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Financial Accounting Standards Board

File Reference: 1235-001

Subject: Selected Issues Relating to Assets and Liabilities with Uncertainties

This letter is in response the Invitation to Comment on the above-referenced matter.

By way of background I have been a security analyst for over 30 years, so this response can be classified as a user comment. My comments focus on the use of probability in recognition and measurement, and, therefore, relate chiefly to Questions 8 and 9.

As an overview, I have long believed that assets and liabilities should be reported in the balance sheet at fair value. Since economic decisions are made based on current, not historic, values I believe financial statement users would benefit from having the same information that managements use in their decision process. The current mixed-attribute model evolved piecemeal as specific accounting standards were issued and does not reflect the way companies are run.

To the extent that changes in fair value are reported in the income statement it would demonstrate the inherent volatility in a company's results and, I believe, would force investors to accept that economic growth is not as stable as companies would like to portray. This, in turn, I also believe would lead to a reduced focus on short-term results and allow managements to concentrate on creating long-term value.

It is quite possible that many investors do not agree with me regarding fair value. However, I am sure the Board has noted that the CFA Institute, in its recent report "A Comprehensive Business Reporting Model," has again reiterated its preference for fair value reporting.

I believe that FAS 5, Accounting for Contingencies, which was issued in 1975, and its companion piece FASB Interpretation No. 14, are outdated and are no longer consistent with the way managements or investors make decisions. This is chiefly because the Statement leads to a single point best estimate rather than focusing on a wide range of possible outcomes. I believe instead that liabilities should be established on the basis of expected cash flows, which, as discussed in the Invitation to Comment, reflect the likelihood, amount and timing of expected outflows.

I also believe that now, 30 years after the issuance of FAS 5, investors have become more sophisticated about stochastic processes and are able to understand the significance of numbers reported in this manner. Keep in mind that when Statement 5 was issued the use

of probability theory for decision making was in its early stages. For example, the Black-Scholes option pricing model had only been formulated in 1973.

Since that time the understanding of mathematics by investors has become much more advanced and financial statement users are now comfortable with stochastic models and the significance of probability-weighted numbers. In other words, we recognize that a liability measured on the basis of expected cash flows will likely not be the amount at which an obligation is ultimately settled.

Thinking about the practical aspects of this issue, I believe both the reporting company and financial statement users would be better served if the company had to calculate liabilities on the basis of expected cash flows. Consider, for example, a company with pending lawsuits. At present, the company would most likely not report any liability even if an eventual outflow of resources were probable since the potential settlement is unquantifiable, except possibly for the costs of mounting a defense.

Yet, in the real world, analysts would be making estimates of the potential liability. While well meaning, these outside projections would be based on limited information and, consequently, would probably encompass a wide range of forecasts.

I believe the company would be better off if it reported its own probability-weighted estimates. Not only would it communicate its thoughts to investors, but also it would reduce the dependence of investors on the limited-knowledge speculation of outsiders. The greater degree of certainty could be beneficial to its stock valuation, despite the lower reported book value.

Also, a footnote table showing the ranges and related probabilities would help investors appreciate the issue since this would explain the degree of uncertainty in the measurement. This would be particularly useful when the forecast encompasses a wide dispersion and where the estimates are for a single event rather than a portfolio of potential obligations.

I recognize that managements might be hesitant to disclose their expectations for fear of influencing either court decisions or opposing counsel's strategies, but I believe the benefit to the company's valuation from enhanced transparency outweighs the negatives.

To the extent that estimates change, and are reported in income, that too would communicate useful information. With proper disclosure, those choosing to view the numbers as non-operating could easily adjust the figures.

Requiring liabilities to be both probable and quantifiable before recognition leads to two problems. The first, is that "probable" creates a bright line threshold i.e., is the probability over 50%, which is contrary to the trend toward principle-based standards rather than rules-based standards. Second, the "quantifiable" requirement has the potential to discourage managements from thoroughly assessing specific issues. In a

preparer's mind the thought process is simply "if we can't quantify we don't have to record, so let's not try to calculate a possible liability."

The actions of the property-casualty insurers in the late 1980s and early 1990s were a good example of this latter point. By not making a strenuous effort to quantify their environmental liabilities they could postpone recognition. But, by not fully appreciating the magnitude of their exposures they were late to begin settling claims, and, I believe, this led to higher payments than would otherwise have been the case.

I would be happy to discuss these comments further.

Sincerely,

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