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Letter of Comment No: 5
File Reference: 1099-001

Date Received:

July 21, 2004

Technical Director
File Reference 1099-001
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Accounting for Conditional Retirement Obligations

Dear Director:

This letter contains my comments on the FASB's Proposed Interpretation, "Accounting for Conditional Retirement Obligations." In summary, I believe the FASB should withdraw this proposal and instead devote immediate attention to developing a consistent and clear definition and implementation guidelines for liabilities. While the proposal deals with a relatively narrow issue, it, along with other recent FASB actions, do not help in determining how liabilities are interpreted and applied in general. It can also be argued that the Board's increasing requirements for fair value recognition and measurement of liabilities are leading to less useful information in financial statements, not to mention implementation nightmares for companies and auditors.

In the next few pages I discuss the Board's positions on related matters from recent pronouncements. Then I will provide some specific comments on the new exposure draft.

Concepts Statement 7

Paragraphs 55-61 in Concepts Statement 7 discuss the relationship between the fair value objective and expected cash flow approach described in that Statement and the accounting for contingencies as specified in FASB Statement 5 and Interpretation 14. Paragraph 55 includes the Board's position that, "The decision to recognize an asset or liability (or a change in an existing asset or liability) is different from the decision about a relevant measurement attribute. However, there are unavoidable interactions between accounting recognition and measurement...."

In paragraph 56 of that Concepts Statement, the Board states, "However, the use of probable in the first recognition criterion of Statement 5 refers to the likelihood that an asset has been impaired or a liability incurred (emphasis added)." Most accountants would agree with that statement. They feel that it has to be probable that a liability has been incurred before it is proper to record it. While there may be "unavoidable interactions between accounting recognition and measurement," they don't affect most accountants' thinking about when it is proper to record a liability. Further, even if there are these "unavoidable interactions," The Board has not made a clear and compelling case for basing recognition decisions more on fair value than probability of incurrence, as discussed further below in the context of other recent FASB actions.

The problem is highlighted by the examples in paragraph 57 of Concepts Statement 7. The examples start with a situation where there is a 90% chance of no loss for a contingency and a 10% chance of a \$10 loss. (In practice, I can't imagine that a company would ever be able to reliably make such a determination, but that's the separate matter of practicality of application and audit). The Board says that this would "lead some" to conclude that no liability should be recorded, although I believe that nearly all accountants and business people would reach this conclusion. However, an expected cash flows (fair value) approach would lead to a conclusion that \$1 should be recorded. At the extreme, this approach would seem to necessitate recording a large liability where a company had been sued and there was a 1% chance that it would lose the case and have to pay \$100 billion.

That paragraph goes on to expand the example by hypothesizing that there are ten similar contingencies. The Board explains that some might feel that there is a chance that at least one of the ten will materialize and that recognizing a loss in this case is consistent with Statement 5. I agree that

this is a much more difficult question, and, as paragraph 57 states, "Recognition issues like these are among the most intractable in accounting and are beyond the scope of this Statement."

But those recognition issues have to be dealt with by reporting companies, by auditors, and (ultimately) by accounting standard setters. My concern is that the Board has not yet articulated clear and consistent positions on these issues. As described further below, the recent positions on other projects may have actually muddled the matter further.

It's important to note that Concepts Statement 7 was not intended to address when assets or liabilities should be measured at fair value (expected cash flows). Rather, the intent was to provide guidance on how to determine fair value measures when the Board concluded, on a case-by-case basis, that fair value was the appropriate approach in a given situation. As the Highlights of Concepts Statement 7 state:

The Board decided to limit this Statement to measurement issues and not to address recognition questions. The Board also decided that this Statement would not specify when fresh-start measurements are appropriate. The Board expects to decide whether a particular situation requires a fresh-start measurement or some other accounting response on a project-by-project basis.

However, since the issuance of Concepts Statement 7, it appears that the Board has increasingly used that Statement to justify a fair value approach to initial measures of liabilities rather than providing persuasive arguments why that approach leads to the most useful answer in a given situation. Rather than "The Devil made me do it," the Board seems to be saying that "Concepts Statement 7 made us do it" in several recent decisions, rather than providing convincing reasoning why a fair value approach is appropriate in the circumstances.

<u>Interpretation 45 on Guarantees</u>

Interpretation 45 calls for companies to record liabilities for guarantees based on their "noncontingent obligation to stand ready to perform in the event that the specified triggering events or conditions occur." The Board divides guarantees into two components: this "stand ready" obligation, which is considered noncontingent, and what it calls the contingent portion –

the later occurrence (or not) of any actual payment under the guarantee. Thus, the Board rejected the arguments by many commentators that the entire guarantee is a contingency and that recording a liability should be based on whether it is probable that a payment will have to be made.

The Board's principal argument for this bifurcated approach appears to be what is stated in paragraph A31:

If a guarantor wants to be relieved of both its obligation to stand ready to perform over the remaining term and its contingent obligation to make future payments (before the triggering events or conditions have occurred and before the term of the guarantee has ended), the guarantor would likely be required to make a payment either to a third party to assume its obligations or to the original guaranteed party. The Board believes that the need for the guarantor to make a future payment to be relieved of its obligations under the guarantee confirms the existence of the liability related to the guarantor's obligations under the guarantee.

This statement is correct – if a guarantor wanted to be relieved of its "stand ready" obligation it would probably have to pay someone to assume this obligation. However, it is equally true that payment would probably have to be made to relieve the company of the second part of the obligation – what the Board considers to be a contingency in this case. Thus, this argument does not support dramatically different accounting for what the Board considers to be separate components of the transaction (and which most business people would consider one contingent obligation).

The guarantees issue could be generalized to cover a wide range of problematic liability matters. Anytime a contingency exists a company likely would have to pay someone to be relieved of it. And in a business combination, buyers no doubt take into consideration the existence of contingencies and a rational buyer would probably adjust the total amount he or she is willing to pay accordingly. However, should liability recognition in an ongoing (i.e., non-business combination) situation be based mainly on whether a payment might have to be made to relieve a company of an obligation, particularly when the company does not intend to offload that obligation and it is very unlikely that any payment would ever be made?

In paragraph A35 of this Interpretation, the Board argues that Concepts Statement 6 explicitly meets the definition of a liability. Paragraph 196 of Concepts Statement 6 is quoted: "Responsibilities such as those to...honor warranties and guarantees also create liabilities under the definition." I read those words to say that warranties and guarantees meet the definition of a liability when they are expected to be <u>honored</u>. Those words do not seem to support the Board's position on the "stand ready" notion that it has developed in Interpretation 45. The words simply say to me that when it is likely that a company will have to honor warranties and guarantees then a liability should be recorded. How can those words explain a finding that a guarantee where a company believes there is only a 10% chance of payment should be recorded as a liability?

Statement 146 on Exit Costs

In Statement 146 the Board seems to return to a more conventional application of liability accounting. In this case, fair value is important in measurement but apparently not for recognition. Exit costs are to be accrued only when the definition of a liability per Concepts Statement 5 is met. The Board states that only present obligations to others are liabilities under the definition. And an entity's commitment to such a plan is not the requisite past transaction or event for recognition of a liability.

Perhaps the Board would argue that its conclusions on guarantees and exit costs are consistent because it is simply deciding what is the requisite past transaction or event in each case. It apparently feels that the obligating event for the guarantee is the "stand ready" promise that an entity makes at the date it issues the guarantee and the obligating event for the exit costs doesn't occur until a later date. However, the Board seems to say that uncertainty is important for recognition in one case but not in the other.

Further, couldn't it also be argued that when a company has committed to an exit or disposal plan it probably would have to pay someone in order to be relieved of that obligation? Wouldn't an acquirer take the existence of such a plan into consideration in determining what it would be willing to pay for a company that had committed to such a plan? It would have been interesting to learn the Board's thinking on these questions so we could better understand how to apply the general theory to other liability questions when they arise.

In paragraph B17 of Statement 146 the Board reminds us that Statement 5 and Concepts Statement 7 deal with uncertainty differently. In that regard, Paragraph B17 states,

To resolve that inconsistency, the Board decided that a liability for a cost associated with an exit or disposal activity should be recognized initially when the liability is incurred. Thus, in determining whether to recognize a liability for a cost associated with an exit or disposal activity, and in measuring its fair value, the guidance in Statement 5 and FASB Interpretation No. 14, Reasonable Estimation of the Amount of a Loss, does not apply.

There is no explanation for the assertion that Statement 5 does not apply. Thus, readers are left with the continuing problem of whether to look at the fair value (expected cash flows) approach in Concepts Statement 7 or the probability approach in Statement 5 when determining the proper accounting for liabilities not covered by authoritative literature.

Comments on the Theoretical Premise of the Current Exposure Draft

This brings me to the current exposure draft on "Conditional Asset Retirement Obligations." I do not believe that the Board has clearly or persuasively explained its reasoning for requiring liability treatment for asset retirements that are not likely to occur.

The main justification of the interpretation appears to be that in paragraph B12 as follows:

This Interpretation is consistent with the fair value measurement objective of Statement 143. In the deliberations for Statement 143, the Board concluded that the initial measurement objective for an asset retirement obligation is fair value. The Board acknowledged that liability recognition under a fair value measurement objective differs from recognition under Statement 5, which requires an entity to consider uncertainly in its determination of whether to recognize a liability. In contrast, Statement 143 requires an entity to consider uncertainly in its fair value measurement of the liability, not in the determination of whether a liability is recognized. Because of the Board's decision that the initial measurement objective is fair value

and, therefore, uncertainty is considered in the measurement of the liability, the guidance in Statement 5 is not applicable.

I believe that this is a faulty premise and uncertainty should not be ignored in the recognition decision. It is simply illogical to recognize a liability that a company believes is highly unlikely to result in a future cash payment. In recent discussions with IMA's Financial Reporting Committee, Board member Ed Trott argued in support of this notion that if a company were buying another company it would probably adjust the amount it is paying if an unlikely conditional asset retirement obligation existed. However, as noted earlier in this letter we generally don't apply purchase price allocation reasoning to "ongoing" accounting recognition decisions.

More importantly, there does not seem to be any reasoning in the proposed interpretation as to why measurement uncertainty should be included in the recognition decision other that the above quoted wording that "we've already required it." Interestingly, the next to last paragraph of the Introduction includes the following sentence: "The requirement to consider uncertainty in the fair value measurement of the liability rather than the recognition of the liability provides information about the uncertainty surrounding future cash outflows." However, that assertion does not appear to be included in the Basis for Conclusions section of the draft interpretation.

I question how recording a very unlikely "liability" could ever "provide information about the uncertainty surrounding future cash outflows." Rather, a user's understanding would be substantially enhanced by <u>not</u> including such dubious liabilities in financial statements but including appropriate footnote <u>disclosures</u> about these matters pursuant to Statement 5 or perhaps some enhanced version of those disclosure requirements.

I do not support the approach in Statement 143 that requires asset retirement obligations to be <u>measured</u> at fair value. However, in the case of 143 the obligation is virtually certain and it is "only" a measurement question that is of concern. Thus, I do support Statement 143's requirement for recognition of the asset retirement obligation. In the case of the proposed interpretation, the Board would compound the measurement issue problem in Statement 143 by recording highly unlikely amounts as liabilities.

Other Comments on the Exposure Draft

In addition to the comments in the immediately preceding section, which I would characterize as conceptual disagreement with the proposal, there are a number of practical problems.

Examples 1 and 2 in Appendix A state that the entity is able to estimate the initial fair value of the liability, in both cases with reference to Concepts Statement 7. Based on the assumed facts given, I suspect that it is very unlikely the companies in question would be able to determine such a "fair value." It would be helpful for the Board to provide real examples of where this has been done rather than simply asserting that is possible to do so.

Example 4 does not require initial accrual because the asset has "an indeterminate useful life." However, it seems to me that Examples 1 and 2 are just as "indeterminate." What Examples 1, 2, and 4 have in common is that the asset is not necessarily going to be retired as soon as the depreciation life is complete. Only the bricks in Example 3 really support the Board's reasoning, and a case might be made that that obligation really isn't conditional, as the company has to keep replacing the bricks in order to achieve the useful life of the kiln.

The proposal provides that accrual may not be possible initially because fair value is too uncertain. Then the accrual would be made at a later date when sufficient information is available to estimate fair value. The only example of when there would be too much uncertainty is in Paragraph 4 – the company might not be able to estimate a range of potential settlement dates. I suspect that many companies would be able to estimate a "range of potential settlement dates" but that range would be wide (e.g., sometime between 2025 and 2050). Thus, it seems as though this is going to be very difficult to apply in practice.

In fact, it probably would be impossible to estimate fair value in nearly all cases. Paragraph B6 states the FASB's opinion that "In some cases, sufficient information is not available to estimate the fair value. "Rather than "some," the proper word here should probably be "most" or perhaps even "all." The Board says that it got certain information from companies when it proposed this same accounting in the context of an FSP. I suggest that you provide information on the kinds of examples where companies are actually making these estimates currently, as you say some are doing.

Finally, will it be clear what asset retirement obligations are covered by this proposal? The asbestos and other contamination examples in Appendix A are fairly obvious. However, what about a Manhattan office tower? Would an owner be allowed to just leave an asset in place after its useful life or would the city require it to be torn down because of safety concerns? What about all of the cables buried by communications companies – might they have to be dug up at some point? There might be a long list of such conditional obligations that no one has thought of yet. Even if they are very unlikely, and even if the asset retirement might be decades into the future, under the fair value recognition approach some consideration of accrual would seem necessary.

In summary, I believe there are both significant conceptual and practical problems with this exposure draft. In my view, rather than continuing to work on what is surely a fairly narrow problem in practice, the FASB should devote more resources to the general matter of liability recognition and measurement. The current work on Revenue Recognition by necessity is closely related to liability matters. I think it would be far more productive to combine the revenue and liability reporting projects and not continue to deal with narrow issues like that in this Exposure Draft until a better, overall approach is decided on.

Sincerely,

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