



# EARLY WARNING AND QUICK RESPONSE

Accounting in the  
Twenty-First Century

David Mosso

Studies  
in the Development  
of Accounting Thought  
Volume 12

**EARLY WARNING AND QUICK  
RESPONSE: ACCOUNTING IN THE  
TWENTY-FIRST CENTURY**

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THOUGHT VOLUME 12

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ACCOUNTING IN THE  
TWENTY-FIRST  
CENTURY**

BY

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INVESTOR IN PEOPLE

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# INTRODUCTION

This book concerns the author's conclusion that the current accounting model – generally accepted accounting principles, or GAAP – is an anachronism. It is unable to cope with the pace and complexity of modern economies. Both the accounting model and the standard-setting process for developing and maintaining the model are broken beyond simple repair. They need to be stripped down and rebuilt for accounting in the twenty-first century.

The most fundamental cause of the muddled condition of accounting is the absence of an effective objective of accounting. A balance sheet under the GAAP model appears to show the value of an entity's assets and liabilities as of a specific date, the entity's net worth. But normally it does not because of major flaws in the model: One, some assets and liabilities are omitted. Two, some liabilities are classified as owners' equity. Three, stated dollar amounts are not taken from a common point in time. Four, relevant value-determining economic events are ignored.

The consequence is that financial statements do not provide information that is adequate for effective decision making by managers, investors, financial analysts, or regulators in a dynamic economy. And they do not provide early warning signals of deteriorating financial health of individual entities or entire industries, signals that are strong enough to invoke capital market or regulatory actions.

A fundamental solution to the inadequacy of the current accounting model starts by adopting a realistic objective of accounting: the measurement of an entity's wealth for the purpose of diagnosing the entity's financial health. With that objective, a balance sheet would display the components of an entity's wealth, assets and liabilities, and the owners' equity in those assets and liabilities. Owners' equity would measure the entity's real economic net worth. An income statement would display the change in wealth, entity income (or earnings). The author proposes a new accounting model based on the wealth measurement objective.

The proposed new accounting model would set the stage for a new standard-setting model. The stage is set because the new accounting model resolves by its own terms, with minimal implementation guidance, most of



the issues that have consumed standard setters' time for the last 80 years. And, perhaps more fundamentally, it shifts the whole accounting system from a fluffy debating society model to a rigorous economic measurement model.

Like the current GAAP accounting model, the current accounting standard-setting model suffers from major flaws: It is disgracefully slow in resolving problems because of labyrinthine due process. It is rife with conflicts of interest because reporting entities heavily influence the terms of their own accountability in reporting to shareholders and the public. It is largely focused on specific transactions so standard-setting effort is fragmented and ineffectual beyond the narrow scope of most projects. And, it fosters buck-passing from practicing accountants to standard setters because dubious self-serving accounting practices at the entity level can survive for years if bucked up the line for standard setters to resolve. The author proposes a new standard-setting model that, in conjunction with the proposed accounting model, corrects those flaws.

The author contends that had those two proposed new models been in place before the financial meltdowns of the late 1980s and of 2007++ , those meltdowns could have been held to a lower level of severity by market and regulatory actions. That is because the epicenter of financial crises is real net worth, wealth, not book value as calculated under current GAAP. The proposed new accounting model is built on the objective of measuring real net worth, and changes in real net worth, or earnings. Shrinking real earnings and shrinking real net worth would be reported each balance sheet date. They would be headline-grabbing numbers prompting managers, investors, analysts, and regulators to more closely scrutinize an entity's financial health. Moreover, unlike the GAAP model, the wealth measurement early warning model produces information that is comparable from entity to entity and from time period to time period. These comparability dimensions would greatly facilitate market and regulatory scrutiny.

David Mosso

# CHAPTER 1

## MAKING AMENDS: REFLECTIONS OF A STANDARD SETTER

Prologue: A double-entry system of accounts can be a powerful tool for managing the economic activities of a business enterprise or any other kind of organization. A double-entry system brings order and discipline to economic data. However, the data inputs to the system must be of high quality, otherwise the outputs from the system will be data garbage – neatly stacked garbage, befitting an orderly system, but garbage nonetheless.

### THE MUDDLE WE'RE IN

Accounting today is a shameful mess. The accounting model is like a pile of junkyard parts cobbled together with duct tape and baling wire. It is an anachronism from simpler times unable to cope with the pace and complexity of modern economies. Both the accounting model and the process for developing and maintaining it are broken beyond simple repair. They need to be stripped down and rebuilt for accounting in the twenty-first century.

I spent three decades in helping to create the accounting mess called generally accepted accounting principles, or GAAP. This book is an attempt to make amends. I try to make amends by writing down some lessons learned along the way and by outlining some thoughts on actions that would make accounting a more effective decision tool. If the ideas expressed herein seem revolutionary, my response is that revolution is long overdue.

Accounting for economic activities should be a rigorous measurement process instead of, as now, a pick-and-choose allocation process. Accounting reports should be tools for diagnosing financial health instead of, as now, tools for disguising financial health. Accounting reports should provide early warning signals of impending financial crises instead of, as now, devices for suppressing warning signals. Accounting reports should provide information that is comparable among reporting entities instead of,

as now, discordant numbers with little in common from line to line or from entity to entity.

Moreover, accounting standards should be capable of being applied by practicing accountants with relative ease and confidence without prolonged wrangling through an elaborate time-consuming legislative style process.

I address my comments to the financial community at large, but especially to the academic community because accounting professors are the only group with the untainted standing to represent the public interest. Professors have the collective ability to lead the charge for constructive change through direct involvement in the present-day rough-and-tumble arena of accounting policy making and through preparation of the next generation of accountants to think more critically about the clutter and contradictions they will encounter in accounting textbooks and, after graduation, in job requirements and client pressures. A determination to take on an advocacy role for better accounting could put academic accountants back into a leadership role for accounting policy development: back, that is, to reasserting the intellectual power and influence of predecessors such as Henry Rand Hatfield and William A. Paton.

Financial analysts could also contribute to promoting change in accounting. They would benefit from an accounting system that provides maximum comparability among entities' financial statements, quick blockage of dubious accounting practices, and an easier way to participate in the accounting standard-setting process.

Practicing accountants and standard setters are not treated gently in my comments but they too have an interest in change, perhaps more than other segments of the profession. They have much to lose if they do not actively work to divert the profession from its long steady slide toward government co-option.

## **TWO NEW MODELS**

Reflections on my standard-setting experience have led me to propose two interrelated new models for rescuing accounting from its dismal swamp.

One is a rigorous new accounting model designed to diagnose an entity's financial health, to enhance economic comparability among entities, and to provide early warning of financial difficulties. I call it the wealth measurement model or alternatively, in some contexts for emphasis in the midst of the 2007++ global financial meltdown, the early warning model.

The second is a new standard-setting model designed to speed up standard-setting decisions, realign standard-setting responsibilities, and

focus standard setting on economic measurement instead of on wrangling with industry lobbyists. I call it the quick response standard-setting model.

My references to the current accounting model are mostly to the conceptual framework adopted by the Financial Accounting Standards Board (FASB) (FASB, 2002). It was a major step in the development of the accounting model, but it fell short of preparing accounting for the twenty-first century. I helped to develop that framework and I share the blame for its many shortcomings. The FASB's conceptual framework was the first of such documents and was used as a guide by other standard setters in developing their own versions.

Throughout this book I use *accounting*, *financial statements*, and *financial reporting* more or less interchangeably depending on the context.

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## CHAPTER 2

# PACIOLI SUMS IT UP: A HISTORICAL PERSPECTIVE

Prologue: About the time that Christopher Columbus was tooling around the Caribbean looking for a shorter route to the Far East spice trade, another Italian named Luca Pacioli was developing a tool for keeping track of merchant trading activities. Unlike Columbus, Pacioli did not have a country named after him but his double-entry accounting system became “the language of business” for the entire world.

### IN THE BEGINNING

Archeologists have often found accounting records to be the first evidence of written communications in ancient societies. Frequently those communications would be between kings and their storekeepers concerning stores of grain, gold, and other valuables. I presume that kings had two reasons for requiring accounting records: One, they needed a tally of their wealth so they could plan how to use it for whatever kings do – such as military conquest, bribery, harems, and such. Two, they needed a means of keeping custodians of the king’s wealth reasonably honest in the face of great temptation. Thus, accounting as a tool for managing wealth and establishing accountability seems to be one of the foundation blocks of civilization.

As far as I know, archeologists have discovered only what today we would call single-entry accounting systems. Luca Pacioli, an Italian monk and a mathematician by training, was the first to write a textbook on double-entry accrual accounting. It was published in 1494 as one part of a larger work entitled *Summa de Arithmetica, Geometria, Proportioni et Proportionalita* (Pacioli, 1494).

Pacioli did not invent double-entry accounting. It had developed as a business practice by the merchants of Venice. Pacioli systematized those practices and set them down in an accounting manual. Although Pacioli was not the inventor of double entry, he had an exceptional understanding of the power of the simple mathematical formula,  $a = b + c$ , to facilitate control of

business activities where “*a*,” “*b*,” and “*c*” are made to represent assets, liabilities, and owners’ equity, respectively. He also had the exceptional pedagogical ability to articulate the double-entry model so clearly that it has withstood the test of time with changes only to accommodate evolving business activity. After 500 years, Pacioli’s double-entry system is still the rock solid foundation of accounting. Among Pacioli’s words that have echoed down through the centuries are the accounting student’s first learning hurdle: “The debit entry must always be put on the left; the credit entry on the right” (Pacioli, 1494, p. 25).

Incidentally, Pacioli was also the first to write a book on magic tricks. Pacioli did not mix accounting practice with magic tricks, but modern accountants have occasionally done so. “Creative” accounting it has been called, a blend of ledger and legerdemain.

## EVOLUTION FOR BETTER AND FOR WORSE

Pacioli’s accounting model had three components:

- One, a classification scheme with three basic classes (now called elements), namely, assets, liabilities, and owners’ equity;
- Two, a pair of universal principles for recognizing and measuring assets and liabilities, namely, that *all* assets and liabilities should be recorded in the books of account, and that *all* assets and liabilities should be measured initially at their cash value; and
- Three, a double-entry bookkeeping system that bound components one and two together to construct a coherent model of an entity’s economic activities.

Pacioli’s model was developed when trading activities were the dominant form of business enterprise. The big business model of that time was the seafaring venture (recall Antonio’s poor-mouthing response to a would-be borrower in *The Merchant of Venice*: “Thou know’st that all my fortunes are at sea; neither have I money, nor commodity . . .”) (Shakespeare, 1602, *Merchant of Venice*, I, i, p. 177). Single-owner proprietorships and multiple-owner limited-life joint ventures were the prevalent forms of business organization. As business activities evolved in scale and complexity, accounting followed. Limited-life trading ventures gradually transitioned to continuous, going concern, operations as with the East India Company. That change brought with it a larger ownership base and new forms of

business organization, companies with transferable shares. The going concern phenomenon coupled with widespread absentee ownership brought a need for periodic distributions of profits in contrast to definitive end-of-voyage profit distributions.

On the one hand, adding new features to Pacioli's model, such as depreciation, helped accounting cope with new and expanding business activities. On the other hand, departure from the universal, no-choice, cash value foundation of Pacioli's model has diminished the usefulness of accounting. The second component of Pacioli's model clearly stated that every asset, no matter how it was acquired and no matter whether it was monetary or nonmonetary by nature, should be booked, no choice, and it should be booked at its cash value, no choice. He illustrated that with an example of a barter exchange showing that gain or loss on a nonmonetary exchange would be the difference between the current cash value of the asset received and the initial cash value of the asset given up (Pacioli, 1494, p. 60).

Somewhere along the line that simple set of universal no-choice principles for initial recognition and measurement was severely compromised. For one example, in a pure barter exchange of nonmonetary assets, the asset received was allowed to be recorded at the book value of the asset given up. That was contrary to Pacioli's explicit illustration. It had the effect of rolling losses forward, thereby deferring loss recognition in the income statement and leaving disemboweled historical cost cadavers on the balance sheet. In the last century, this rolling loss phenomenon came to permeate accounting in a variety of transaction types, both monetary and nonmonetary. In a loan refinancing transaction in which the new loan was recorded at the value of the old loan, one insightful wag captured the essence of the practice in the aphorism "a rolling loan gathers no loss." Gains could be deferred too, but immediate recognition was more readily tolerated.

The rolling loss phenomenon is only one of many problems with present-day accounting, but I belabor it a bit here because it illuminates some important points that I will deal with later.

- Rolling losses demonstrate the metastasizing consequences of making exceptions to basic principles. Netting assets against liabilities, timing discretionary gains to cover up losses, burying losses in dark corners of the equity section instead of in the income statement, burying losses in "special purpose entities," labeling losses "extraordinary," and putting them below the "net income" line – those are other ways that entities' financial health has been disguised by exceptions to basic principles. The central purpose of those kinds of tinkering with financial statements is



always to mislead shareholders and potential investors. Often the intent is to muffle alarm bells that might signal rough going ahead.

- Rolling losses also demonstrate the difficulty of eliminating exceptions once they become embedded. Five centuries after Pacioli, the Accounting Principles Board in its Opinion 29 (FARS, 2008, APB 29, par. 18–23) tried to restore Pacioli’s principle of recognizing gains and losses on nonmonetary exchanges to eliminate widespread exceptions in practice. In about 90 sentences, as compared to Pacioli’s 3, the Opinion concluded that Pacioli’s principle should be followed – *except* for this, *except* for that, *except* for some other things. Modern standard setting showcased!

Pacioli’s model matched the current cash value of a sale against the historical cash value of a purchase to arrive at profit. The model did not have a period concept. Profit was recorded in the year of sale even though the purchase may have been in a prior year. So for 500 years, accountants have wrestled with the problems of periodic income measurement.

# CHAPTER 3

## WEALTH MEASUREMENT: AN EARLY WARNING MODEL

Prologue: A model needs to have a well-defined objective so that each component of the model contributes to achieving that objective. Whether it is a mechanical model, like a butchers' scale or an airplane, or a mathematical simulation, like an economic model of gross domestic product or of enterprise net income, a clear objective helps the model builder design each part in a way to maximize achievement of the model's objective.

### **FUNDAMENTAL PROBLEMS WITH THE CURRENT ACCOUNTING MODEL**

As startling as it may seem, the current accounting model has no clear objective! One whole FASB concepts statement of the original five conceptual framework statements is entitled "Objectives of Financial Reporting" (FASB, 2002, CON 1, par. 32). But in the 63 paragraphs subsumed under that title there is no single objective that is dominant and no one that is even modestly helpful in decision making about a particular accounting transaction. The statement has objectives like "information that is ... useful in investment and credit decisions ... or ... useful in assessing the enterprise's cash flow prospects." Objectives that broad could be fulfilled by extracting information from the *Wall Street Journal*, accounting degree not required.

The lack of a clear objective is a fatal flaw that undermines the common sense notion of a balance sheet. The words "assets" and "liabilities" are widely understood by lay people to mean things of economic value. On their face, balance sheets imply that they are compilations of all of the named entity's assets and liabilities. The balance sheet display of dollar amounts of line items and the addition and subtraction of those amounts to arrive at totals and subtotals clearly imply that the dollar amounts have some common meaning. Published balance sheets are called statements of financial position as of a particular date and that caption unambiguously

reinforces the common sense notion of value measurement. Anyone who has applied for a loan has had to prepare a balance sheet of sorts and most likely it was designed to include all significant items stated at something like current value. Most business balance sheets do not represent anything like those common sense lay perceptions.

Absence of a clear objective does not directly affect the content of the balance sheet, but it is largely the cause of four fundamental problems that do.

The first of those fundamental problems is that the balance sheet is often incomplete. It omits some assets and liabilities that have demonstrable economic value, such as many intangible assets and most lease liabilities.

A second and related problem is that the current model misclassifies some liabilities as equity shares such as options written on an entity's own stock. Thus, the liability element of the balance sheet is often understated and the equity element is overstated.

A third problem is that the balance sheet is stated in many diverse and inconsistent units of monetary measure. The balance sheet violates the mathematical principle that, put in layman terms, "you cannot add apples and oranges."

A fourth problem is that the current model by its design delays the reporting of the effects of many current economic events that would serve as early warning signals and by its flexibility permits managers to delay the reporting of bad news.

As a result of those four problems, the current accounting model permits financial measures of the same or similar things to be reported in many different ways all in accordance with some existing accounting principle. The model suggests that accounting should make like things look alike and different things look different. It does not come close to doing that. The model says that comparability and consistency are desirable qualities of accounting information, but the model produces financial statements that are almost always noncomparable and inconsistent to a large degree (FASB, 2002, CON 2, par. 111–122).

## **A FUNDAMENTAL SOLUTION: A NEW ACCOUNTING MODEL**

The solution to those fundamental problems is a new and far more rigorous accounting model. It is essentially an expanded version of Pacioli's foundational concept of universal, no-choice principles. Pacioli's recognition and initial measurement principles are still valid though often not

practiced. They need to be resurrected, made universal, meaning applicable to all entities, and augmented by four other universal principles, six in total, and pronounced as mandatory standards. They are as follows.

**Principle 1.** The objective of accounting is to measure an entity's economic wealth (net worth) and income (earnings) for the purpose of diagnosing the entity's financial health.

This principle would tell readers what a set of financial statements is supposed to measure. Wealth is the driver of the model. Income is the change in wealth net of owners' capital contributions. The principle's focal terms – income and wealth (alternatively, earnings and net worth) – serve as common sense operational guides for applying the remaining five principles. Wealth is the lifeblood of economic activity. Production, consumption, and accumulation of wealth make up the perpetual cycle of human economic activity. Principle 1 makes that economic cycle the sole focus of accounting.

**Principle 2.** All measurable assets and liabilities of an entity must be recognized on the entity's balance sheet, along with owners' equity in those assets and liabilities.

A tally of wealth must necessarily include all components of wealth, both positive and negative. The principle would have to be accompanied by much tighter definitions of the elements of financial statements – assets, liabilities, and owners' equity – than are part of the current model. A start at tightening the definitions (Principles 2A assets, 2B liabilities, and 2C owners' equity) is set forth in Chapters 9 and 10. The new definition of owners' equity would stand on its own, independent of asset and liability definitions. It would force some instruments now classified as equity into the liability element.

**Principle 3.** All balance sheet assets and liabilities, and changes in them, must be measured at fair value.

This principle would make the balance sheet and income statement genuine measures, albeit estimates, of economic income and wealth. FASB standard FAS 157 (FARS, 2008) prescribes a methodology for estimating fair values. That standard, or its successors, would be the foundation for applying this principle.

There are many exchange value numbers in the economic universe that could be called fair-value measures. For accounting purposes, two broad categories are called entry values (purchase price) and exit values (selling price). FAS 157 requires exit values. Exit values may not be suitable for all purposes, but FAS 157 makes them a baseline from which entry values or

other special purpose value measures can be estimated. Requiring all entities to use the same value concept in their financial reports would provide a comparability tool that has never existed in accounting.

This principle is the heart of the early warning features of the new model although each of the other principles contributes in its own way.

**Principle 4.** All issues and redemptions of owners' equity shares must be measured at fair value with gain or loss recognition in earnings for any difference between the fair value of shares and the fair value of things received or given in exchange.

This principle would complete the fair-value measurement theme of this model. In conjunction with a tighter definition of owners' equity (Principle 2C), this principle would shine light on a dark corner of the current accounting model and draw a clean line between owners' capital contributions and entity earnings. It would force some gains and losses out of the capital section of owners' equity into the retained earnings section and thereby preserve the fundamental economic distinction between return of and return on equity investment.

**Principle 5.** All major nonmeasurable assets, liabilities, commitments, and contingencies of an entity must be disclosed in notes to the financial statements.

This principle would assure that significant but not presently recognizable assets and liabilities are kept in front of financial statement users to enable them to assess the potential impact on an entity's future financial health.

**Principle 6.** The primary financial statements (the balance sheet displaying wealth and the income statement displaying change in wealth, i.e., earnings) must be segmented and supplemented in a manner to facilitate the diagnosis of an entity's present financial health and its future prospects.

Two display matters are particularly important to the new model. For early warning purposes, there should be only one income statement with change in wealth (earnings) as the bottom line. The income statement should be segmented into two major components with subsegmentation and delineation within each as appropriate for diagnosing financial health. One major component should deal with unrealized gains and losses and the other should deal with operating revenues and expenses.

Most of the display and consolidation practices in the current GAAP model are transferable to this new model. The FASB and the International Accounting Standards Board (IASB) have an ongoing project on financial

statement presentation, or display, issues, including consolidation of related entities (FASB-IASB, 2008). Whatever comes out of that project will no doubt be compatible with this new wealth measurement early warning model. In addition, the CFA Institute recently published its views on financial statement display in a paper entitled “A Comprehensive Business Reporting Model” (CFA, 2007). That paper endorses fair-value measurements.

## **A COMPLETE MEASUREMENT MODEL**

Those six basic principles – including the supporting principles dealing with strengthened definitions of assets, liabilities, and owners’ equity – constitute a complete accounting model, an economic measurement model.

## **ANALOGY TO STANDARDS OF WEIGHTS AND MEASURES**

A useful way to think about the wealth measurement model is that it represents the financial equivalent of the standards of weights and measures used in all other commercial and scientific endeavors. Like standardized units of weight, length, time, or volume, fair value has been defined in FAS 157 by reference to observable real-world phenomena. Also like other standard measures, fair value would be applicable universally to all kinds of entities and all kinds of transactions across all industries. The long time will-o-the-wisp goal of achieving universal comparability of financial reporting information would be within grasp, subject only to application and estimation errors.

Standard weights and measures have been a feature of civilization since prehistoric times. Adopting the wealth measurement model would raise financial statements to a level of integrity similar to the scales in a butcher shop. For the first time, an investor would get protection from arbitrary measurement equivalent to that of a butcher’s customer – with equivalent risk of getting a thumb on the scale, of course.

## **IMPERATIVES FOR IMPLEMENTATION**

Although the six basic principles constitute a complete accounting model, they need to be implemented by clear rules firmly applied. Following are three imperatives.

**Rule 1.** It is imperative that the six principles be adopted as mandatory standards, not as nonauthoritative concepts.

Mandatory standards are a guide to real word practice. Nonauthoritative concepts are an agenda for debate without end. Case in point, the current standard-setting process can be described as a debating society model. Nonetheless, the FASB and the IASB, in a joint project to develop an improved conceptual framework, have tentatively decided to continue the debating society model (FASB-IASB, 2008). If the six basic wealth measurement principles were adopted as standards, *there would be no need for a separate conceptual framework of accounting* except as an educational vehicle for explaining the rationale underlying the wealth measurement and early warning model. Likewise, there would be no need for most existing accounting standards except for excerpts to serve as implementation guides for the six basic principles of the wealth measurement model.

**Rule 2.** It is imperative that the six principles be applied universally to all kinds of entity – without choice, without exception. The mantra for implementation should be: All on, all fair – universal, no choice, no exceptions.

To measure economic income and wealth *all* components of wealth must be recognized on the balance sheet and they must *all* be measured at *fair* value. However, to be optimally successful in a lobbyist infested accounting world, “all on” and “all fair” need to be conjoined with the words “universal, no choice, no exceptions.”

**Rule 3.** It is imperative that recognition and measurement principles be rigorously applied, continuously improved, and constantly adapted to new circumstances and new measurement technologies.

FAS 157 establishes a comprehensive methodology for measuring fair value. This book outlines a process for developing a similarly comprehensive standard for recognition of the elements of financial statements. The new quick response standard-setting model, discussed later, is structured so that continuous updating of both recognition and measurement standards would be built into the standard-setting process.

# CHAPTER 4

## WEALTH MEASUREMENT: THE COMPARABILITY PAYOFF

Prologue: Comparison is the scale on which decisions are weighed.

### DECISION MAKERS

Accounting is a decision maker's tool. It can be useful to anyone with a decision-making interest in the economic activities of a particular entity.

The current accounting model is focused primarily on investment and credit decisions, that is, buy-sell-hold decisions about equity or credit instruments of business enterprises. The wealth measurement model is meant to be useful for all classes of decision makers: To external investors and financial analysts and their investment and credit decisions as with the current model, to shareholders and their decisions about such things as hiring-firing-compensating the CEO, to directors and their decisions about such things as corporate governance and dividend policy, to top executives and their decisions about such things as strategic direction and product lines, to division managers and their decisions about such things as operating methods and technology policy, to regulators and their decisions about market efficiency and fairness and about popping financial bubbles before they burst out of control. All of those decisions, and many others, would be enhanced by information from the wealth measurement accounting model.

Just as it is applicable to all classes of decision makers, the wealth measurement model is meant to be applicable to all kinds of organization: business, government, and not-for-profit.

### ACCOUNTING FOR WEALTH

Wealth is a timeless and universally understood concept. Wealth is the central measure of the financial health of an entity. Diagnostic



readouts from financial statements of profitability, liquidity, solvency, sustainability – all look at different aspects of wealth. Both the current model and the wealth measurement model are concerned with an entity's wealth. But they differ dramatically in how wealth is accounted for.

First, the balance sheet of the wealth measurement model includes all measurable items of an entity's wealth. In contrast, the balance sheet of the current model often omits some items of wealth.

Second, the balance sheet of the wealth measurement model measures everything at fair value as of the balance sheet date. Thus, all values are expressed in dollars of equal purchasing power on that date. In contrast, the balance sheet of the current model shows some items at fair value as of the balance sheet date, some items at fair value as of the items' origination dates (historical cost), and some items at a residual amount after historical cost has been fed into income over the intervening years through various allocation formulas. Inevitably, during those intervening years there will have been supply and demand changes affecting the value of individual balance sheet items and price level changes affecting the value of the dollar.

The gist of those two differences is that the owners' equity element of the wealth measurement model represents estimated total wealth that belongs to and is controlled by owners on a specific date. In contrast, the owners' equity element of the current model does not represent anything definable or rationally explainable – it is a residual of many different recognition, measurement and allocation methods.

A wealth measurement balance sheet stands as a bridge between an entity's past and future – its accumulation of wealth to date and its prospects for future accumulation. From that bridge, an analyst can look back on all of an entity's past economic transactions and events leading up to the bridge and forward to trends and forecasts of economic transactions and events into the entity's future.

The current model, in contrast, represents an archaic stewardship notion that requires only that the accounting model keep track of the numbers of economic things going in and out of an entity without regard to changing economic conditions. The current model is in no way like a bridge. It is more like a swamp that analysts have to wade through to get an occasional murky glimpse of either past or future.

Many financial analysts rely on the current accounting model because they are not accountants and do not have time to acquire an understanding of the body of esoteric rules that make up the current model. They put their (misguided) faith in professional accountants to give them good information. Other analysts have mastered the accounting rules to the point that they know

many of the deficiencies of the model. They try to compensate by adjusting the present model to construct a rough substitute for the wealth measurement fair value bridge. In the absence of insider information, however, even knowledgeable analysts are forced to adjust the current model's balance sheet numbers by rough estimates, rules-of-thumb, rumors, hunches, or personal black boxes. That is why accountants have earned their pejorative label of "bean counters," meaning: Count things and add up the attached dollar signs regardless of how or when the dollar signs became attached.

## **COMPARISON: THE HEART OF FINANCIAL ANALYSIS**

Comparison is the heart of financial analysis. Analysts, whether for external investment decisions or internal management decisions, need to make comparisons between line items in the financial statements of a single entity, between different entities reporting in the same currency unit, between different entities reporting in different currency units, and between any of those entities reporting at different points in time.

All of those comparisons can be made easily in the wealth measurement model with reasonable reliability within the limitations of estimation methodologies and classification differences. Comparison between line items of a single entity's financial statements can be made easily and reliably because all line items are measured in US dollars (or other currency unit) of equal purchasing power as of the balance sheet date, no adjustment necessary. The same is true for comparison of any two entities reporting in dollars as of the same date. Comparison between a dollar reporting entity and foreign currency reporting entity as of the same date can be made by a simple translation of one set of statements into the currency of the other at the exchange rate on the balance sheet date. Comparison of the financial statements of a single entity between two points in time or for multiyear trends can be made by adjusting the statements by a price level index for any chosen point in time. Everything needed by an analyst is on the face of financial statements except for foreign exchange rates and price indexes and those are readily available in public records.

Contrast the ease and reliability of comparison under that wealth measurement model with the current accounting model. The current model combines amounts calculated by different methods (several variants of historical cost and several variants, until FAS 157, of fair value) and from different time periods. Within a single line of a balance sheet, for example,

you might have some inventory items at FIFO and some at LIFO. You might calculate a current ratio by combining that mixed-bag inventory number with receivables and payables at undiscounted net realizable value, plus cash and marketable securities at mark-to-market values. Between entities you might compare that current ratio with the current ratio of another entity, which values inventory at average historical cost, receivables and payables at discounted net realizable value, and marketable securities at lower of cost or market. That example just covers the small stuff. Throw in fixed and intangible assets, leases, deferred taxes, pension, and health care liabilities, and a batch of hedges, and you are in a numbers swamp where comparability is a dirty word. Moreover, the swamp is more treacherous than the measurement mess makes it look because it is pitted with holes created by unrecognized assets and liabilities.

In sum, none of the basic comparisons – between line items of a single statement, between entities reporting in a common currency, between entities reporting in different currencies, between any single entity at different points in time – can be made easily or reliably in the current accounting model. The best an analyst can hope for is that the two sides of a dollar amount comparison will each be in the ball park of what they purport to represent. And in the case of cross currency and cross time period comparisons, an external analyst cannot even get in the ball park without access to the internal accounting records of the entity involved and then only with tedious adjustments.

## **RATIOS AND SUCH**

Ratios are a form of comparison that is critically important for analytic purposes. Because of the deficiencies just noted, all ratios derived from the current accounting model are suspect. At best they are only rough approximations of what they purport to represent.

Consider, for example, that all the recognition and measurement flaws in the current model eventually get dumped into earnings and earnings get dumped into owners' equity. Four of the most cited ratios in financial market analysis are earnings or equity based: price to earnings, debt to equity, price-to-book value, and return on equity. Major investment decisions are predicated in part on those ratios without understanding or acknowledging that earnings and equity are junk numbers. The wealth measurement model would put all of those ratios on a fair value basis and

that would turn the ratios into reliable measures, within the limitations of estimating methodologies, of what they purport to represent.

All ratios would be vastly improved under the wealth measurement model, but I would single out one for special comment. That is the ratio of return on equity. That ratio should be the centerpiece of financial analysis because in a competitive market economy return on equity is what entities seek to maximize for the benefit of owners. Sadly, under the current model earnings is the trash can of the accounting process and owners' equity is the dumpster. Thus, the ratio of return on equity is a mixed bag of value distortions that make it an indicator of dubious reliability.

Under the wealth measurement model, the ratio of earnings to owners' equity would become a realistic economic measure of total return on owners' investment. Total return on investment is the common measure by which all kinds of investments are compared and evaluated. The ratio would be useful for comparison of an entity's rate of return over a series of years and for comparison to other entities and for comparison to other types of investments such as real estate, bonds, or commodities.

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# CHAPTER 5

## WEALTH MEASUREMENT: THE “Q” FACTOR AND GOODWILL

Prologue: There is a symbiotic relationship between the accounting-determined fair value of the equity element on an entity's balance sheet and the market-determined value of that same element as measured by share price times number of shares outstanding. In one sense the two valuations are independent of one another because they are determined by different people and by different estimating processes. But the market uses information from the entity's accounting system to arrive at share price, and entity management uses share price as one factor in its decisions about operating policies and strategic direction.

### THE EQUITY ELEMENT: TWO PERSPECTIVES

This chapter deals with two relationships between market capitalization value ( $MC = \text{share price} \times \text{number of shares outstanding}$ ) and book fair value ( $BV = \text{the difference between assets and liabilities each measured at fair value}$ ).

Both values are based on market expectations about the future. Tension exists because book fair value ( $BV$ ) is based on markets for an entity's individual assets and liabilities; market capitalization value ( $MC$ ) is based on markets for whole entities.  $BV$  markets look to estimated future cash flows only to the extent of the finite productive lives of an entity's individual assets and liabilities.  $MC$  markets look to the entity's future cash flows with no finite time limits. Notionally  $MC$  equals  $BV$  plus or minus expectations about the effect of future events beyond the balance sheet date.

### THE “Q” FACTOR

Economist James Tobin developed a theory for predicting whether capital investment in the economy would increase or decrease. It was expressed by a

ratio he called “q.” In the words of *The Concise Encyclopedia of Economics* “The q is the ratio between the market value of an asset and its replacement cost. Tobin pointed out that if an asset’s q is less than one – that is, the asset’s value is less than its replacement cost – then new investment in similar assets is not profitable” (Tobin, 2007).

I believe that Tobin’s q can be adapted to investment in business entities by letting MC represent the entity’s market value and BV represent the entity’s replacement cost. The ratio of MC to BV is roughly comparable to Tobin’s q, call it Q for this purpose. Although BV measured under FAS 157 is exit value not replacement cost, but it could be adjusted to replacement cost for computing this ratio.

A Q less than one would indicate on the surface that an entity is underperforming. Other things equal, it would appear that the entity’s mix of assets and liabilities could more profitably be employed in other ways or sold to another entity with better uses for them. An analyst would have to dig deeper to see if the apparent problem is just a temporary aberration or something more fundamental. In any event, a Q less than one would be a condition calling for management and analyst attention.

I use this example to show how the wealth measurement model can bring more useful tools for analytic purposes. In the current accounting model, price-to-book (or MC-to-BV) is a flaky number – price divided by the contents of a trash dumpster. In the wealth measurement model, price-to-book becomes a valid and useful analytic tool. If all entities were using the wealth measurement model, the Q ratio would be a valid comparative tool for both management and investor decision making.

## **PASSIVE GOODWILL**

The ratio of MC to BV approximates Tobin’s q. The difference, MC minus BV, resembles the concept of goodwill.

Under the current accounting model, goodwill is measured and accounted for upon acquisition of one entity by another as the difference between the purchase price of an acquired entity and the sum of the fair values of the acquired entity’s individual assets and liabilities. Fair values are measured only as of the acquisition date. Under the wealth measurement model, on the other hand, fair values of assets and liabilities are determined at each reporting date. Thus under the wealth measurement model, MC minus BV can be seen as a kind of running goodwill measure determined by passive (i.e., noncontrolling, nonacquisitive) shareholders. It measures passive

shareholders’ collective perception of the value of a whole entity as compared to the market value of the entity’s individual assets and liabilities.

In the absence of a known acquirer, passive goodwill is not a proxy for purchased goodwill. However, passive goodwill is still an indicator of disparate market perceptions that is worthy of management and investor attention as a measure of entity performance. If a potential acquirer surfaced, passive goodwill would move in the direction of the market’s perception of what the control premium would be. As with the Q ratio, passive goodwill can be calculated under the current accounting model, but it is of dubious value at best because of the flawed nature of the equity number.

## **PURCHASED GOODWILL**

So let’s turn to purchased goodwill. The concept of goodwill has bedeviled the accounting profession and the rest of the financial community from the beginning of corporate acquisitions and mergers. The wealth measurement model would revolutionize and rationalize accounting for goodwill.

Consider this simple example. A debt-free entity with \$1,000 in fair-valued assets and a contra \$1,000 in equity purchases a smaller debt-free entity with \$200 in fair-valued assets and \$200 in owners’ equity. The acquirer pays \$500 for the smaller entity, a control premium of \$300 ( $\$500 - \$200$ ), funded entirely by a cash equity offering. The two entities continue to operate separately for the first year.

Both entities were earning a 20% annual return on equity, \$200 and \$40, respectively, before the merger and continue to earn those returns for the year following the merger. All earnings are paid out as dividends at year-end. The \$300 control premium was justified by the expectation that consolidated return on equity would increase from \$240 to \$360 in the second year of the merger and beyond.

Since the assets of both entities were already measured at fair value, no revaluation was needed to account for the merger. The acquirer paid \$500 for \$200 worth of assets so after the merger the consolidated entity had \$1,200 of fair-valued assets and \$1,500 of stock outstanding. The question is what to do with the \$300 control premium.

Under the current accounting model the \$300 would be booked as an asset, making the balance sheet show \$1,500 of assets and \$1,500 of equity. With that accounting, consolidated return on investment in the first year would fall from 20% ( $\$240/\$1,200$ ) to 16% ( $\$240/\$1,500$ ). Not a very



attractive outcome for a merger that was expected (and no doubt touted to shareholders of both merged entities) to improve future consolidated return.

But a problem arises under the wealth measurement model – goodwill does not qualify as an asset under the model’s tighter definition (to be discussed later). In fact, goodwill does not qualify as an asset even under the current model’s looser definition. But the current model’s definition is only a “nonauthoritative concept,” so an asset is whatever the standard setters permit to be called an asset whether it qualifies conceptually or not.

In the rigorous wealth measurement model an asset is defined by an authoritative standard, not a concept statement. The mandatory asset standard forces a solution to the goodwill problem. Goodwill is a debit and if it is not an asset there is only one thing to do with it (no choice in a Pacioli inspired model) – expense it to equity leaving assets and equity at \$1,200. Return on equity for the first year stays at the premerger rate of 20% ( $\$240/\$1,200$ ) and increases to 30% in the second year ( $\$360/\$1,200$ ). In sum, return on equity of 20% and 30% in the wealth measurement model compares to returns of 16 and 24% in the current model. Booking goodwill as an expense provides a subsequent measure of success that comports with the economic objective of a merger, whereas booking goodwill as an asset depresses return on equity as long as goodwill stays on the books as an asset. What an asset!

In the current accounting model goodwill is like a gangrened thumb that needs to be partially amputated from time to time and bandaged to be as inconspicuous as possible. In the wealth measurement model goodwill disappears in the process of making performance ratios better reflect the economic reality, the effect on financial health, of a merger.

Goodwill under GAAP is a variation on the rolling loss phenomenon. In the classic rolling loss case, the unrealized loss on one asset or liability is rolled into a successor asset or liability. Eventually the loss gets rolled into earnings through depreciation, amortization, or disposition without a replacement. But a business acquisition has no successor asset at inception. So an “asset” is hypothesized, divined might be a better word, and the loss is first parked on the balance sheet and then rolled into earnings over time through amortization or impairment.

## **PURCHASE VERSUS POOLING**

Given that goodwill would no longer be shown as an asset on the balance sheet under the wealth measurement model, and that assets and liabilities

would always be carried at fair value, what happens to the perennial dilemma of purchase versus pooling accounting? Along with goodwill, it too would go away. Every merger would be like a pooling in that the merging entities would carry their existing BVs into the combination. Every merger would also be like a purchase except that an excess of purchase price over fair value would be expensed and the whole long-standing controversy over purchase versus pooling would evaporate.

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# CHAPTER 6

## WEALTH MEASUREMENT: EVOLUTION NUDGED

Prologue: Accountability is painful to the executive who is responsible for bad news. The current accounting model is a veritable medicine cabinet full of stuff for relieving accountability pain. Over the years, those afflicted have had a choice of deferring losses, accelerating gains, or using other accounting techniques for offsetting, smoothing, off-lining, dark cornering, and otherwise putting a prettier face on an ugly loss. Current accounting standard setting is largely a process of periodically raiding the medicine cabinet to seize illicit painkillers.

### A REVOLUTION

A serious proposal to adopt the wealth measurement model in lieu of the current GAAP model would be greeted with outrage in most sectors of the business world. Accounting standard-setting bodies would be lobbied and threatened with financial extinction if they made a formal move to consider the proposal. They would be “due processed” into virtual life imprisonment.

Be that as it may, the accounting model is broken. In 1984, the FASB said: “The Board intends future change to occur in the gradual, evolutionary way that has characterized past change” (FASB, 2002, CON 5, par. 2). That prophecy was spot on – accounting change has indeed been gradual, painfully gradual, seeming to approach standstill at times. Unfortunately, business change has not been gradual – it has been accelerating, leaving accounting standard setters and business regulators to sweep up the debris left by bad accounting practice while practice goes on to new creative accounting exploits in a dynamic business environment.

Evolution is not enough. A revolution is much needed. Adopting the wealth measurement early warning model could be the first shot.

## WHY OPPOSITION?

The business community, supported by some in the regulatory community, would throw their substantial resources into defeating a move to the wealth measurement model. The *unspoken* foundation for opposition would be that the wealth measurement model would take away most of the legal strata-gems for postponing accountability for bad news and for smoothing an entity's income stream.

The spoken opposition to the wealth measurement model would be cast in more respectable terms, not so obviously self-incriminating. Opposition would center on the model's alleged adverse effects on investors and the general public. Both the recognition principle (all assets and liabilities on the balance sheet) and the measurement principle (all at fair value) would be attacked.

## OPPOSITION TO "ALL ON" RECOGNITION

As for recognition, there would be fierce opposition to putting leases and other off balance sheet liabilities on the balance sheet and to reclassifying some items from the equity element to the liability element as discussed in Chapter 10. Those actions would affect the debt–equity ratio, a key indicator of financial health.

If measuring real income and real wealth were to be firmly established as the objective of accounting notwithstanding opposition, the arguments against recognizing any particular item on the balance sheet would be reduced to two: Either the item in question is not an item of wealth and therefore not an asset or liability, a legitimate argument, or the item is acknowledged to be an asset or liability but balance sheet recognition would be against public policy.

Whether an item is or is not an asset or liability is essentially a factual issue. The recognition criteria outlined in this book and refined in the quick response standard-setting process should resolve those issues with relative ease and finality.

If an item is judged to be an asset or liability, the fallback position against recognition would almost certainly be a resort to government intervention on the grounds that recognition would cause some kind of hardship or misrepresentation. The investment tax credit, post-employment benefits, and executive stock options are examples of standards that were forged in that crucible. The opposition to fair valuing derivative financial instruments in

the 2007++ crisis took this familiar line of attack with regulators and legislators being lobbied to suspend the application of FAS 157.

## **OPPOSITION TO “ALL FAIR” MEASUREMENT**

Controversy over fair-value measurement versus historical cost allocation has a long history. Opposition to fair-value measurement is generally based on three lines of argument. One is that fair value can never be known except when confirmed by an exchange transaction and that is only for an instant in time. Thus, it is argued that fair-value estimates are so subjective that they are unreliable representations of value and consequently they mislead analysts and permit management to manipulate financial results. A second argument is that fair-value estimates are so volatile from period to period that they produce unstable and misleading financial results. A third argument is that fair-value estimates are not cost-beneficial.

FAS 157 addresses all of those concerns and it cuts through the haze by setting a baseline value, an exit value, with standardized definitions and methodologies that provide comparability across all entities. Variations from that baseline can be used for particular analytic or decision purposes. FAS 157 provides for disclosure of market uncertainties through a hierarchy of measurement sources, called by one cynic mark to market, mark to model, and mark to myth. That is clever but misses the point. Although it is true that fair-value estimates are rarely precise realizable values, the counter argument is that fair values of goods and services and financial instruments are the stuff of business and investment decisions, knowable or not, and a roughly accurate best estimate is far better than a historical cost number that has no relevance at all for current decisions.

Moreover, the process of estimating fair values is as important as the result, perhaps more so. In addition to enhanced comparability and other analytic and decision-making benefits of fair-value estimates, the process of setting up the estimating methodology, gathering data, weighing uncertainties, testing alternatives, and arriving at a best estimate, and then repeating that process each reporting period, provides insights into matters highly relevant to managing an entity and to picking up early warning signs. It focuses attention on the interaction of value-determining variables that would not be under close surveillance in the historical cost allocation process.

If fair value were the measurement standard for all entities, everyone in the financial community would quickly climb the learning curve. New estimating methodologies would be developed. Management estimators,

auditors, and analysts would all become more expert at estimating and using fair values. Fair value would become a well understood medium of communication. That contrasts with the current accounting model of which non-accountants understand virtually nothing about how the dollar amounts are calculated and even expert accountants understand very little about the more complex standards that they do not deal with regularly.

## **VOLATILITY AND EARLY WARNING**

Volatility of earnings is the most cited argument against fair-value measurement. And it is true that under the wealth measurement model earnings would almost always be more volatile than earnings as calculated under the current model because of changes in prices and changes in values of other inputs to estimation models. If earnings were the only number reported, volatility would be a legitimate concern for investors as well as for reporting entities. However, volatility can be dealt with by segmenting the earnings statement into more volatile and less volatile components, keeping operating revenues and expenses separate from uncontrollable price changes and other events.

More important, however, is that volatility is one of the most useful characteristics of fair-value estimates because it serves as the preeminent early warning signal. Volatile income is a curse for a management that wants to have a smooth income stream through good times and bad, and also for a management that wants to defer the reporting of bad news. But the other side of the coin is that volatility is caused by changes in economic conditions that affect an entity. Volatility is itself an important indicator bearing on the diagnosis of financial health. Either bad news or good news is exactly what market analysts and managers need to know as soon as possible to help them diagnose the health of an entity.

## **SUMMARY OF THE BENEFITS OF THE WEALTH MEASUREMENT MODEL**

In the next chapter I turn to the standard-setting process. I will end this chapter with a summary of the major benefits of the wealth measurement model that have been discussed so far in this and preceding chapters. These benefits are in contrast to the current accounting model, which is sadly deficient in all of these features.

One, the model provides a *defining objective*. The objective of measuring wealth is like a keystone in an arch. It keeps all the pieces in place and working together. Further:

- Wealth is widely understood by both lay people and professionals. Thus, it bridges a serious communications gap, an understandability gap that plagues the current accounting model.
- Wealth is measurable, within the limitations of estimating methodologies. Wealth measurement puts accounting in touch with real-time business activities and enhances accounting's value as a decision maker's tool.
- Wealth is the lifeblood of the economy. Change in wealth, income (earnings), is the heartbeat of an entity's financial health. Wealth and income are the logical focus of an accounting model that purports to describe the financial health of an entity.

Two, the model provides maximum *transparency* into an entity's operations and financial health because the *all on* and *all fair* maxims force all components of an entity's earnings and net worth to be included in financial statements, all as of the beginning and ending balance sheet dates.

Three, the model provides *early warning* of impending disasters for an entity and for an industry such as, had the model been in place, the Savings and Loan fiasco of the 1980s and the subprime mortgage crisis of 2007++. That is because financial disaster begins with shrinkage of an entity's real income and real net worth, and those measures are the essence of the wealth measurement model.

Four, the model provides *comparability* between line items of an entity's financial statements, between entities using the same currency, between entities using different currencies, and between any entity's statements at different points in time. Comparison is the prime tool of financial analysis and decision making.

Five, the model provides for greater *accountability* of managers because of greater transparency, item two, and because the *all on* and *all fair* maxims eliminate accounting alternatives that make it easy to disguise management and entity performance.

Six, the model draws a sharp line between liabilities and equity, discussed later, by defining owners' equity in terms of the wealth that owners control for their own benefit. This improves earnings measurement and ratio analysis.

Seven, the model sets the stage for *simplification and acceleration of the standard-setting process* through universal principles that eliminate the need for transaction by transaction standard setting. This point is elaborated in the following two chapters.



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# CHAPTER 7

## STANDARD SETTING: UNDUE PROCESS

Prologue: A fox in the chicken house always creates a bloody mess. The fox has only one problem, which chicken to choose.

### **FUNDAMENTAL PROBLEMS WITH THE CURRENT STANDARD-SETTING PROCESS**

Like the current GAAP accounting model, the current standard-setting process is broken. It is beset with two underlying problems, namely, that the FASB lacks true independence and that the current accounting model is choice based with no clear objective to guide the choices. Those two underlying problems have led to four symptomatic problems as follows.

The first problem is excessive due process. The present form of due process causes delay beyond reason – it takes far too long to complete a standard-setting project. Serious accounting practice problems fester for years while standard setters wrestle with constituents over what is the best way to solve them. Because of all the delaying mechanisms built into the current process, new standards that might throw off early warning signals of impending trouble are suppressed for years.

A second problem is conflict of interest. Entities that issue public financial statements, and have their performance judged by those statements, have far too much influence on the standard-setting process. Entities' interest in having accounting standards that can be manipulated to fuff up reported earnings is in direct conflict with the public interest in having standards that result in reporting on management accountability fully, accurately, and timely.

A third problem is the narrow scope of most standard-setting projects. Most projects focus on only one major issue and a few subsidiary issues. Consequently, few standards apply unambiguously to all entities in all

industries. Transaction by transaction standard setting is like fighting a forest fire one tree at a time.

A fourth problem is buck-passing. The standard-setting process fosters a pass-the-buck attitude among issuers and auditors. Accounting procedures that are not prohibited in the current model can be used until standard setters rule them to be flawed. Issuers are motivated to use the most favorable procedures they can dream up and auditors, if they disagree, are inclined to buck problems up the line to the standard-setting body and use their own professional accounting skills to twist the current model to fit the answers that issuers want.

### **PSEUDO INDEPENDENCE: AUTHORITY WITHOUT POWER**

The FASB has the authority under its charter to adopt the wealth measurement model. It does not have the power. The FASB's power to set standards, stemming from its chartered authority and independence, has proven to be illusory. The best evidence of that is the due process model that the FASB has developed. It is excessive due process by any standard of effective regulation. Excessive due process is attributable to the pseudo-independent status of FASB and to the current choice-based accounting model.

Ever since the crash of 1929, public accounting firms and their corporate clients have been fearful that the federal government would take over the job of setting accounting standards. In fact, the soon to be Securities and Exchange Commission (SEC) was given the authority to do that in the 1933 securities act. The SEC decided, however, to look to the accounting profession to do the job and has for the most part stuck to that decision. But the authority to step in at any time still exists.

The FASB was the third private sector body created to set accounting standards. The first two bodies (the Committee on Accounting Procedures in 1939 and the Accounting Principles Board in 1959) were created as committees within the American Institute of Certified Public Accountants. In the late 1960s, the SEC and the United States Congress became dissatisfied with the APB because of the perception that the APB was unable to resolve controversial accounting issues. That inability was attributed to an inherent conflict of interest in having audit firms, through their representatives on the APB, regulate their respective corporate clients. To counter the implicit threat of an SEC takeover of accounting standard

setting, the FASB was chartered in 1973. The FASB was designed to be independent of the AICPA and of corporations and their auditors.

That was the design, but as a regulatory body without statutory authority (the SEC had that), without enforcement authority (the SEC and the AICPA had that), without a controllable source of financing (the auditing firms and their corporate clients had that), and with a trustee oversight body made up mostly of representatives of audit firms and their corporate clients (the regulated overseeing the regulator), the FASB's independence, and its ability to make tough unpopular decisions, was extremely fragile.

The FASB's survival strategy in that environment was to adopt a form of due process to ensure that everybody's views on a topic were heard. Not only heard by the FASB but, through a wide open "sunshine" process, open for the world to hear and see and read all FASB proceedings. As it turned out, the process ensured that everybody's views would be heard over and over and over again, ad nauseam.

A pattern of "due process" was developed built around sequential exposure of three basic documents for public comment: a DISCUSSION DOCUMENT, a PROPOSED ACCOUNTING STANDARD, and a final ACCOUNTING STANDARD. Each of those three documents entail roughly eight steps of process: (a) formation of and consultation with a task force of experts from the financial reporting community, predominantly from corporations and their auditors, (b) drafting the document and issuing it for comment, (c) analysis of the written comments, (d) a public hearing, predominantly hearing corporations and their auditors, (e) analysis of the hearings comments, (f) numerous Board and staff member speeches in public forums, mainly corporations and their auditors, with feedback about the issues, (g) numerous letters and meetings with industry lobbyists and their representative organizations, and (h) throughout the process, many Board decision-making deliberations, in meetings open to the public, taking into account all the feedback received.

That is, 8 process steps for each document, or 24 steps for each topic covered by the 3 basic documents. Those 24 steps could easily consume two years minimum and usually much longer. For a complex topic, there might be at least two more documents: a PRELIMINARY VIEWS document between the discussion document and the proposed accounting standard and a second version of the PROPOSED ACCOUNTING STANDARD between the first proposed standard and the eventual final standard. That brings us to 40 steps and it does not include implementation guidance after the final standard was issued, often including formal INTERPRETATIONS OR AMENDMENTS to the standard, which entailed another 8 steps each.

Nor does it include quarterly meetings with the Board's standing advisory council and occasional meetings with the SEC Commissioners.

Without genuine independence, the FASB did not have the power to bang the gavel when it had heard enough. Corporate pressure, with auditor support, Congressional pressure, and even White House involvement made gavel banging a risky business, threatening the FASB's existence. So the FASB would stretch due process, striving for a reasonably acceptable solution and usually settling for a diluted solution, or just letting a project die from exhaustion.

I should note that, notwithstanding the time devoted to stroking the corporate financial statement issuer community, the FASB considered the users of financial statements to be the primary beneficiaries of accounting standards. Financial analysts, representing the interests of investors and creditors, were always encouraged, even coaxed, to participate in the standard-setting process. However, the analysts and their professional associations typically did not have much financial backing. Further, analyst participation was an extracurricular, on your own time, activity from the standpoint of the analysts' employers. Major corporations and auditing firms, on the other hand, had pools of talent to throw into the process, both accounting experts and political lobbyists. If their accounting experts could not hammer their views into an FASB proposal, they would go for a bigger hammer in the person of lobbyists who would try to bring Congressional pressure on the SEC and the FASB.

### **CHOICE-BASED STANDARDS: A PICK-AND-CHOOSE MODEL**

Compounding the pseudo-independence problem, the FASB inherited an accounting model filled with choices of allocation and measurement methods and with little or no guidance on recognition criteria. Some choices in the inherited model had been made by earlier standard setters. Those choices had been made transaction by transaction and were often inconsistent with one another because of shifting membership and prejudices of members of the standard-setting body. Some choices had been left to the discretion of the companies issuing financial statements and their auditors.

The FASB's objective in each new project was to eliminate free choice of alternative methods. The existence of a variety of methods complicated and lengthened the process of adopting new standards because every method had its "groupies" who would fight to uphold it as opposed to other

alternatives. Further, the entire business community united and fought vehemently to prevent adoption of any form of fair value.

After its first few years of operation, the FASB attempted to cut a swath through this thicket by adopting a conceptual framework. The hope was that by laying out the essentials of the accounting model, particularly by clearly defining assets and liabilities, the debate about particular accounting issues on the Board's agenda would be focused on those essentials. Everyone, it was hoped, would come to the debate using this common framework instead of their own personal framework.

The conceptual framework helped, but it was intended to be primarily a reference work for the Board itself and not an authoritative standard that must be followed in practice. In hindsight, I am certain that was a serious mistake. Had the asset and liability definitions been made mandatory standards, they would have been applicable across all industries. Accounting practice would have been messy for a transition period, but it would have straightened itself out. As it turned out, accounting practice has been messy anyway for over three decades and the straightening out process is not yet in sight.

The conceptual framework did nothing to establish operable recognition criteria. More importantly, the framework did not even try to eliminate choice of methods. In fact, the framework implicitly endorsed alternative methods by devoting one whole concepts statement, CON 2, to so-called qualitative characteristics: "...the qualities to be sought when accounting *choices* are made" (FASB, 2002, CON 2, par. 5). [My emphasis] Unfortunately, the 10 or so qualitative characteristics described in CON 2 are truisms. They are essential qualities of any good measurement system but they are consequences not causes.

My butchers' scale has all of the CON 2 characteristics, the current accounting model has none. The difference is that the butchers' scale has a clear objective, a design to achieve it, and an inspection process to maintain its integrity. The accounting model does not. The moral is: Establish a clear measurement objective and the characteristics will follow naturally. Meanwhile, the continued existence of the characteristics in the FASB conceptual framework fosters the post-Pacioli mythology that choice is acceptable and promotes due process as a vehicle for perpetuating the aimless model through endless wrangling about multiple alternatives.

In another major endorsement of choice, the FASB identified five "measurement attributes" in the then-current accounting model and said: "The Board expects the use of different attributes to continue" (FASB, 2002, CON 2, par. 66). That was in 1984. The attributes are still with us. The five attributes listed were: historical cost, current cost, current market value,

net realizable value, and present value of future cash flows. But five understates the problem. There are many variations of each.

I have noted before that the most explosive choice in standard setting has been between historical cost allocation and fair-value measurement. FASB wrestled with this issue throughout the development of its conceptual framework, but it concluded with this statement in CON 5: “Information based on current prices should be recognized if it is sufficiently relevant and reliable to justify the costs involved and more relevant than alternative information” (FASB, 2002, CON 2, par. 90). That is not a concept. It is a waffle.

### **A MODEL FROM GREEK MYTHOLOGY**

The current choice-based accounting model has turned the standard-setting process into a gargantuan maze. The toleration of choice has planted and fertilized seeds of controversy around virtually every line item of every document that the FASB has ever issued. The most basic problem with choice is that there is no way to prove that one allocation method is better than another – it all depends on what “feels right” to each participant in the standard-setting process.

In the absence of a rigorous measurement model and a fully independent and forceful standard setter, companies have contested the adoption of any accounting procedure that would make their financial statements look less favorable or that would reduce their flexibility in manipulating reported earnings.

The “due process” that has evolved over the years is much like the mythical labyrinth on the island of Crete where the Minotaur lurked. The Minotaur was a people eater. The labyrinth was so complex that anyone who went in to kill the Minotaur would get lost, if not eaten, and never return. The modern day accounting analogue to the Minotaur is the current historical cost accounting model. It feeds on fuzzy numbers and gullible investors and hides in a labyrinth called “due process.” (Note: Legend has it that a Greek named Theseus went into the labyrinth, slew the Minotaur, and found his way out by following a string held by a friend on the outside. Accountants are still lost in the historical cost–due process labyrinth.)

Standard setters could get out of their labyrinth by adopting the wealth measurement model (it has a sword and a string). But to adopt that model, they would have to follow their formal due process outlined above. Following current due process would make it virtually impossible to adopt the wealth measurement and quick response models. Catch 22!

## CHAPTER 8

# STANDARD SETTING: A QUICK RESPONSE MODEL

Prologue: The current accounting model makes accounting standard setters look like baseball umpires. The model does not by its own terms make any of the close calls on accounting for particular transactions. It passes the buck to standard setters. To a question like “does this transaction create an asset or an expense?” the standard setters’ answer might well paraphrase umpire Bill Klem who said when asked if a pitch close to the plate was a ball or a strike: “It ain’t nothin’ ‘till I call it”(Klem, 2008). When shown a photo proving a runner he had called out was clearly safe, Mr. Klem said: “Gentlemen, he was out because I said he was out.” In a “mixed attribute” model with no defining objective, standard setters have had to adopt the Bill Klem approach: “It is what we call it.” Goodwill is an example of a Bill Klem asset.

### **THE WEALTH MEASUREMENT MODEL SETS THE STAGE**

The wealth measurement early warning model would set the stage for overhauling the standard-setting process. The model itself substantially answers most recognition and measurement questions and is tight enough that practitioners can apply it in most cases without standard-setter intervention. Following are some of the perennial standard-setting issues that would be solved by adopting the wealth measurement model. These issues have consumed most of standard setters’ time over the past 80 years or so. The wealth measurement model resolves them as briefly noted in each case:

- All fair value versus historical cost allocation issues. (Fair value is universal in the wealth measurement model so there is nothing to deliberate.)
- All cost allocation issues. To name only two: inventory at FIFO versus LIFO; financial instruments at cost only versus market only versus cost or market whichever is lower versus net realizable value. (Fair value is universal so there is nothing to deliberate.)



- All goodwill acquisition and disposition issues. (Goodwill in the wealth measurement model is by default an expense that enhances the measure of postmerger return on equity.)
- All purchase versus pooling issues. (Expensing goodwill leaves all mergers looking like poolings with nothing to deliberate.)
- All hedge accounting issues. (Universal fair value leaves no option for deferring gains and losses. Hedge matching could be achieved through earnings statement segmentation if standard setters desired.)

Taking all of those issues off the standard-setting agenda, present and future, would free up huge blocks of standard-setting time leaving standard setters to deal with three sets of implementation issues. The three are concerned with applying and improving the six basic principles established by the wealth measurement model to make them better measures of wealth and better instruments for diagnosing financial health. The issues are:

- Implementation issues for basic Principles 2 and 5, balance sheet recognition, and contingency disclosures, respectively. These issues concern how to apply and refine the element definitions, including identification of recognition triggering events.
- Implementation issues for basic Principles 3 and 4, involving refinement of fair-value estimating methodologies.
- Implementation issues for Principle 6, financial statement display involving, as in the current accounting model, statement segmentation and delineation, supplemental note disclosures, and consolidation of related entities.

### **THE QUICK RESPONSE MODEL: A NEW STANDARD-SETTING PROCESS**

The following decision-making model, the quick response model, stresses speed in reaching standard-setting decisions on those three sets of implementation issues.

The role of standard setters in this new model would change from conducting protracted pre-standard due process to conducting speedy resolution of issues in applying the wealth measurement standards. The role of entity accountants and their auditors in the new model would change from advocacy of the entity's preferred accounting treatment to finding

an accounting solution that conforms to the principles of the wealth measurement model.

**Level One.** Financial statement preparers and their auditors would be responsible for applying the principles of the wealth measurement accounting model to all kinds of transactions and events affecting an entity. They would be guided in those decisions by the six basic principles of the wealth measurement model, the measurement standards (FAS 157 and its successors) and a comparable recognition standard (see Chapters 9 and 10), and the generalized precedential standards developed in this new standard-setting model at Level Five. Thus, application decisions would be guided for the most part by standards that define the wealth measurement accounting model, universal, no choice, no exceptions.

**Level Two.** If a highly unusual circumstance were encountered at Level One, the standard setter could be asked by the preparer and auditor to make a quick decision within the time limits of the preparer's financial statement deadline. This would have to be done with little or no due process and probably often without full participation by members of the standard-setting body.

**Level Three.** Levels One and Two decisions would stand unless challenged by an outside party at interest after the financial statements were issued. (Challengers might be, e.g., a financial analyst, the Securities and Exchange Commission [SEC], or the standard-setting body.) An outside challenger could ask the standard-setting body to review the challenged decision and decide whether to let the decision stand without a hearing, or to hold an informal hearing, or to undertake a formal deliberation. Notwithstanding a challenge, the initial decision would stand until the standard setter confirmed or changed it.

**Level Four.** If dubious accounting practices somehow escaped the challenge process in those early steps, the standard setter could adopt, with limited due process, stopgap standards that would be applicable until it could resolve the issue through more extensive due process.

**Level Five.** The standard setter would refine the wealth measurement model by sharpening recognition criteria, measurement methodologies, and financial statement display and disclosures based on experience at Levels One through Four. Entity-specific decisions would be generalized and pronounced as elaborations of the wealth measurement model for application by all entities.

**Level Six.** Issues that could not be resolved with expedited due process at Levels Three, Four, and Five would be given formal deliberation by the standard setter with fuller, but still expedited, due process.

Reducing the extent of due process at all levels is reasonable because of the change from a choice-based model to a measurement model. Because the current accounting model is choice based with no clear objective to guide the choice making, it invites debate, negotiation, and lobbying. The wealth measurement model takes most of the choice out of accounting. It does not take much due process to find the best way to identify and measure an item of wealth.

## INITIAL RESPONSIBILITY

By making the six basic wealth measurement principles mandatory standards rather than nonauthoritative concepts, the burden of getting the accounting right initially would be shifted from standard setters to practitioners. This shift of responsibility would deter auditors from concocting contorted interpretations of accounting literature to satisfy their clients. As mandatory standards under tightened recognition criteria, unreasonable interpretations would subject auditors to challenge by any party at interest and put them at risk to incur professional, regulatory, and legal sanctions plus negative scrutiny by analysts, the media, and others. Professional reputations, lawsuits, license revocations, and SEC sanctions would be in play.

Due process would shift from being predominantly a negotiation process preceding a standard to being predominantly an appeals process following application of the wealth measurement model.

## EARLY WARNING

In addition to quickly resolving most emerging accounting issues, Levels Two, Three, and Four of this new standard-setting process provide an early warning mechanism for spotlighting problems that might under the current standard-setting process take root and spread throughout an industry and beyond as did, for example, varieties of special purpose entities. The current standard-setting process has an emerging issues mechanism but it is a stopgap mechanism with no way to reach a final authoritative solution except through the tedious labyrinth of due process discussed in the next

chapter. The design of the quick response process forces unresolved issues at one level quickly up to the next level until final resolution is reached. Each level in the process is designed to expedite resolution.

## **OBSTACLES**

Notwithstanding the benefits, existing “due process” would make adoption of either the wealth measurement model or the quick response model extremely unlikely without strong outside influence, probably the SEC or the United States Congress. Existing due process is the enemy of change.

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# CHAPTER 9

## COMPONENTS OF WEALTH: ASSETS AND LIABILITIES

Prologue: Economists have long debated the nature of income and wealth. J. R. Hicks defined income something like “well-offness” or “better-offness” at the end of a period as compared to the beginning. That is a common sense definition that helps get any given transaction into or out of the ballpark of income and wealth. It needs help, however, when the decision gets down and dirty with 24 hours to press release time – is this particular item on the balance sheet or off? Is it a ball or a strike?

### RECOGNITION PRINCIPLES

This chapter and the next two are written for standard setters and really serious students of accounting. Less specialized readers can get the gist of the three chapters from the following summary and then skip on to Chapter 12.

The three chapters deal with definitions of the elements of financial statements – assets and liabilities, the positive and negative components of wealth, and owners’ equity in those assets and liabilities. Their purpose is to start fleshing out basic Principle 2 (recognize all assets, liabilities, and owners’ equity) with a set of recognition criteria comparable in comprehensiveness and authoritativeness to the measurement criteria established by FAS 157.

Chapter 9 builds on existing FASB definitions of assets and liabilities by expanding and clarifying them to deal with some problems encountered in the past. The asset and liability definitions are phrased to make the receivable and payable sides of financial claims identical except as to sign. The existence of a promise of wealth transfer is highlighted as the essence of a liability.

Chapter 10 defines owners’ equity independently of liabilities and thereby forces some instruments now classified as equity to be reclassified as liabilities. Ability to withdraw an entity’s net worth for owner benefit is a prime characteristic of equity ownership. Absence of a promise of wealth transfer is a characteristic of an equity share.

Chapter 11 demonstrates how current accounting for equity transactions buries real economic losses in the owners' capital contributions section of the balance sheet and thereby fuzzes up the distinction between return of and return on capital.

## BUILDING ON EXISTING DEFINITIONS

The FASB and most other standard setters have one-sentence definitions of assets and liabilities. Different standard setters use different words but the core meanings are essentially the same. They capture the essence of assets and liabilities. However, they have always generated fierce debate when used for sorting out new and complex transactions in practice. So, while keeping their core meanings, they need to be restructured to make them more explanatory and more integrated with one another. My suggested definitions go beyond one sentence.

## DEFINING ASSETS AND LIABILITIES

There are two essential steps in the recognition process. Does an item meet the definition of an asset or liability? Does the item have a material nonzero value that is material to the financial statements? The first step is the hardest and the only one I will address.

Here are the definitions I suggest for starters.

**Principle 2A.** An asset is a resource that embodies economic benefits that are controlled by a particular entity. Control means that an entity can obtain the embodied economic benefits and prevent other entities from obtaining them. Economic benefits mean monetary instruments, goods, and services, including passive services such as standing ready to act in the event of a contingency or refraining from acting in a manner that would disadvantage other entities.

A claim receivable is an asset that conforms to this definition and also to the counterparty side of the liability definition (Principle 2B).

The terms "other entities" and "counterparty" mean entities, which are either independent of the particular entity that controls the resource or owners of shares of the particular entity acting in nonowner capacities.

An entity may not account for its own reacquired liabilities or equity shares as if they were assets.

The FASB definition is: “Assets are probable future economic benefits obtained or controlled by a particular entity as a result of past transactions” (FASB 2002, CON 6, par. 25).

Principle 2A gets rid of the words “probable future economic benefits” that have caused many interpretation arguments. Some accountants interpreted “probable” as imposing a higher standard than the FASB intended and some thought “future economic benefits” did not fit the description of a present asset. Other changes from the FASB wording deal with issues that have been troublesome in practice and establish the linkage between the asset and liability sides of a claim.

**Principle 2B.** A liability is an unfulfilled binding promise made by a particular entity to transfer specified economic benefits to one or more counterparty entities in determinable amounts at determinable times or on demand. *Binding* means that adverse consequences likely to follow from breaking the promise are significant enough to impel the promise maker to carry out the promise to the best of its ability.

A *binding promise* means any unconditional promise that has been accepted by the promise recipient with reasonable expectation that the promise will be kept, and any conditional promise when the conditions have been met. As in the asset definition, *specified economic benefits* mean monetary instruments, goods, or services.

A binding promise is a claim payable that is equal and opposite to a claim receivable held by one or more counterparty entities. The payable and receivable counterparties must be identifiable, individually or in a representative capacity, and they must be independent of one another or, if they are share owners of their counterparty entity, acting in arms length nonowner capacities.

The FASB definition is: “Liabilities are probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events” (FASB, 2002, CON 6, par. 35).

As with the asset change, Principle 2B gets rid of the futuristic words “probable future sacrifice.” More importantly, it substitutes “unfulfilled binding promise” for present obligations. “Promise” better captures the broad inclusiveness of liabilities as the wealth measurement objective requires and as the FASB intended. The FASB said, in a footnote that few accountants read: “*Obligations* in the definition is broader than *legal obligations*. It is used with its usual general meaning to refer to duties imposed legally or socially; to that which one is bound to do by contract,



promise, moral responsibility, and so forth (*Webster's New World Dictionary*, p. 981). It includes equitable and constructive obligations as well as legal obligations" (FASB, 2002, CON 6, par. 34).

Substituting "binding promise" for "obligation" interprets obligation the way that the FASB explained in Concepts Statement 6 rather than the more legalistic way it has been interpreted in practice. A conditional promise becomes unconditional when the conditions are met, so *unconditional promise is the essence of a liability*. The FASB put this concept in practice in an accounting standard, FAS 116 (FARS, 2008, par. 18). Although that standard applied to business entities, its main focus was on not-for-profit entities and it was largely overlooked in the business community.

To emphasize this important point: Every promise to transfer economic benefits is a potential liability. It becomes a recognizable liability when the promise becomes binding because of adverse consequences that would reasonably follow from breaking the promise.

## ASSET CLASSES AND LIABILITIES

To be recognized on the balance sheet, assets and liabilities must conform to the basic short definitions, as above, but determining whether an item conforms to the definition is not always obvious. In general, the point of recognition is the point at which control over the specified economic benefits is obtained (or relinquished in the case of liabilities). That point is well established for tangible assets and need only be generalized and standardized. The control point is less well established for intangible assets, especially internally generated assets, and more intensive standard setter attention is needed.

Claims receivable are the third class of asset, and their opposites, claims payable, are the only class of liability. Financial engineering in recent years has turned this class into a kind of no man's land of exotic instruments. But close analysis shows that there are only a few generic types and for those types recognition criteria are straight forward. I offer some guidelines for this class.

## CLAIMS RECOGNITION

Claims are two sided, every claim receivable held by one entity is a claim payable by another entity. The two sides are equal and opposite. So we can

economize discussion by identifying criteria that apply to both the asset and liability sides of the balance sheet. Equity shares are not claims in that they do not convey promises to transfer wealth. Owners' equity is defined and discussed in the next chapter.

There are only two broad criteria for recognizing claims: A mutual understanding and a triggering act.

## MUTUAL UNDERSTANDING

The first criterion for recognizing a claim as an asset or a liability is the existence of a *mutual understanding* about the terms of a promise of a future transfer of economic benefits from one entity to another. The understanding can take the form of either a promise undertaken through voluntary negotiation, a contract for example, or a promise undertaken as a condition of membership to comply with mandates or rules of a membership organization, a government, for example.

Mutuality requires that the payable and receivable entities be identifiable. Usually they will be identified in the evidence of the mutual understanding. However, in cases such as environmental clean-up liabilities there are no specific receiving entities for the transferred benefits, only a specified benefiting community. In those cases, the enforcing authority, trustee, or other representative of the receivable parties must be identified as the stand-in for the receivable parties.

Mutual understandings will normally be evidenced by written documents, but they need not be as long as it is clear that the promise embodied in the understanding is binding – legally, morally, equitably, circumstantially, or otherwise. That leads to the second recognition criterion, the triggering act.

## TRIGGERING ACTS

The second criterion for recognizing a claim as an asset or liability is a *triggering act* that makes the future transfer binding on the payable party. The time at which the triggering act occurs is the time of balance sheet recognition. There are four generic triggering acts.

- One, a promise of future payment (or other performance) bound by the triggering act of actual performance by the counterparty in accordance with the terms of the agreement or mandate.

This kind of triggering act is typical in purchase–sale agreements, conditional gift agreements, and authoritative mandates. Payment, or other settlement, comes after performance. Performance of an agreed act is the trigger for recognizing the promise to pay on the balance sheets of the two counterparties. Variations of this trigger are the most common triggering acts for mandates, such as earning taxable income or infractions that lead to fine or forfeiture.

- Two, a promise of future performance bound by the triggering act of prepayment (or other compliant act) in accordance with the terms of an agreement.

This is the opposite of the preceding trigger. Payment precedes performance. Prepayment is common in some industries, it is almost universal for agreements that pay off only if a contingent event occurs. Contingency agreements go by many names, for example, insurance, guarantees, price supports, sureties, or put and call options on anything buyable or sellable. The prepayment is usually simultaneous, or nearly so, with the promise. In some cases, such as government price support programs, there is no prepayment, just a promise bound by qualifying circumstances of farmers or other specified entities.

Whatever they are called, options and other contingency contracts are purchased for protection against the adverse effects of a specified contingent event or as bets or hedges on the direction of a price, an index, or some other contingent variable. The service provided by option writers is to stand ready to pay off if contingent events occur. Option writing is a line of business in its own right, the primary business for some entities, an incidental line for others. Under the current accounting model, some option writers may recognize the premium income when received and postpone liability and loss recognition until the contingent event occurs. In the wealth measurement model, the option would be continuously measured at fair value from its inception.

- Three, reciprocal promises of future performance or payment bound by the triggering act of the exchange of simultaneously effective promises on opposite sides of a contingent event.

Futures and swap contracts are in this class as are fixed price forward purchase contracts. The triggering act is the signing by both parties of an agreement that puts the two parties on opposite sides of a contingent event. For example, if the price of X goes up, A pays B; if the price of X goes down, B pays A. In the wealth measurement model, the reciprocal promises are

recognizable immediately and measured at fair value at each reporting date by both counterparties. At the signing point the two sides are often of equal value so if the contracts are recognized on a net basis, their fair value is zero. I have not dealt with the netting issue in this book, it is an aspect of basic Principle 6.

- Four, a promise of future payment of an unconditional gift pledge bound by the triggering act of acceptance by the gift recipient.

The FASB calls these “nonreciprocal transfers” because there is no exchange of goods or services of equal value. However, acceptance normally binds the promising party and creates an expectation of a flow of economic benefits. Even unconditional gifts involve a kind of exchange. The donor promises to make future payments in exchange for the implicit or explicit promise of the recipient entity to continue carrying on all or a selection of its activities that the donor wants to support. The FASB requires asset and liability recognition of unconditional pledges even though legal enforceability is tenuous at best and keeping the promise is subject to a higher probability of default than in the other three kinds of promise. The wealth measurement model requires recognition if they represent expected future benefit flows.

## **THE FINANCIAL SIDE OF THE ECONOMY**

The preceding few paragraphs on claims provide the generalized recognition criteria for the entire financial side of the economy. All non-equity financial instruments, all trade accounts, all prepayments and deferred payments for goods and services fit into this structure.

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# CHAPTER 10

## OWNERS' EQUITY: OWNERS' WEALTH

Prologue: Owners control an entity's operations and net wealth. Creditors do not.

### EQUITY DEFINED

The balance sheet element called owners' equity, or net assets, has no independent identity in the current accounting model. It is described as a residual, the difference between assets and liabilities. However, a residual is not a definition. A residual does not include or exclude anything, as an independent definition should do. This leaves the equity element open to classification errors in applying the asset and liability definitions and therefore to inaccurate measurement of wealth and financial health. Equity gets the leftovers in the current GAAP model.

As a consequence of not having an independent definition, owners' equity has been stuffed with instruments that stretch the concept of ownership. An apparent limit to this stretching was reached with the introduction of mandatorily redeemable preferred stock, intended by its creators to be classified as equity. The Securities and Exchange Commission (SEC) balked at that classification so mandatorily redeemable preferred sat in balance sheet limbo between liabilities and equity for years – a monument to standard-setting paralysis – until standard setters finally ruled that the disputed item was a liability.

Because of all this, the wealth measurement model defines equity in terms of the objective of wealth measurement, the nature of ownership, and the transactions that determine the amount of equity.

**Principle 2C.** For ownership type entities, owners' equity is the wealth (entity net worth) that belongs to and is controlled by the entity's shareholders. An entity's wealth is measured by the sum of cumulative net capital contributions by shareholders plus the entity's retained earnings.

It is the amount that, in a voluntary liquidation of the entity, shareholders could distribute to themselves after settling all liabilities and restrictive covenants.

Terms used in that basic definition have the following meanings.

A *shareholder* is one who owns all or a portion of an entity's *equity shares* as defined by the entity's charter and by mutual agreement of all shareholders. *Equity shares* represent a compact among owners; they convey two rights, one, a right to vote on the selection of members of an entity's governing body and on all policy issues that shareholders have not delegated to the governing body and, two, a right to share in an entity's unencumbered net worth and future earnings. *Equity shares* do not convey a promise of return of or return on shareholders' investment and do not convey preferential rights in an involuntary liquidation of the entity.

*Net capital contributions* mean contributions to an entity in exchange for equity shares less reacquisition by the entity of its own equity shares. An entity may not recognize earnings gains and losses from directly buying or selling its own equity shares at fair value but must recognize gains and losses from buying or selling at more or less than fair value.

Shareholders may enter transactions with their owned entity in nonowner capacities, such as employee or creditor, in which case those transactions must be accounted for on an arms' length basis at fair value the same as transactions with independent entities.

For nonownership type entities, equity is the wealth (net worth) of an entity that is controlled by those constituents with the right to vote on the selection of an entity's governing body. Since there are no shareholder capital contributions for those entities, net worth is measured by the balance of cumulative revenues less cumulative expenses.

Although owners' equity is primarily a business enterprise concept, governments and not-for-profits sometimes organize activities with ownership shares. In those instances, the owners' equity definition applies.

## **LIABILITIES AND EQUITIES DISTINGUISHED**

The equity definition, Principle 2C, set beside the liability definition, Principle 2B, sharply distinguishes equity shares from liability claims.

Equity shares convey rights to vote on the entity's policies.

Liability claims do not have voting rights, except sometimes in stressful conditions specified and agreed to by the equity shareholders.

Equity shares convey no promise of return of or on investment, but they convey rights to share in unencumbered profits from entity operations without limits as to amount or time and without conditions other than those established by the equity shareholders themselves.

Liability claims convey a binding promise, made by the equity shareholders to creditors, of return of or on investment, but within limits of amount and time and often with conditions.

Equity shares convey no right of recourse if owners receive no return of or on their investment.

Liability claims convey rights to impose legal restraints on entity actions if the promise of return is not kept.

Equity shares rank last in priority in bankruptcy liquidations.

Liability claims rank above equity shares in priority in bankruptcy liquidations.

Equity shareholders can bind an entity in dealings with other entities.

Liability shareholders cannot bind an entity in dealings with other entities.

The point of the equity–liability distinction is simple: Owners control an entity's operations and net wealth. Creditors do not.

## **LIABILITIES REVISITED**

In the current accounting model, owner is not defined but in practice the owners' equity element of the balance sheet seems to include as owners everyone with a tie to an entity through a linkage to an instrument called stock. The linkage may be through outright holding of an instrument called stock or through options written or purchased by the entity to buy or sell its own stock. There may be other possibilities that I am not aware of. The Principle 2C equity definition of owner would move instruments lacking essential ownership characteristics from the equity element to the liability element.

Preferred stock, stock purchase warrants, and stock compensation options, perhaps others, are classified as equity instruments in the current accounting model. They are liabilities in the wealth measurement model.

Preferred stock and warrants were on the scene long before formal standard setting existed. When standard setting was formalized, standard setters seem to have taken the existing equity classification of those instruments for granted without much scrutiny. I acknowledge that I did not challenge the conventional classifications when the conceptual framework was under development.



As long as equity was just a residual, there was no line between defined liabilities and undefined equity that forced close scrutiny of the nature of either liabilities or equity instruments. A legal enforceability notion of liability dominated conventional thinking and the FASB, while insisting that legal enforceability was not a necessary condition for liability recognition, never got around to addressing the liability–equity line until redeemable preferred stock finally forced its hand.

In the conceptual framework, the FASB, of which I was a member, weaseled out of line drawing this way [my emphasis]: “Equity in a business enterprise is the *ownership* interest, and its amount is the cumulative result of investments by *owners*, comprehensive income, and distributions to *owners*.” That sentence is the essence of Principle 2C of the wealth measurement model, but oddly, it seems to me now, the FASB followed that sentence with this one: “That characteristic ... makes equity not determinable independently of assets and liabilities” (FASB, 2002, CON 6, par. 213). Duh? A classic non sequitur, I believe.

In explaining the residual notion of equity, the FASB discusses at length the nature of owners as distinct from creditors and says that preferred stock has both debt and equity characteristics. But we never defined owner and never explained why preferred stock fell on the equity side of the line (FASB, 2002, CON 6, par. 49–63). In retrospect, I see that we followed the Bill Klem approach: “It is equity because we say it is equity.”

Principle 1 of the wealth measurement model puts a spotlight on the issue by introducing wealth (net worth), as the substance of equity. Combine wealth with the notion of ownership, which means control of wealth, and the line between equity and liabilities snaps into focus. An independent definition of owners’ equity like Principle 2C confronts the borderline issue.

On the credit side of the balance sheet, a borderline instrument has to meet one definition and fail the other, liability or equity share. There is no balance sheet limbo, no mezzanine, in the wealth measurement model. On the debit side of the balance sheet, a repurchased equity share does not qualify as an asset because it is not a claim on another entity and thus it is not a component of an entity’s wealth.

## PREFERRED STOCK

Preferred stock meets the liability recognition criteria. It conveys a promise from owners to preferred holders with clear expectations on both sides of

the promise that the promise will be kept and with negative consequences for the owners if the promise is not kept.

On the other hand, preferred stock fails the equity share criteria. Preferred stockholders do not have voting rights or unlimited earnings potential. Preferred holders are dependent on owners to keep their promise. Nominal preferred stockholders who in fact do have full voting and earnings sharing rights have crossed the semantic line, they are substantively common shareholders, not preferred except in name, and I exclude them from further references to preferred stockholders.

To the equity shareholders, the owners, preferred stock is a negative component of their wealth, a liability they must pay off before they can distribute the entity's wealth to themselves. Therefore, the wealth measurement model's objective of measuring wealth requires that the fair value of preferred be deducted from the fair value of assets to arrive at owners' net worth.

Preferred stock carries the same implicit default option as all other liabilities. For most liabilities, default can force an entity into bankruptcy. Default on preferred stock does not have that legal power but preferred stock does have the default consequences of credit and credibility degradation that no entity would undergo if it could avoid it. Inability to force bankruptcy is not sufficient grounds for tilting preferred stock away from the liability classification.

Preferred stock is the littlest fish in the credit food chain – the appetizer at the bankruptcy banquet. It is a sub-junk bond.

## **STOCK PURCHASE WARRANTS**

Stock purchase warrants meet the liability criteria in spades. They are legally enforceable so the “binding promise” criterion of Principle 2B cannot be questioned. They have no voting rights. They are dependent on owners to keep their promise of redemption if and when. By nature warrants are written options, which are liabilities in any other context. A warrant holder becomes an owner only if and when the warrant is exercised and the warrant holder receives equity shares.

Accounting for warrants in the current model is to credit the warrant proceeds to an equity account, often called paid-in capital, where it stays whether the warrants are exercised or not. If the warrants are exercised because the market price yields the warrant holder a profit, the stock is issued and credited to capital stock outstanding in the amount of the exercise price, which is less than the stock is worth in the market.

In contrast, accounting for warrants in the wealth measurement model is to credit the warrant proceeds to a liability account, an unearned option premium. If the warrants expire unexercised, the option premium – the warrant liability – is credited to earnings. If the warrants are exercised, the stock is issued and credited to capital stock outstanding at fair value and the difference between market price and exercise price is charged to earnings as a loss. The amount of the option premium, revenue, less the loss on exercise determines whether the option writing activity produced a net gain or loss in earnings.

From the entity's standpoint, issuing stock and issuing warrants are independent decisions. It can issue stock without warrants, it can issue warrants without concurrent issue of stock, or it can issue warrants with cash settlement at exercise with no stock issuance at all. A dilemma for the current accounting model arises if warrants or other written options offer a choice to settle in cash or stock. The model says if the choice is likely to settle in cash, call the warrant a liability and recognize gain or loss on exercise. If it is likely to settle in stock, call it equity and recognize no gain or loss on exercise. That is a nonsensical answer. The effect on an owners' wealth is the same. It is a good illustration of the inconsistencies in the current model. Even Bill Klem would have trouble with that call.

## STOCK COMPENSATION OPTIONS

Stock compensation options are similar to stock purchase options. The entity writes options on its stock as compensation sweeteners – to attract and retain employees. Unlike stock purchase options, employee compensation options are generally not marketable. That lack of liquidity reduces their fair value, but it does not by any stretch strip them of all value or turn them into equity shares.

As with all liabilities, there are two steps in the employee compensation process, the earning step and the payment step. In the earning step, the employee works according to the employment contract terms, resulting in an account payable for the entity. In the payment step the account payable is liquidated by giving the employee cash or other assets. One of the other assets frequently used is options on the entity's stock. The option liquidates the compensation payable – end of story for compensation but not for the option writing business. The entity has written a covered call option and must stand ready to pay off if the option is exercised.

Stock compensation options meet the liability criteria. They are binding promises, legally enforceable contracts. Recipients of the options are not

owners, they are employees. They are nonowner entities from the standpoint of the asset and liability definitions. They become owners only if they exercise the options and stock is issued to them.

Stock compensation options are accounted for like stock purchase warrants in the current accounting model, except that the initial debit is to compensation expense instead of to cash. The credit is to an owners' capital contribution account such as paid-in capital.

In the wealth measurement model, stock compensation options would be accounted for like stock purchase warrants. Both are written options. The cash proceeds in the case of warrants and the employee service in the case of compensation options are the equivalent of option premiums. If the compensation options were not exercised, the liability would flow to earnings, not as an adjustment of compensation but as revenue from option writing. If the options were exercised, the loss for the difference between exercise price and market price would go to earnings, not as an addition to compensation expense, but as a loss from the entity's option writing activity.

I do not know the magnitude of the earnings distortion caused by stock compensation options. Stock compensation expense is correctly recognized if the options are measured at estimated fair value when issued. But the gains and losses from writing options are buried in owners' capital contributions and are probably large in some cases. For entities whose stock price has increased over time, earnings would have been overstated by omission of net losses from exercised options. For entities whose stock price has been stagnant over time, earnings would have been understated by the omission of net premium revenue from unexercised options. Overall it seems likely that losses would exceed gains because of the backdating of options, reissuing underwater options, extending option life, and by volatility of stock prices even for stock with no long-term gain. All of those things increase the probability of the options being exercised with a gain to the holder and loss to the issuing entity.

All ratios involving debt or equity are being distorted in the GAAP model. The fundamental objective of separating return of and return on shareholder investment is misrepresented in the current model.

## **STANDARD-SETTING PROJECTS**

The Financial Accounting Standards Board and the International Accounting Standards Board have an ongoing joint project dealing with the issue of

differentiating liability claims from equity shares (FASB-IASB, 2008). It has been on and off the active agenda since 1990. One of the alternative equity definitions under consideration looks to be similar conceptually to the definition in Principle 2C. But it still has to go through the due process grinder.

# CHAPTER 11

## OWNERS' EQUITY: STEALTH PAYMENTS

Prologue: "To rob Peter and pay Paul" (Heywood, 1546, p. 148).

### THE NATURE OF EQUITY SHARES

Dilution of equity share value occurs when shares are issued by an entity at less than fair value or repurchased at more than fair value. Dilution occurs in the current accounting model from, among other things, an entity writing options on its own stock. I did not make a point of the dilution aspect in the preceding chapter. I will illustrate below, but because dilution is integrally related to accounting for an entity's transactions in its own shares, some discussion of the broader subject is needed first.

There is a mystique about equity shares that the current accounting model has never quite figured out. That is evident in the nonsensical answer pointed out in the preceding chapter, that is, one answer if a liability is settled in cash and a different answer if it is settled in stock notwithstanding the fact that they have the same economic effect on shareholders' wealth.

Unissued equity shares are a means of exchange, a means of payment. They can be issued in exchange for cash, goods and services, debt reduction, or other entities' shares and, as discussed in the preceding chapter, they can serve as cover for writing options. Thus, equity shares are a perfect substitute for assets and liabilities in executing exchange transactions.

Unlike assets and liabilities, however, equity shares have no individual identity and no recognizable individual value (neither fair value nor cost basis) until issued at a price. Until issued they are nothing but a notation on the balance sheet about authorized and unissued shares, with no monetary value attached. If outstanding shares are repurchased by the entity, the shares disappear again into that balance sheet notation with no monetary value attached and with no gain or loss recognized in earnings.

Although it is convenient to speak of transactions between an entity and its shareholders, and I do, an entity is nothing apart from its shareholders. It is a shell, a vehicle for multiple shareholders to operate collectively and do business with other entities with the goal of generating earnings. An entity does nothing in its own right; it acts only at the owners' direction. An entity, acting at the owners' direction, can issue and repurchase shares to or from owners, normally at different market prices between the time of issue and the time of repurchase. Such transactions, if at market price, generate profits and losses for individual owners on the other side of the transaction, but they do not generate earnings for the entity from doing business with other entities. They are internal to the entity, between shareholders using the entity as a conduit. If such transactions are not at market price, another story unfolds.

## THE NATURE OF DILUTION

To restate the opening sentence to this chapter, dilution of equity share value occurs when shares are issued by an entity at less than fair value or repurchased at more than fair value. The result of either of those acts is to transfer wealth from one individual or group of shareholders to another individual or group of shareholders. That would be OK if the transactions were accounted for openly at fair value as they are in the wealth measurement model. In the current accounting model, however, the equity shares are accounted for at the amount of cash received or paid for the shares even if the cash amount is more or less than the shares are worth in the market. That amounts to a kind of wealth transfer by stealth, bypassing the earnings statement and lodging real losses in the obscurity of owners' contributed capital accounts.

For example, if an employee exercises a stock compensation option by paying the exercise price of \$100 for a share worth \$800 in the market, the employee has a \$700 gain and, in the wealth measurement model, the entity has a \$700 loss. It is a loss to the entity from option writing not from selling stock to an owner. The stock is a means of payment, a substitute for cash to liquidate the option liability that has a fair value of \$800. But in the current accounting model the liability (a covered call option written with a strike price of \$100) is initially recorded in owners' equity as a capital contribution, not as a liability. The stock issue is recorded at \$100 and the \$700 loss is ignored, no accounting entry anywhere.

Readers may recognize that accounting result as a variation of the rolling loss phenomenon, a particularly virulent variation. In the classic rolling loss

case, losses are postponed but eventually get rolled into earnings. With stealth payments, however, losses are permanently omitted from earnings, making the entity look healthier than it is in perpetuity. To borrow an expression from Batman's sidekick, "Holy Pacioli!"

## **DILUTION ILLUSTRATED**

An extremely oversimplified, but directionally correct, example will show how dilution works. Assume an entity with four shareholders, one share each, and a net worth and market capitalization (MC) of \$400. For this illustration, market cap always equals net worth. The market price per share is \$100 just before each of the following four transactions. Each transaction is executed on day one without public knowledge and then reported to the public market on day two. The transactions are not sequential and not related to one another; each starts independently from the same base.

### *Transaction 1: Routine Issue of Stock at Market Price*

This is a sale of stock to Shareholder Five for \$100. Net worth increases to \$500 and when reported to the market, share price holds at \$100 ( $\$500/5$ ). Each of the four preexisting shareholders, and the new fifth shareholder, end day two with no gain or loss. This illustrates an important principle, arithmetically speaking, an increase in the number of shares outstanding at fair value reduces the proportion of net worth held by preexisting shareholders but simultaneously increases the value of net worth so the wealth owned by each shareholder is unchanged, thus, shareholders lose no wealth. The reverse is true for reductions of the number of shares outstanding by repurchase at fair value. This transaction also presents a benchmark for comparison to Transactions 3 and 4, which involve stock transactions at over or under market price.

### *Transaction 2: Routine Loss Incurred*

This is an uninsured asset loss of \$50. Net worth drops to \$350 and when reported to the market, share price drops to \$87.50 ( $\$350/4$ ). Each shareholder lost \$12.50 ( $\$100 - \$87.50$ ) on day two. In total, the four shareholders lost \$50 ( $\$12.50 \times 4$ ). This is a run-of-the-mill transaction that



illustrates, for comparison to Transactions 3 and 4, the effect of a pure unambiguous loss, a depletion of entity fair value, a reduction in share value. The accounting for this loss is the same in the current and wealth measurement models, debit earnings (expense), credit the lost asset.

*Transaction 3: Dilution through Sale of Stock Below Market Price*

This is a sale of stock to Shareholder Five at a discounted price of \$50 (market price \$100). Net worth increases to \$450 and when reported to the market, share price drops to \$90 ( $\$450/5$ ). The four preexisting shareholders each lost \$10 ( $\$100-\$90$ ) on day two. The new Shareholder Five, paid \$50 for stock valued at \$100 for a gain of \$50 on day one. But on day two the share price drop to \$90 gave Shareholder Five the same \$10 loss as the other shareholders. In total, the five shareholders lost \$50 ( $\$10 \times 5$ ) on day two, the same amount as in Transaction 2 but with a different accounting result in the current model, the same result in the wealth measurement model, as follows.

Transaction 3 illustrates the effect of dilution. The current accounting model does not recognize losses from dilution, the wealth measurement model does. The comparative accounting would be:

Current accounting model

Dr	Cash	50
Cr	Capital stock	50

Wealth measurement model

Dr	Cash	50
Dr	Earnings (expense)	50
Cr	Capital stock	100

In Transaction 3, the \$50 expense was paid for literally by issuing a share worth \$100 for \$50 cash. That gave Shareholder Five the same proportion of net worth as Shareholders One to Four, but caused all five shares to lose value on day two. The net effect was that the expense was really paid for by picking the pockets of all five shareholders in order to pay Shareholder Five for reasons discussed below. Shareholder Five had a \$50 gain on day one and a \$10 loss on day two. The current model pushes the expense and the shareholder losses off the books by recording the cash flow and ignoring fair value.

*Transaction 4: Dilution through Purchase of Stock at  
More than Market Price*

This is a purchase of a share from Shareholder Four for \$150. Net worth drops to \$250 and when reported to the market, share price drops to \$83.33 ( $\$250/3$ ). Each of the three remaining shareholders lost \$16.67 ( $\$100 - \$83.33$ ) on day two. Former Shareholder Four received \$150 for stock worth only \$100 for a gain of \$50. In total the three remaining shareholders lost \$50 ( $\$16.67 \times 3$ ) on day two, the same amount as in Transaction 2 but again with a different accounting result in the current model.

Like Transaction 3, Transaction 4 illustrates dilution. The comparative accounting would be:

Current accounting model

Dr	Capital stock	150
Cr	Cash	150

Wealth measurement model

Dr	Capital stock	100
Dr	Earnings (expense)	50
Cr	Cash	150

In Transaction 4, the \$50 expense was paid for by repurchasing a share for more than it was worth. That cashed out Shareholder Four from ownership leaving three shareholders with equal shares of a smaller net worth and a large loss of share value. As in Transaction 3, the net effect was that the expense was really paid for by nicking three shareholders for the benefit of one. The current accounting model again pushes the expense off the books by recording the cash flow and ignoring fair value.

## ANALYSIS

Transactions 2, 3, and 4 have an identical effect on shareholders' collective wealth, the value of their shares is depleted by \$50. Loss per share varies for each transaction depending on the number of shareholders before and after the transaction. As shown by Transaction 2, reduction in share value is the consequence of expense or loss. So what gives? No entity gives away assets without a reason.

What is happening here is that the gaining shareholders in Transactions 3 and 4, acting in an “other entity” capacity not in a shareholder capacity, performed a \$50 service of some kind for the entity. That was an expense to the entity and revenue to the service provider. For whatever reason this stealth technique, dilution, is how the service providers were paid – no loss recognized in earnings but a reduction of shareholder value equal to the wealth effect of an ordinary loss like Transaction 2.

The current problem of major import is gains and losses on option writing, executive stock compensation being by far the largest. By recording stock issues at exercise price instead of fair value, gains and losses on option writing are buried in a back lot cemetery – in owners’ contributed capital instead of in entity earnings.

# CHAPTER 12

## TAX- AND GIFT-BASED ENTITIES: ACCOUNTABILITY IS KEY

Prologue: In the political arena, if you mix cold facts with hot air you get fog. Your tax dollars at work!

### THE CASE FOR ACCOUNTABILITY

Government and not-for-profit entities have made much progress in the last decade in adopting the current GAAP accounting model in addition to their traditional cash and encumbrance accounting. They have come kicking and screaming, about a century late, but the breakthrough is laudable and probably irreversible. Not-for-profits resisted on the grounds of poverty. Governments resisted on the grounds of sovereignty. Both eventually gave in, reluctantly, on the grounds of accountability for other peoples' wealth.

The case for GAAP accounting for governments and not-for-profits is strong but still not widely understood. In most respects, governments and not-for-profits are like every other entity on earth. They acquire and consume assets to produce goods and services. They have the same bottom line measure of solvency as all other entities – an excess of the monetary fair value of assets over the monetary fair value of liabilities. And despite protests to the contrary, they have or should have a profit motive. The profit motive is to produce an excess of benefits over costs.

Excess of benefits over costs is the generic definition of profit. But here is where the sloggng gets tough. Governments and not-for-profits usually cannot measure the benefits they produce in monetary units. A growing number of governments are measuring benefits in nonmonetary units and then matching those measures against the monetary costs of producing the benefits. That process can produce some useful measures of efficiency and effectiveness, but it cannot measure a net benefit that is comparable with business profit.

Not-for-profits depend on donors' evaluation of benefits in comparison to alternative uses of donors' money. That makes the receiving entities subject to some degree of market discipline through decisions by individual donors.

Governments, on the other hand, depend on their citizens to pay taxes on demand with no direct and immediate choice about if, when, or how much, and no direct and immediate choice about which benefits, how many, and to whom they will flow. The connection between voter decisions in selecting their representatives and the representatives' decisions about taxes and benefits are so far separated in time and personal contacts that market discipline is in play only at the edges.

The loose connections between voters and their representatives and between taxes and benefits make accountability through transparent accounting the only way to bring a modicum of discipline to the governmental system, a smidgen of truth in the land of politics where the language consists of a mixture of half-truths, routine lies, and really big lies. Throwing a few cold facts into that environment would likely fog in the entire East Coast periodically, but it might save taxpayer dollars here and there and it would preserve the principle that sovereignty resides in the voting body and that elected foghorns owe voters accountability through maximum transparency about how their taxes were used.

## **THE WEALTH MEASUREMENT MODEL**

Governments do not have equity shares and they do not compete much in the product and service revenue markets so there is not as much need for comparative analysis with other government entities or with business entities as there is within the business community. Still there are many areas of government that could be illuminated by comparative analysis, like the many business-type activities that most governments engage in and the many similar activities that different governments engage in.

Moreover, governments have other problems in need of illumination. Governments are notoriously bad at asset management and notoriously good at liability denial. At the federal level, the words "fraud, waste, and abuse" are so common in Congressional hearings that they are spoken almost as one word without hyphens "fraudwasteandabuse." Also, cost overruns trail behind government procurement projects like the tail of Halley's comet. The military industrial complex is alive and well and duplicated in other areas of government. All of which underscores the need

for heavy-duty accounting and auditing with an emphasis on accountability for managing and consuming other peoples' wealth.

The wealth measurement model would bring the same rigor to accounting for government operations as it would for business. Although governments do not generally compete in revenue markets, they compete vigorously in the wealth consumption arena. Better accounting, particularly, if coupled with output and benefit measurement, would improve accountability of elected officials and government managers. Insights provided by the process of fair-value measurements would be useful for managing government programs, which are all measurable wealth consumers even if benefits may be wispy. For some assets such as infrastructure and military hardware, replacement cost might be a more attainable measure of fair value than exit values. Other than that possibility, the wealth measurement model can be applied to government without change.

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# CHAPTER 13

## EARLY WARNING: CRISIS PREVENTION

Prologue: “When sorrows come, they come not single spies, but in battalions!”  
(Shakespeare, 1602, Hamlet, IV, v, 75).

### FINANCIAL MELTDOWNS

I am writing this book in the midst of the global financial crisis of 2007++. I first began formulating ideas about crisis prevention in the midst of the Savings and Loan meltdown of the late 1980s. I believe that both of those crises would have been spotted and brought to heel before they reached such disastrous proportions if the wealth measurement model, with its early warning features, and the quick response standard-setting model, with its prompt corrective features, had been in place before the problems started to fester. And in between those national crises some lesser scandals like Enron, Worldcom, and their likes would have been unmasked much sooner.

Although national financial meltdowns are fascinating, I did not design the wealth measurement model with any grand macroeconomic scheme in mind. I designed it to be a tool to help diagnose and maintain the financial health of individual entities. However, national financial crises start with individual entities and build one entity at a time. Hence, the model’s relevance to national crises lies in its ability to publicly disclose deteriorating financial conditions in a disproportionate and growing number of entities in any given industry. Public disclosures of that sort would allow market forces and regulators to move in before it was too late to prevent a meltdown.

### MEASURING AND MANAGING

“People manage what they measure.” So goes an old management seminar maxim. To illustrate, it has been said that government program managers



measure and manage their unused spending authority but do not measure or manage unit costs of program outputs. Unfortunately, the current accounting model that purports to be a management tool does not measure anything that is definable in the aggregate. But the model throws off a lot of numbers that look like pieces of wealth. And it labels them with names and applies arithmetic procedures that imply that they are pieces of current wealth even though many are not measured at current value. So an unsuspecting non-accountant manager, who has to make decisions about managing real wealth in real time based on whatever information he or she has, can fail to see trouble brewing in an entity because the current accounting numbers do not highlight the trouble spots. And when trouble begins to show up despite the hodge-podge of numbers, a resourceful entity accountant can postpone public acknowledgement by moving some of the pieces around. There are some numbers in the current model that represent pieces of wealth measured at fair value, but the value numbers tend to get blended out in a stewpot of backward looking cost allocations.

### **ALL AND FAIR, NOW AND THEN**

The reasons the wealth measurement model could head off crises for individual entities can be summed up succinctly.

First, real net worth is the epicenter of financial crises. Shrinking real net worth is how financial crises progress from bad to worse. The wealth measurement early warning model measures real net worth (wealth). The current GAAP accounting model does not.

Second, the wealth measurement model measures *all* of an entity's wealth. There are no oxymorons like "off balance sheet liabilities" in the wealth measurement model. All assets and all liabilities are on the balance sheet in full view. Wherever financial deterioration sets in, it shows up on the balance sheet and in the income statement.

Third, the wealth measurement model brings accounting into juxtaposition with real business decision making, not quite in real time but much closer than the current accounting model. For better or worse, owners, managers, analysts, and regulators have to make decisions based on their perceptions of economic values. Markets would work better if all market participants developed their perceptions starting from a common baseline of best estimates of economic values derived from a disciplined estimating process. Communication would be improved because the entire business community would become accustomed to and relatively expert at using fair

values – a true language of business that accounting textbooks have always talked about but never delivered. Estimates can never be precisely accurate but in the wealth measurement model they are made under firm methodological guidance and they are subject to independent audit and independent analyst scrutiny.

Fourth, everything on the wealth measurement balance sheet is measured as of *now*, the balance sheet date, in prices that are current on that date. There are no old sleeping dogs on the balance sheet, at historical cost, to be roused unexpectedly. And Principle 5 of the wealth measurement model (contingency disclosures) keeps an eye on the old dogs sleeping in the footnotes.

Fifth, and this is where early warning really kicks in, income (earnings) is the difference between net worth now, the end-of-period balance sheet, and net worth then, the start-of-period balance sheet. Deterioration of financial health will show up through analysis of earnings, through analysis of changes in key assets and liabilities, and through analysis of trends. Trend analysis is a much more powerful tool in the wealth measurement model because of its comparability features through time. Each balance sheet is a compilation of values current on the balance sheet date. Thus, a series of balance sheets are directly comparable with one another on a nominal dollar basis and can be adjusted easily to a common dollar basis if need be.

Sixth, all entities in an industry would have the same set of financial statement characteristics and would be largely comparable with one another. Deterioration evident in one entity's statements would cause others to take a closer look. Further, each entity in an industry would have a different set of value estimators and auditors so if some missed a trouble sign, others might pick it up. Still further, financial analysts would scrutinize all major entities in an industry looking for similarities and differences to probe for financial deterioration.

Seventh, if quirky accounting practices spring up in an industry, the quick response standard-setting model is designed to crack down on them expeditiously.

## **NATIONAL CRISES**

The prologue to this chapter could be paraphrased like this: “When failures come, they come not single banks, but aggregations!” I contend that that consequence need not follow if the wealth measurement early warning

model were in place for all entities. I contend that it need not have followed in the banking crises of the 1980s and 2007++ with the severity that it did.

Both battalions of soldiers and aggregations of failing banks are built up one at a time. The wealth measurement model is designed to throw off warning signals for individual banks as soon as net worth begins to shrink. Shrinking net worth is accompanied by value changes in particular assets and liabilities and variations in line items of the income statement, all revealing to managers' and analysts' eyes. Those signals are masked in the current accounting model. GAAP equity can be positive long after real net worth is negative. (That is why GAAP equity is no longer called net worth as it once was.) The wealth measurement model gives the capital markets a chance to tap the bank on the shoulder before it fails. One errant bank is an early warning to look for others. And if others begin to show up in disproportionate numbers, bank regulators have an opportunity to start corrective actions before a whirlwind turns into a tornado and sucks up the entire industry.

The 2007++ crisis demonstrated the point in a limited way, but far too late to avoid the crisis. The FASB tightened the rules for measuring the fair value of derivative financial instruments in late 2007. The tighter fair-value measurement rules caused huge write-downs in derivative portfolios and took many bank capital ratios below required minimums. As the carnage spread, some market participants and financial pundits blamed the entire meltdown on "mark-to-market" accounting. In fact, of course, the accounting just unveiled losses that were already there.

The point is that the sudden huge write-downs in 2007++ would have started gradually showing up well before 2007 if rigorous fair-value accounting had been in effect. As valuations fell, the capital market would have been able to react to force weakling banks to seek help or die gracefully. If market forces did not stem the tide, bank regulators would have had the information and the time (I am not sure about the inclination) to clamp down on risky practices before taxpayer bailouts became their only resource.

The early warning accounting model is not a substitute for other indicators of financial health or of impending crisis. Financial regulators have reams of reports from institutions in their respective jurisdictions designed to point up problem areas. Market analysts have less detail but they too have many indicators available. However, the wealth measurement early warning model adds a major new dimension. It boils down an entity's financial health into two headline-grabbing numbers – earnings and net worth – backed up by integrated supporting data of various kinds. Earnings,

change in net worth, would be an attention getter that would feed the analytic processes of both market and regulatory analysts. Neither the markets nor the regulators have that now because the current accounting model is only loosely indicative of financial health, is only loosely related to economic events of the current reporting period, and is only loosely comparable to prior periods or to other entities.

Fair-value measurement is a universal principle in the wealth measurement model rather than its limited application in the current model. So its beneficial impact from early warning about impending crises extends to all entities throughout the entire economy. Financial crises are not limited to financial institutions. Crises in individual entities and industries would hit market radar screens much sooner than under the current accounting model.

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# CHAPTER 14

## WANTED: A FEW GOOD LEADERS

Prologue: As scarce as truth is, the supply has always been in excess of demand (Billings, 1865).

The accounting profession emerged as a major player on the economic scene following the 1929 stock market crash. There was concern in government and elsewhere that loose accounting practices contributed to the crash. Under the leadership of the American Institute of Accountants, the profession started to wrestle with the problem of alternative accounting practices or what I call choice-based accounting.

The first accounting standards (called principles in those days) were pronounced by the American Institute in 1934. That pronouncement might have avoided government intervention, but it came a little too late to forestall adoption of a provision in the 1933 Truth in Securities Act granting the administrator of the act, soon to be the Securities and Exchange Commission (SEC), the authority to set accounting principles for companies registered under the act. Luckily, the profession got a reprieve when the SEC voted to look to the accounting profession, the American Institute, for developing accounting principles. Still, the law is on the books like a sword of Damocles and only forbearance by the SEC allows the profession to set accounting standards for registered companies.

Even before 1929, there was concern about diversity of accounting practice and calls for uniformity of accounting. But from 1929 on, the profession has made continuous concentrated efforts to eliminate free-choice accounting alternatives. The debate terminology has changed. Initially the debate was couched in terms of uniform principles versus professional judgment. More recently it has been rules-based versus principles-based standards. But the ideals have never changed for investors, namely, greater comparability between entities and fewer loopholes for misrepresenting accounting results.

Sadly, after almost 80 years of concentrated effort by the accounting profession, it is not clear to me that we are gaining on the solution. There have been hundreds of standards established that have eliminated choice

and plugged loopholes, but the speed of change in the business environment so far exceeds the speed of change in standard setting that we may be losing ground in the pursuit of comparability, faithful representation, and the new imperative, early warning.

If the gap between ideals and reality does not close soon, the government will eventually take over the accounting standard-setting function, either by exercise of the existing authority of the SEC or by new Congressional intervention. The profession has already lost its authority to set auditing standards. The Sarbanes-Oxley Act established the Public Company Accounting Oversight Board (PCAOB) effectively as a wholly owned subsidiary of the SEC. The PCAOB is a tax-financed federal agency notwithstanding the law's eyewash declaration that it is not. The Act also moved the FASB closer to federal agency status by allowing part of the PCAOB tax to be diverted to the FASB.

The hot breath of government is searing the profession's last claim to be a true profession, that is, a profession that develops and controls its own intellectual property. If the accounting standard-setting function is fully nationalized, following in the footsteps of auditing standards, the accounting profession becomes essentially a public utility. Rate regulation and regulatory straightjackets cannot be far behind.

The profession has endeavored to fix a broken accounting model. Eighty years of tinkering has not done the job. The underlying reason is that it is a legislative model, a policy choice model, not an economic measurement model. There are no final answers in a legislative model. In any legislative arena, expertise lies in working the system to your own special interest advantage and, in case something goes wrong, having a scapegoat ready to heap the blame on. In the case of business failures, the company's auditors are usually the scapegoats, but I suspect that accounting standards are often more, or at least equally, at fault.

The balance sheet and income statement have no overall guiding objective for an auditor to look to, only thousands of accounting standards that govern bits and pieces of the statements. So auditors have to rummage through the bits and pieces that make up the formal statements and then scratch around in the off balance sheet stuff that does not even have the discipline of double entry to help find skeletons. Auditors can be blindsided by loose accounting standards that encourage promiscuity of interpretation.

Auditors go wrong through errors of judgment and oversight. Current GAAP accounting standards go wrong through deliberate historic design, a flawed design that is not fit to provide a reasonable measure of truth in support of the accountability of managers of other peoples wealth. In

corporate failures, accounting standards escape blame because lay people do not understand, and are a little afraid of, arcane accounting rules. They defer to accountants because they believe that the role of accountants is to protect them from an entity's misrepresentation of its financial health. Lay people understand wealth. They do not understand why they are periodically flimflammed by financial statements that purport to show wealth, but do not.

What we need now is a measurement model with something real and understandable to measure, wealth. We need a butchers' scale instead of a teeter-totter.

What we need also is a standard-setting model that slices the fat out of due process (you do not need due process to read a butchers' scale) and resolves issues promptly. We need a race car instead of a garbage truck.

To fulfill those needs, we need leadership, new leaders willing to take on the established bureaucracy to save the accounting profession from sliding into the maw of government. I believe academic accountants and financial analysts make good candidates for leadership roles because the wealth measurement model would serve their respective areas of interest and thus provide motivation for scrapping the current accounting model. Academics seek truth allegedly as an end in its own right. Financial analysts seek truth as a means of accumulating and managing wealth. Truth is a hard sell as Mr. Billings observed. We need leaders to work on both the supply and demand sides.

## **PACIOLI'S LAMENT**

Five centuries ago, Luca Pacioli set down the rules for establishing and maintaining a double-entry system of accounting. In the introduction to his accounting manual he said: "My wish is to provide the minimum number of accounting rules for businessmen to keep all their accounts and books in good order (Pacioli, 1494, Introduction)."

Pacioli would be saddened to see what subsequent accountants have done to his elegantly simple rules. His rules numbered only two fundamentals: book all assets and liabilities and measure them initially at cash value-plus a handful of bookkeeping rules like put the debits on the left. We now have, I am guessing, tens of thousands of rules, none as simple as Pacioli's. The wealth measurement model has only six fundamental rules, Pacioli's two plus four more to bridge the five centuries of business evolution since Pacioli wrote. In addition, the new model has a bunch of subsidiary rules to sharpen



the application of those six basic principles and a mechanism for continuously sharpening the wealth measurement capability of the model.

Pacioli said elsewhere: “Without order, there is chaos (Pacioli, 1494, p. 3).” He would be amazed to find that you can have both order and chaos in one system. Scientists have discovered that in the physical universe, a chaos of facts can exist within a roughly discerned system of order. Accountants have discovered that in the accounting universe, a chaos of facts can exist within a perfectly defined double-entry system of order. That describes the current GAAP accounting model. The wealth measurement model, in contrast, fills the orderly double-entry system with orderly and internally consistent facts.

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