JOHN S. FERGUSON
1219 Stratford Drive
Richardson, TX 75080-2918
Tel (972) 699-8214
Fax (972) 699-9396

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Technical Director
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

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Re: File Reference 1235-001

This is in response to the September 30, 2005 Invitation to Comment on Selected Issues Relating to Assets and Liabilities with Uncertainties, and explains why I believe that this phase of the convergence project is an appropriate time for the FASB to revisit SFAS 143 and Interpretation 47 and for the IASB to revisit the treatment of legal and constructive obligations specified by IAS 37. My interest in the accounting treatment of legal and other obligations stems from a career that included conducting the special studies needed by entities practicing the group concept of depreciation accounting to determine whether their existing depreciation rates remain valid. While now retired, my interest in depreciation accounting remains, and I continue to follow actions of the Board and others that influence such accounting.

SFAS 143 responds to a perception of inconsistent recognition of expenditures to remove or abandon assets at the end of their life (removal costs). I believe this perception is valid, because I am aware that non-regulated entities tend to record such expenditures as an expense when incurred, whereas the Uniform Systems of Accounts of regulators dictate that jurisdictional entities record such expenditures ratably over the life of the related assets. I view SFAS 143 as being positive to the extent that it forces non-regulated entities to disclose otherwise unrecognized legal obligations. However, SFAS 143 has failed to solve the inconsistency problem, and has damaged the ability of the financial statements of regulated entities to accurately depict their results of operations and changes in financial position. This damage results from (1) shifting removal costs for legal obligations from being recorded ratably to being severely backloaded, thereby creating a mismatch between the recording of accretion expenses and the usage of the related assets, and (2) the presumption that U.S. GAAP dictates that removal costs be expensed when incurred. I explain later in these comments why I believe this presumption is incorrect.

The shift away from ratable treatment of removal costs by regulated entities is significant, because such costs are not trivial. For example, my experience is that the removal cost for energy and water utility distribution lines can be expected to exceed the depreciable investment in the lines.

The FASB has expressed concern about the possibility for accumulated provisions for depreciation to exceed depreciable investment. While this is possible, I explain later in these comments why I believe there is no reason for this concern to lead to something like SFAS 143 or IAS 37.

The treatment specified by SFAS 143 for legal obligations is that the initial present value of the expected settlement expenditure be added to the depreciable cost of the asset and be recorded as a liability for which future accretion as the discounting unwinds is recorded as accretion expense. The specified treatment is a single-payment (prepaid) annuity, but is recorded in a manner that gives it a structure similar to a multiple-payment annuity -- the typical form of sinking fund depreciation. The backloading of recording accretion expenses that is inherent in SFAS 143 causes the amount recorded each year to increase as the discounting unwinds. For example, for an asset having a life of 40 years a discount rate of 8% causes the accretion amount recorded in the final year to be about 20 times the amount recorded during the first year. This backloading gets really interesting when the settlement timing of the obligation is not accurately estimated, or -- as is typical for power plants – when settlement occurs well after operations cease.

Regulators recognize the problems inherent in this backloading, so have tended to adopt SFAS 143 for accounting purposes, but not for ratemaking purposes. However, the Federal Communications Commission rejected SFAS 143 for either purpose. Rejection for ratemaking purposes keeps regulators having to sort out how to deal with the intergenerational customer inequity inherent in the imposed deferral. Intergenerational customer equity is a basic regulatory principle, whereby customers pay the costs incurred to serve them and such costs are not shifted to a different generation of customers. Since the assets that provide service are typically utilized at a constant rate, the intergenerational equity principle dictates that asset costs (including removal costs) be recorded and charged ratably over the productive life of the assets. This principle makes a lot of sense for regulatory purposes, and, in my opinion, makes just as much sense for financial accounting purposes.

It is interesting that SFAS 92 defines sinking fund depreciation as a phase-in plan, thereby precluding its use. Like sinking fund, SFAS 143 defers the recording of removal cost relative to the pattern of usage of the related asset. SFAS 143 gets around this inconsistency by treating removal cost as a liability, rather than as depreciation, so the specified treatment is not required to match the usage of the asset. While SFAS 92 is generally interpreted as applying only to investment, I view the deferral of removal costs through sinking fund depreciation or something similar as being just as inappropriate and have observed regulators to be in general agreement with my view. Over the years, I have found the most common regulatory response to proposals for adopting sinking fund depreciation for ratemaking purposes to be rejection, because of concerns for the impact of not accurately estimating when removal will occur and for the inherent shift of recording and recovery of removal costs to when the facilities are old and least able to provide service.

Interpretation 47 was prompted by the Board recognizing that SFAS 143 was not being consistently applied. I judge Interpretation 47 to be an improvement, but to not eliminate inconsistent application. It is not surprising that the Board perceived Interpretation 47 as being needed, because SFAS 143 was not written with the group concept of deprecation accounting that is practiced by regulated entities in mind. As a result, SFAS 143 is difficult to apply to the assets of entities practicing the group concept, which, in my opinion, is responsible for regulated entities being reluctant to recognize AROs for certain of their assets. For regulated entities, Interpretation 47 will shift certain obligations from being recognized ratably to being deferred, thereby increasing the mismatch between asset usage and the recording of asset costs and further damaging the ability of their financial statements to accurately depict the results of operations and changes in financial position.

IAS 37 specifies treatment of both legal and constructive obligations that is similar to SFAS 143. The FASB's intent was for SFAS 143 to also apply to both legal and constructive obligations, but settled for only legal obligations after concluding that constructive obligations could not be defined tightly enough for consistent application. This conclusion suggests that IAS 37 is not being applied consistently.

My proposed solution to the problem that SFAS 143 was intended (and failed) to solve and to the problems it has created will eliminate inconsistent recognition of obligations, and is simple to accomplish. All that is needed is for the Board to recognize that *salvage* in the U.S. GAAP definition of depreciation accounting is intended to mean *net salvage*, and to add one word - *net* - to this definition, perhaps including an explanation that net salvage is the estimated salvage proceeds less the estimated removal costs, and for the IASB to adopt the modified U.S. GAAP definition. These actions would make it clear that all removal costs are to be recorded ratably over the life of the related assets by all entities, and would allow the FASB to rescind SFAS 143 and Interpretation 47 and the IASB to modify IAS 37.

This solution would make it possible for accumulated provisions for depreciation to exceed the depreciable investment for certain assets, but unlikely for all of the assets of an enterprise. If the Board and the IASB remain concerned about this possibility, it would be a simple matter to move the removal cost portion or the salvage and removal cost portions of the accumulated provision to the liability side of the balance sheet. While I think users of financial statements will better understand such provisions if they remain on the asset side, the reporting convention was for the entire accumulated provision to be on the liability side, until about the time of World War II.

The solution I propose is timely and simple to implement, would bring the treatment of depreciation for financial accounting purposes back into consistency with regulatory accounting practices, and would improve the ability of the financial statements of non-regulated entities to accurately depict their results of operations and changes in financial position. I urge the FASB and IASB to consider implementing it.

The remainder of these comments address why I believe current U.S. GAAP dictates that removal costs be recorded as a component of depreciation.

U.S. GAAP states:

> Depreciation accounting is a system of accounting which aims to distribute cost or other basic value of tangible capital assets, less salvage

> value (if any), over the estimated useful life of the unit (which may be a group of assets) in a systematic and rational manner. It is a process of allocation, not of valuation. Depreciation for the year is the portion of the total charge under such a system that is allocated to the year. Although the allocation may properly take into account occurrences during the year, it is not intended to be a measurement of the effect of all such occurrences.

Three aspects of this definition are significant to the treatment of removal costs – the requirement to be systematic and rational, consideration of salvage, and the recognition that depreciation accounting is a process of allocation, not of valuation.

The *rational* aspect of *systematic and rational* means that depreciation is to be recorded in a manner that matches the pattern of usage or revenue-generating capability of the related asset. Thus, if the asset usage or revenue pattern is decreasing, the depreciation method should be accelerated relative to the life span of the asset. If the asset usage or revenue pattern is constant, the depreciation method should be constant (ratable) relative to the life span. If the asset usage or revenue pattern is increasing, the depreciation method should be deferred relative to the life span. I am aware of types of assets of regulated entities that exhibit a decreasing or a constant usage pattern over their lifetimes, but have not encountered such assets that exhibit an increasing usage pattern.

I believe that the definition's reference to *salvage* is intended to mean *net salvage*, thereby incorporating removal costs into depreciation, because:

> At the time the GAAP definition was issued, it was common for *salvage* to be utilized to mean either salvage proceeds or net salvage (salvage proceeds less removal costs), and some still utilize this terminology. This usage is unfortunate, as it creates confusion concerning how removal costs are to be dealt with for accounting purposes, and I believe it is responsible for the true intention of the definition to have become lost.
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> The GAAP definition was issued during the 1950s, which is at least 40 years after salvage and removal costs began to be treated as components of depreciation for regulatory accounting purposes. The earliest indication of this regulatory accounting treatment I have discovered is the 1913 Interstate Commerce Commission (ICC) telephone Uniform System of Accounts. I am aware that this treatment rapidly became universal for energy and water utilities, pipelines and telecommunications companies, and suspect that the ICC is not the first U.S. regulator to incorporate removal costs into depreciation. This timing of adoption for regulatory accounting and the fact that the concept of *retirement accounting* was abandoned for regulatory accounting purposes earlier than for financial accounting suggest that the GAAP definition quoted above may well have been written to recognize the validity of the then existing regulatory accounting treatment for salvage and removal costs.
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> It is inconsistent to specify that investment and salvage be recorded in a pattern matching the usage or revenue-generating capability of the asset, while removal cost is not allowed to. Some would say that it is more than

just inconsistent -- it is misleading. Consistent matching of all asset costs is particularly important for long-lived assets, as it is not unusual for the removal costs of such assets to exceed the depreciable investment.

Treating removal cost differently from investment and salvage conflicts with the premise that accounting be reliable and relevant. The removal cost estimate for accrual purposes is at least as reliable as is the salvage estimate, and perhaps more so, and ratable treatment through depreciation makes it just as relevant. I view the removal cost estimate as being more reliable than the salvage estimate, because it is easier to predict future cost escalation rates than it is to predict future scrap prices. However, the magnitude of removal costs relative to scrap proceeds is likely to cause removal costs to have more influence on financial statements.

The concept of cost allocation, rather than valuation, is consistent with the requirement that depreciation accounting be *rational* and with the regulatory principle of intergenerational equity described previously.

Sincerely,

John S. Ferguson