)

24. Fair Value for All Assets

The Report states that using fair value for all assets would exacerbate the existing questions about relevance and reliability. (CF29) However, item 11 above shows that allocated acquisition cost is completely unreliable, and CF demonstrates that current selling price reporting is completely relevant. (CF308)

25. Depreciation Methods

The Report doesn't address the optionality of depreciation methods. (R12n27) However, they are as harmful as any other alternative accounting practices.

26. Reasons for Alternatives

The Report states that alternatives are caused by a number of reasons. (R22) However, item 5 above ascribes most alternatives to the acquisition cost basis.

27. Trade off Between Relevance and Reliability

The Report discusses trade off between relevance and reliability. (R27) Such a trade off is needed only in the context of acquisition cost reporting. It doesn't exist using current selling price reporting. (CF309)

28. More Verifiable Basis

The Report asserts that the acquisition costs basis is more verifiable than current value. (R29) However, acquisition costs that have not been allocated are in principle irrelevant for any purpose of financial statements, and acquisition cost that have been allocated represent nothing in the real world and are therefore completely unverifiable. (CF243)