



Letter of Comment No: 47
File Reference: 1215,001
Date Received: 9/12/05

September 12, 2005

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

Via email: director@fasb.org
File Reference: 1215-001

Dear Director:

The American Gas Association (AGA) is pleased to submit its comments concerning the Financial Accounting Standards Board's (FASB) Exposure Draft on Accounting for Uncertain Tax Positions (an interpretation of FASB Statement No. 109). The American Gas Association represents 195 local energy utility companies that deliver natural gas to more than 56 million homes, businesses and industries throughout the United States. AGA member companies account for roughly 83 percent of all natural gas delivered by local natural gas distribution companies in the U.S. AGA is an advocate for local natural gas utility companies and provides a broad range of programs and services for member natural gas pipelines, marketers, gatherers, international gas companies and industry associates. Natural gas meets one-fourth of the United States' energy needs.

AGA supports FASB's efforts to reduce inconsistencies in the application of FASB Statement No. 109 by clarifying the accounting for uncertain tax positions. When the proper application of accounting rules is unclear it creates difficulties for financial statement preparers and auditors alike. While AGA enthusiastically supports the overall objective of consistency, it respectfully submits the following comments for your consideration.

Diversity in Accounting Practices

Paragraph two of the proposed interpretation states that diversity in practice has developed in the accounting for uncertain tax positions. AGA believes that the vast majority of companies in this industry follow a liability model, whereby they record a liability under FASB Statement No. 5 for loss contingencies associated with uncertain tax positions. There may be a need to improve the consistency with which this general liability model is applied, but an inconsistency of models is not apparent in this industry. On a recent teleconference including at least a dozen large public utility companies and in discussions surrounding this comment letter, we have yet to identify a single industry member that reports using an asset-based model, as the FASB is proposing. The AGA

questions whether there is much diversity in the general model that companies are applying.

Recognition and Measurement

Paragraphs 6 to 12 of the proposed interpretation describe a three-pronged asset model, requiring a “probable” threshold for initial recognition of tax benefits, a “more likely than not” threshold for derecognition and a “best estimate” measurement approach. AGA is concerned that this proposed asset model could result in less, rather than more, comparability in financial reporting, that the financial statements using this model will not be as representationally faithful as those generated under the more commonly used liability model, and that the proposed method will add complexity and cost.

Comparability

Under the proposed dual threshold for recognition/derecognition, two companies with the same tax position (one filed when it was considered clearly valid and another filed when validity became questionable) may have very different tax benefits recognized based solely upon when they first took the tax position. Similarly, a single company filing the same tax position over multiple years may have tax benefits recognized for some of those periods but not for others. In contrast, under the commonly used liability model, two companies with the same income tax issue would be reasonably expected to have somewhat similar loss contingency liabilities recorded. Therefore, AGA questions whether the proposed interpretation will “increase comparability” as intended.

Representational Faithfulness

AGA is concerned that the asset model, when combined with a “probable” initial recognition threshold as proposed, will result in the routine overstatement of liabilities and the routine recognition of certain tax benefits only upon the final resolution of the tax positions. This would occur because, for a variety of reasons, certain tax positions are generally not challenged. For instance, a minor infraction in a qualified pension plan can technically disqualify the plan and limit deductions for plan contributions. However, it is understood that Internal Revenue Service general practice is to promote compliance with qualification requirements and not seek the disqualification of pension plans. Minor infractions are allowed to be corrected without disqualification of the plan. Under the Exposure Draft, in order to assert a “valid” tax position, a company might be required to complete an annual compliance audit of their qualified plans. If a minor infraction were discovered during the audit, the tax benefit of the contributions would not be recognized under this proposal until the statute of limitations has expired. AGA believes this will cause unnecessary income statement volatility and a result that is not representationally faithful, as that concept is described in FASB Concept Statement No. 2. Just as paragraph 64 explains that amounts legally receivable “may misrepresent large sums as collectible that, in fact are uncollectible,” AGA believes that the proposal will cause companies to record liabilities that, in fact, will never be paid. The recognition criteria proposed by FASB is biased, just as described in paragraphs 77 and 78 of the Concept Statement, such that it has the tendency to “fall more often on one side than the other of what it represents instead of being equally likely to fall on either side” “so that the

resulting measurement fails to represent what it purports to represent.” If the intent of the proposed accounting is to represent a technical legal interpretation then it might do that, but AGA believes the intent should be to best represent economic reality as we do with accounts receivable.

To obtain a result that better represents economic reality, it may be appropriate to allow (under paragraph 9) additional factors to be considered in determining whether a “probable” threshold has been met. Specifically, taxpayers should be allowed to consider the common practice of a taxing jurisdiction not to challenge a particular position under the same or substantially similar situations, regardless of whether the position was “obviously presented” in prior years’ tax returns or actual “legal precedent” can be identified.

FASB should consider that the liability model could be applied to groups of uncertain tax positions for a given jurisdiction and time period, rather than applied to individual tax positions. When individual tax positions are evaluated as loss contingencies, the result is that no liability is recorded for those that have a remote chance of loss. However, uncertain tax positions are settled in groups. The objective of this approach would be to derive a single probability-weighted contingent liability for each jurisdiction/period, after considering all of the individual uncertain tax positions in the group, including those that are not individually probable of loss. Such a probability-weighted “best estimate” of loss for the group of issues would most likely be closer to the actual loss than would result from the proposed asset model. As judgments change, the liability model would also factor the changes into the accounting results more quickly and result in fewer adjustments upon settlement.

If a liability model will not be reconsidered, AGA strongly supports a single “more likely than not” recognition threshold that allows for the common practice of a taxing jurisdiction to be considered. A dual threshold for recognition/derecognition can result in inconsistencies, as previously noted, and the proposed “probable” threshold would routinely result in the overstatement of liabilities and income statement volatility that is not representative of the economics. AGA believes that either a liability model or an asset model with a more obtainable recognition threshold would result in more representationally faithful accounting than what has been proposed.

Complexity

In light of the Securities and Exchange Commission's June 15, 2005 report calling for less complex standards, AGA questions whether the proposed recognition/measurement approach will only add confusion and complication. The liability approach commonly used in our industry is very easy to understand and apply, and we believe the concept is easily grasped by financial statement users. Since income taxes are an expense, it seems that a loss contingency/liability model would be more intuitive to the financial statement user than an asset-based model. The proposed three-pronged recognition/measurement approach, on the other hand, is not initially intuitive and can be more difficult to explain. Some believe the Exposure Draft raises more questions than it answers. The AGA questions whether moving to a more complex model that can be difficult to explain meets with the objective of the Interpretation to "clarify the accounting."

Classification of Interest and Penalties

AGA notes that FASB ultimately decided to exclude guidance on the classification of interest and penalties from the Exposure Draft. In order to improve consistency in financial reporting, AGA believes additional guidance is warranted concerning the appropriate classification of interest and penalties on the income statement. Some companies classify interest on potential tax deficiencies as interest expense, others as income tax expense and still others as miscellaneous expense. In addition, if an interest classification is used, there can be confusion regarding the proper classification of interest credits that result from favorable changes in estimates.

Transition

The FASB proposes, in paragraph 20, recognizing only tax benefits associated with positions that meet the "probable" recognition threshold upon the initial adoption of the Interpretation. AGA believes the better alternative is to use a "more likely than not" threshold upon initial adoption. As with the accounting FASB proposes after initial adoption, AGA believes the proposed implementation guidance will cause companies to write off tax benefits as part of the cumulative effect adjustment only to recognize them again at a later date.

Effective Date

The FASB states in paragraph B41 of the proposal that "sufficient time should be provided to evaluate those prior (tax) positions." AGA agrees with this objective, yet we question the conclusion that a year-end effective date allows sufficient time. With meetings on this subject scheduled through October, it seems unlikely that a final Interpretation could be issued more than six weeks prior to year-end. Six weeks is not sufficient time to take the necessary steps required to effectively change from a liability model to an asset model.

At first glance it seems that this interpretation would be fairly simple to implement. After all, most preparers already keep lists of their tax exposures for evaluation in applying a FASB Statement No. 5 liability model. Reviewing those tax exposures in light of the new accounting model should not take much effort. However, because the proposal will flip many companies from a liability model to an asset model with a high recognition

hurdle, some believe the Exposure Draft would necessitate a comprehensive review of every tax position taken in every jurisdiction in every year. Still others believe that additional explicit evidence supporting all tax positions will need to be gathered or obtained, in some cases from outside experts (e.g. “should” opinions) and in other cases from formal compliance reviews (e.g. pension compliance). If such a level of documentation is necessary, it will be difficult and costly to develop and maintain, and very difficult, if not impossible, to achieve in the proposed interpretation period.

In addition, by creating an initial recognition criteria that differs from the filed return, tax departments will have yet another recordkeeping challenge. In this industry, preparers are already required to track income tax amounts as filed on the tax return, as recorded for book purposes and as recorded for regulatory purposes. It seems that by requiring deferred income taxes to be computed on the difference between the book basis and the “best estimate” tax basis, rather than on the difference between the book basis and the “as filed” tax basis, this interpretation will require yet another set of income tax records to be maintained.

In light of the fact that income tax accounting was one of the most common material weaknesses cited in the inaugural year of internal control reporting, AGA believes it is inadvisable to issue an interpretation requiring what is essentially an entirely new accounting model just prior to year-end for the many companies with calendar-year reporting. New internal controls will need to be created surrounding the application of this new interpretation, and there will be not be time to test the new controls prior to year-end, leaving no time for potential remediation.

If an asset model is retained in the final interpretation, AGA supports an effective date no earlier year-end 2006. This would allow sufficient time for companies and their audit firms to develop an appropriate uniform set of expected procedures necessary to meet the requirements of the Interpretation, and for companies to gather the documentation needed to adopt the new provisions and to create, test and potentially remediate internal controls surrounding the new process.

Conclusion

AGA supports the effort to reduce inconsistencies in the accounting for uncertain tax positions. AGA prefers a liability model because we believe it produces a more representationally faithful result, it is less complex than the asset model and we believe it is more consistent with the current practices of the vast majority of our member companies. If the proposed asset model is retained in the final Interpretation, AGA urges FASB to defer the effective date and strongly supports a single “more likely than not” recognition threshold that does not hinge entirely on the technical validity of the tax position.

AGA appreciates this opportunity to contribute to the standard-setting process and hopes that our views will be helpful to you in your deliberations.

Very truly yours,

[s] *Stephen P. Dickson*

Stephen P. Dickson
Chairman, American Gas Association, Accounting Advisory Council