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These comments on the June 17, 2004 Exposure Draft, *Accounting for Conditional Asset Retirement Obligations*, are limited in scope – but have significance extending well beyond the Exposure Draft. I support the position that uncertainty concerning the timing or method of settlement is to be reflected in the measurement and not in the timing of recognition, as it is consistent with my own interpretation of SFAS 143. These comments address what I perceive to be a significant inconsistency between two of the four examples in Appendix A of the Exposure Draft, which I view as demonstrating a basic flaw in SFAS 143 that I also address herein.

The conflicting examples are those for the wood poles and the oil refinery. Poles are removed in the process of renovating and/or upgrading the power or telecommunications system of which they are a part, and the removal is stated to be a conditional event requiring recording an ARO. The oil refinery is also renovated and/or upgraded, yet is stated to have an indefinite life that precludes recording an ARO. The life of a power or telecommunications system is just as uncertain as is the life of a refinery, so the different ARO treatment is inconsistent. I see two options for eliminating this inconsistency. One option is to define the two renovation and/or upgrading situations in a manner that clearly distinguishes them. The other option is to recognize that the situations are identical, thereby requiring identical ARO treatment.

Developing a definition clear enough for consistent application is likely impossible, as happened with the initial intent to include both legal and constructive obligations in SFAS 143. Therefore, the only practical solution I see is to recognize that the situations are identical, so require identical ARO treatment. The fact that wood poles are mass assets of entities that typically practice the group concept of depreciation leads me to favor not recording an ARO for this situation, because SFAS 143 was not written with the group concept in mind so is quite messy to apply to such assets. I have observed that those writing accounting rules often are not sufficiently conversant with the group concept to keep the rules from having unintended consequences for entities practicing this concept, and SFAS 143 is no exception.

In view of the difficulty in applying SFAS 143 by entities practicing the group concept, it is not surprising to find such entities reluctant to admit to legal obligations, which has led to this Exposure Draft. As is evident from this letter, I view the Exposure Draft as

dealing with a symptom of a basic problem with SFAS 143. The following comments provide suggestions for dealing with the disease rather than symptoms.

Solving the problem of inconsistent treatment of removal costs that SFAS 143 was intended to address could have been accomplished by merely recognizing the intended meaning of the term *salvage* in the GAAP definition of depreciation accounting. At the time this definition was written, it was common to utilize *salvage* to mean *net salvage* (the net of salvage proceeds and removal costs), and some still do. This usage is unfortunate, as it can lead to misinterpretation of the purpose of depreciation accounting, as is demonstrated by SFAS 143.

Further evidence of the intent of the GAAP definition is that it is not logical for financial statements to match the recording of investment and salvage with the usage or revenue-generating capability of the assets, while precluding removal costs from having the same match. Some would say that it is more than just not logical – it is misleading. Consistent matching is particularly important for long-lived assets, as it is not unusual for the removal costs of such assets to exceed the depreciable investment.

Financial accounting would benefit from emulating the regulatory objective known as *intergenerational customer equity*, which means that each generation of customers is to bear only those costs incurred to serve that generation. This objective leads to known depreciable investment and estimated salvage proceeds and removal expenditures being accrued over the life of the related asset, thus producing a match between the usage of the asset and the recording of these costs and credits directly associated with the asset. Reflecting costs recorded in this manner in authorized tariffs matches revenues to the usage of the assets providing service, thereby assuring that the asset costs incurred to provide service are borne by the customers actually being served. The accrual is usually ratable, because the typical usage pattern of the assets of regulated entities is relatively constant. This treatment of removal costs is *rational*, as is required by the GAAP definition of depreciation accounting, since the recording of asset costs matches asset usage.

SFAS 143 ignores existing GAAP and dictates that ARO removal costs be recorded as liabilities rather than through depreciation. The specified treatment is deferred relative to the pattern of usage of the related asset. To illustrate, the specified accounting for an asset having a life of 40 years and an 8% discount rate causes about 95% of the obligation to be recorded as accretion and the accretion expense recorded during the final year to be more than 20 times the amount recorded during the first year. This deferral is severe enough to cause some types of facilities – such as power plants for which removal typically occurs several years after operations cease – to have a large portion of their accretion expense recorded well after the revenues from the facility have ceased.

The SFAS 143 treatment is a form of sinking fund. The degree of deferral for sinking fund depends upon the magnitude of the interest rate. For example, ratable can be thought of as a special case of sinking fund with an interest rate of zero. The SFAS 143 treatment is a single-payment annuity, but is recorded in a manner that makes it the equivalent of a multiple-payment annuity due.

Much of my career has involved dealing with price-regulated entities, so I am keenly aware of the impact of the ratable, SFAS 143 and expense-when-incurred (cash) treatments of removal costs on the customers of such entities. Ratable treatment matches the recording of removal costs with the usage of the assets, and rate base regulation imposes the lowest cost on customers. Deferral increases the costs that must be borne by customers, with the payments for service increasing as the extent of the deferral increases. SFAS 143 severely defers the recording of depreciation and accretion expenses, but not as much as does cash treatment. Further, SFAS 143 limits – and cash treatment eliminates – an internal source of capital during the lifetime of the removed assets, so damages the financial viability of the entity. Thus, good accounting is also good for utility customers and for the economic viability of the utility service territory.

The detrimental impact of deferring the recording of removal costs is not unique to regulated entities. While non-regulated entities do not disclose the bases for their pricing decisions, such entities understand the market power of pricing and that ignoring the interests of customers is at their own peril.

SFAS 92 defines compound interest methods as phase-in plans, thereby precluding the use sinking fund depreciation – a reasonable reaction to its mismatch with asset usage. SFAS 143 creates a mismatch for entities previously utilizing straight-line depreciation for removal costs, and decreases (but does not eliminate) an existing mismatch for entities previously expensing when incurred. In addition to being detrimental to customers and providing an inaccurate indication of the results of operations and changes in financial position, such a mismatch may encourage earnings management through manipulating the timing of removal expenditures. Further, allowing removal costs to be recorded in a manner that does not match asset usage is inconsistent with current concerns for financial statement accuracy.

The major SFAS 143 flaw is the discounting. I urge the Board to replace SFAS 143 with an interpretation clarifying the meaning of *salvage* in the GAAP definition of depreciation accounting, thereby eliminating the discounting and requiring depreciation treatment for all removal costs. This action would eliminate the need for special rules for recording the removal costs for legal obligations and would treat all removal costs in the same manner. If special rules are deemed necessary to differentiate legal obligations, they could merely involve financial statement disclosures. In addition to producing more consistent and more meaningful financial reporting, my suggested action is consistent with existing GAAP.

I am aware that concern is sometimes expressed for the accumulated provision for depreciation becoming larger than the recorded investment when removal costs exceed salvage proceeds, as is typical for long-lived assets. While I do not share this concern, it can easily be dealt with, if deemed necessary. An approach that would make financial statements more user-friendly would be to segregate the accrual of removal costs from the investment and salvage components of depreciation expenses, and disclose in the notes to financial statements that portion of the accumulated provision representing removal costs. Regulated entities are already doing this. A further step might be to show

the removal cost portion of the accumulated provision on the liability side of the balance sheet.

Segregation of removal costs is not difficult to accomplish, especially for regulated entities, as they typically know the removal cost component of the net salvage factors incorporated into their depreciation rates. Most entities are likely to find removal cost segregation easier to deal with than the ARO discounting required by SFAS 143. Further, segregation seems child's-play in relation to the efforts that I understand are (or would be) required for derivatives and stock options. While I do not believe it warranted, shifting a portion of the accumulated provision to the liability side of the balance sheet should not be a significant issue, since the accounting convention was to record the entire accumulated provision on the liability side until about the time of World War II.

These comments do not explain the group concept of depreciation accounting. If more information on this concept is desired, please refer to my December 19, 2003 letter commenting on the AICPA's proposed statement of position on property, plant and equipment accounting that was recently rejected by the Board, as it addresses the group concept in considerable detail.

Sincerely,



John S. Ferguson