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April 12, 2004

Ms. Suzanne Q. Bielstein  
Director of Major Projects and Technical Activities  
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**Exposure Draft: Proposed FASB Statement, *Exchanges of Productive Assets, an amendment of APB Opinion No. 29* (File Reference No. 1200-300)**

Dear Ms. Bielstein:

We support the Board's ongoing efforts to improve U.S. generally accepted accounting principles and, for the topic identified for short-term convergence, to converge U.S. GAAP with international accounting standards. We agree with the Board's conclusion in the Exposure Draft (ED) that the guidance in APB 29 that requires determining whether a nonmonetary exchange is an exchange of similar productive assets has been difficult to apply in practice. We also agree with the Board's general principle that exchanges of nonmonetary assets should be recorded at fair value of the assets exchanged. However, we are concerned about the operationality and auditability of the proposed *commercial substance* concept.

Additionally, we believe that the *culmination of the earnings process* is an important concept that is embedded in the current financial reporting model. While we understand that the Board is reconsidering this concept and other related issues in its revenue recognition project, we believe that the concept should be retained until that project is completed.

The remainder of the letter contains specific comments about the ED.



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### **Issue 1: Commercial Substance. Is commercial substance guidance operational?**

We agree with the Board's conclusion that an exchange must have *commercial substance* for gain recognition to be appropriate. Additionally, we believe that preparers should have a clear understanding of the business purpose of the transaction to account properly for the exchange. While it may be conceptually appropriate to evaluate changes in the risk, timing, or amount of future cash flows, we believe that for many exchanges, the parties to the exchange do not make a contemporaneous evaluation of the future cash flows that they expect will result from the asset(s) received in the exchange. Thus, we believe that in many situations it will be difficult to apply the proposed process for establishing whether an exchange has commercial substance. As a consequence, the operability of the principle will be called into question.

#### Tax cash flows

The ED notes that there could be a circular interaction between the commercial substance test and the tax business purpose test "if (a) the determination of commercial substance is predicated solely on changes in tax cash flows and (b) the tax business purpose asserted is the achievement of a specified financial reporting result." Because taxes are reflected in the financial statements, any change in tax treatment can have a "financial reporting result." Accordingly, the ED could be read to say that an exchange where there is a change in only the tax cash flows does not meet the commercial substance test. An alternative understanding of the Board's proposal is that commercial substance cannot be demonstrated when an exchange results in future tax deductions only if there is a resulting *step-up in basis* for financial reporting purposes. If the Board retains the commercial substance test, it should clarify how or whether the tax treatment of an exchange is incorporated into the analysis.

#### Entity-specific value versus fair value

Because the test of commercial substance is based on entity-specific value, we believe that the Board should clarify that the information used to determine whether commercial substance exists will not, necessarily, provide the entity with a measure of the fair value of the exchange.

### **Issue 2: Scope Exceptions**

We agree with the proposal to add paragraph 4(f) to APB 29 to exclude from the scope of APB 29 transactions that are subject to paragraphs 44(b) and 47(e) of FASB Statement No. 19, *Financial Accounting and Reporting by Oil and Gas Producing Companies*.



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For exchanges currently addressed by paragraph 44(a) of Statement 19, however, we believe that there is an important difference between exchanges of proved properties versus exchanges of unproved properties. We agree that exchanges of proved properties should be accounted for at fair value if the exchange has commercial substance. In view of the subjective nature of the commercial substance evaluation and the difficulty in assessing the amount or timing of future cash flows associated with unproved properties, we believe the information needed to evaluate whether commercial substance exists is not sufficiently reliable and, thus, exchanges of unproved properties should continue to be accounted for at book value.

We believe that the additional scope exception proposed to be paragraph 4(e) of APB 29 should be narrowed. To the extent that the exchange constitutes a business combination, it should be accounted for under FASB Statement 141, *Business Combinations*. However, if the exchange is not a business combination, the guidance in APB 29 could be relevant to the accounting for the exchange. The Board notes that including that exchange within the scope of APB 29 may constitute a presupposing of answers to issues that it is addressing in other projects. Alternatively, that approach could be characterized as a temporary solution, and the accounting for these exchanges could be further affected by the Board's deliberations on other projects (e.g., revenue recognition). However, since final standards in other projects may not be issued in the near term, we do not believe that these transactions should be excluded from the scope of this amendment of APB 29, because significant questions may arise about the appropriate standard to apply to those exchanges in the interim.

### **Issue 3: Real Estate Transactions**

Generally, we agree with the Board's conclusion that nonmonetary exchanges that involve real estate should be within the scope of APB 29. However, we also believe that certain concepts of FASB Statement No. 66, *Accounting for Sales of Real Estate*, should be applied to exchanges of real estate for other real estate. If those exchanges have commercial substance and, therefore, would be measured at fair value in accordance with APB 29, we believe that the guidance in paragraphs 25 to 44 of Statement 66 related to continuing involvement in the transferred asset also should be applied. The proposed amendment to paragraph 3(c) of APB 29 does not address the specific issues surrounding this assessment for transactions that involve exchanges of real estate assets.

Paragraph A.6 of the ED states that the Board did not intend to establish a less restrictive standard for gain recognition than the standard for gain recognition that applies to transactions that involve monetary consideration. Consequently, the gain recognized should not depend on whether the real estate is exchanged for cash or other real estate.



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**Issue 4: Amendment of Statement 140**

We agree with the proposal to eliminate the scope exception in FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, for exchanges of equity method investments for similar productive assets. We believe that the Board should further clarify this change by modifying paragraph 4(e) to remove the reference to investments accounted for using the equity method.

In paragraph A.14 of the ED, the Board noted that amending Statement 140 would bring the scope of that Statement closer to the scope of the proposed IASB changes. We believe that it is appropriate to include equity method investments in the scope of Statement 140 because transfers of interests in equity method investments may take many forms in which the transferor might have continuing involvement with either the interest transferred or the transferee. Transfers with continuing involvement raise issues about the circumstances under which the transfers should be considered sales, and how transferors should account for these transactions. Additionally, equity method investments are financial assets as defined by Statement 140.

**Effect of EITF Issue No. 01-02, "Interpretations of APB Opinion No. 29"**

We note that the ED does not indicate that Issue 8(a) of EITF Issue No. 01-02, "Interpretations of APB Opinion No. 29," would be nullified. Currently, Issue 8(a) requires that, if the boot in a transaction is less than 25 percent of the fair value of the exchange, the pro rata gain recognition required by paragraph 22 of APB 29 should be applied to the receiver of the boot, and the payer of boot would not recognize a gain. We suggest that the Board identify the nullification of Issue 8(a) as one of the results of the proposed amendment to APB 29.

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If you have questions about our comments or wish to discuss further any of the matters addressed herein, please contact John Guinan at (212) 909-5449 or Paul Munter at (212) 909-5567.

Sincerely,

KPMG LLP