

Beforehand, however, three definitions are required to contextualize the subsequent discussion¹:

- Economic income: net asset change over the course of a period, i.e., ending-period net-asset value minus beginning-period net-asset value – exclusive of equity transactions.
- Permanent income: the value that can be perpetually and constantly consumed on a periodic basis.
- Windfall: an unexpected capital gain or loss.

Economic income is synonymous with the comprehensive income of the FASB/IASB (Financial Accounting Standards Board/International Accounting Standards Board) conceptual framework. Permanent income is the academic term for what is frequently termed “recurring income.” The annual payment of an annuity, for example, is permanent income. As a comparative example, consider a company that always pays its income as dividends. In any period, it has a per-share economic income of either \$5.00 or \$15.00, with equal probability. The per-share permanent income is \$10.00, that is the average of \$5.00 and \$15.00.

To see why investors want permanent income is readily apparent from the example and the contingency table shown below. Suppose that both a buyer and seller can know only one income number – either the most recent economic-income number or the permanent income number. Which of the two income numbers would investors prefer? Suppose, for the moment, that the most recent economic-income number is \$5.00 and that this number is the basis for a trade between a buyer and a seller. If the subsequent economic-income number proves to be \$5.00, then expectations for both buyer and seller are met, as indicated by the “=” sign in the table. If, however, the subsequent economic-income number proves to be \$15.00, then both buyer and seller will perceive that buyer has gained at the sellers’ expense, as indicated by the “+” and “-” in the table. Similarly, suppose, for the moment, that the most recent economic-income number is \$15.00 and that this number is the basis for a trade between a buyer and a seller. If the subsequent economic-income number proves to be \$15.00, then expectations for both buyer and seller are met, as indicated by the “=” sign in the table. If, however, the subsequent economic-income number proves to be \$5.00, then both buyer and seller will perceive that seller has gained at the buyer’s expense, as indicated by the “+” and “-” in the table. In all variations – whether economic income is \$5.00 or \$15.00 – both the buyer and seller risk whether the economic-income number is repeatable. With permanent income, there is no income-number risk. Consequently, investors naturally prefer the permanent-income number.

¹ These terms are more precisely defined and demonstrated in the attached paper: “The Third-way – A Financial Reporting Synthesis.”

According to Benjamin Graham and David Dodd, authors of the classic 1934 investment book *Security Analysis*:

For what the investor chiefly wants to learn from an annual report is the *indicated earning power* under the given set of conditions, *i.e.*, what the company might be expected to earn year after year [i.e., permanent income] if the business conditions prevailing during the period were to continue unchanged. (Graham and Dodd 1934: p.354)

As a result of investor needs for a permanent income estimate, Paton and others developed the revenue-and-expense paradigm (R&E-Paradigm), which became the basis for 20th century financial reporting. The fundamental deficiency, however, with the R&E-Paradigm is its inability to directly handle asset-and-liability-value trends and fluctuations. As Previts and Merino write:

By the end of the decade [1919?], academic theorists appeared to agree on how to measure operating profits; the key question, still unresolved [today, i.e., 1998, 2008], was how, given the constraints of double entry, could the accountant accurately report both an increase in corporate wealth [economic income] and earned income [permanent income]. (Previts and Merino 1998: p. 262)

This deficiency on the part of the R&E-Paradigm is the first, of the two, historical pivot points. Because of the deficiency, two things occurred. First, assets were kept on the books at historic cost. Second, “income smoothing” was applied to spread significant asset-value changes across several reporting periods.

Starting perhaps in the 1950s, both practices – keeping assets on the books at historic cost and employing income smoothing – were railed by many people, including specifically academics. Endless debate ensued, with many concluding that resolution was impossible. This conclusion was congruent with the then decades’ old belief that resolution was impossible:

Implicit in the early debate [circa 1920] was the enduring belief that accountants must view either the income statement or the balance sheet as fundamental, and the other residual. (Previts and Merino 1998: p. 213)

Circa 1960 is the second historical pivot point. At this time, many leading accounting academics became enchanted with Nobel laureate economist J.R. Hicks’ *Value and Capital*, published in 1946. They interpreted his statements:

...it would seem that we ought to define a man's income as the maximum value which he can consume during a week, and still expect to be as well off at the end of the week as he was at the beginning (Hicks 1946: p. 172)

...*ex post* is not a subjective affair, like other kinds of income; it is almost completely objective. The capital value of the individual's property at the beginning of the week is an assessable figure; so is the capital value of his property at the end of the week; thus, if we assume that we can measure his consumption, his income *ex post* can be directly calculated (Hicks 1946: p. 179)

The silver bullet is to apply stochastic calculus to estimate instantaneous asset and liability incomes. Stochastic calculus is same silver bullet that Fischer Black and Myron Scholes used to develop the Black-Scholes option valuation formula. Prior to their breakthrough, option valuation had been a long-time unresolved problem. Today, stochastic calculus is the mathematical underpinning of option-valuation theory and practice.

As described in the paper, “The Third-way – A Financial Reporting Synthesis”, included with this comment letter, applying stochastic calculus is simplified to a formula that is directly related to the present value formula. This simple formula is called the *Ex-Ante Equation*.³ The instantaneous asset and liability incomes, along with operating income, yield permanent income. Ideally, all assets and liabilities are mark-to-market or mark-to-model, with all non-equity postings passing through the income statement. There is no income smoothing; there is a clean surplus. As a side benefit of the credit and debit mathematics, an asset-and-liability stewardship metric results and is naturally part of the income statement.

I believe implementation of the Third-way to be straight-forward. No additional data is needed beyond that required of Fair Value accounting. Rather than posting to homogenous revenue and expense accounts, mark-to-market and mark-to-model postings are made to a new type of income statement account, termed windfall accounts. Application of the *Ex-Ante Equation* can be automatically performed just before income statement generation.

At this time, financial accounting is on the cusp of coalescing into a global standard. The standard that is set in the next few years will likely remain for decades to come. The question thus arises: what do we want to bequest to subsequent generations? Will it be the paradigm of the 19th century that yields only economic income, or will it be a paradigm that yields both economic and permanent income and that fixes the fundamental flaw of 20th century financial reporting by handling asset-and-liability-value trends and fluctuations?

I would be glad to meet with the Committee at its convenience.

Best regards,

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The Third-way – A Financial Reporting Synthesis

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Abstract: A Synthesis of the “asset and liability” and the “revenue and expense” income views is presented. The synthesis results in complementing the fair-value market-based balance sheet with an equally fair-value market-based income statement. This is accomplished by employing stochastic calculus, via the Ex-Ante Equation, to estimate instantaneous asset-and-liability incomes. These incomes, coupled with operating income, yield permanent income. Asset-and-liability windfalls are calculated based upon the instantaneous incomes and market-value changes. Permanent income plus windfalls yields fair-value economic income on a clean-surplus income statement. No data beyond fair-value requirements is needed for implementation.

Introduction

What is the fundamental issue in financial reporting? I submit that it is the decades’ old debate between the “asset and liability” and the “revenue and expense” income views.¹ And that undergirding the debate is the limiting belief that either the balance sheet or the income statement can be valid, and the other residual.

What is gained by a synthesis of both sides of the debate? Such a synthesis can yield a balance sheet based upon current-market values AND an income statement based upon current-market values AND a permanent income estimate.

Who gains from such a synthesis? Likely most everyone gains. Financial-statement users gain better financial data for analysis and decision making. Practitioners, academics, and standard setters gain a simpler, more useful theory and practice methodology.

As will be shown, the key to synthesis is the application of stochastic calculus to calculate instantaneous asset and liability incomes that appear on the income statement. Stochastic calculus is the basis of the Black-Scholes option valuation formula and today is the mathematical underpinning of option-valuation theory and practice. As will be shown, this income calculation is an implementation of Nobel laureate economist J.R. Hicks’ prescription contained in his book, *Value and Capital*. The implementation yields a permanent-income estimate.

¹ Robert Anthony (1987) makes the same point.

