One Pine Lane Valley Stream NY 11581 March 12, 2002 Letter of Comment No:/ File Reference: 1050-001 Date Received: 3/19/02

Timothy Lucas, CPA FASB Director of Research and Technical Activities 401 Merritt 7 Norwalk CT 06856-5116

Dear Tim:

Re: Proposal to add a major project to the Board's agenda on issues related to the recognition of revenues and liabilities.

Here are my comments on the Proposal:

 p. 3. "...business entities sometimes recognize deferred revenues even though those items do not meet the liabilities definition."

That's one of the old what-you-may-call-its that the Conceptual Framework outlawed. Outlawing them caused the Board to abandon the deferred method of interperiod income tax allocation and go to the liability method. These items should be explicitly outlawed too when the Board reexamines the areas.

This illustrates the harm done by the Board not fulfilling a promise it made 23 years ago in the Foreword to Concepts Statement 1:

The Board recognizes that in certain respects current generally accepted accounting principles may be inconsistent with those that may derive from the objectives and concepts set forth in the Statement and others in the series. In due course, the Board expects to reexamine its pronouncements, pronouncements of predecessor standard-setting bodies, and existing financial reporting practice in the light of newly enunciated objectives and concepts.

The Board should add a major project to its agenda to fulfill that promise.

p. 3. "In practice, revenue recognition seems to [conflict with liability recognition by overriding the liabilities definition] even though, conceptually, it should not."

The Conceptual Framework as it is should control until and unless the Board amends the Conceptual Framework. When the Board reconsiders a practice area, any conflict of the Conceptual Framework with practice should be removed by mandating change to practice. A definition in the

Conceptual Framework of one of the elements of reporting entities represented in financial statements should not be newly overridden by the Board.

This again illustrates the harm done by not fulfilling the promise.

Though representational faithfulness is not defined comprehensively in one place in the Conceptual Framework, its definition can be inferred from the following:

Concepts Statement 1, paragraph 18, states that "...financial statements involve...depicting economic things and events."

Concepts Statement 2, paras. 62, 63, and 86, holds that representational faithfulness requires the data to purport to represent phenomena external to financial statements and their underlying documentation, by stating that "Accounting information is reliable to the extent that users can depend on it to represent the economic conditions or events that it purports to represent," "Representational faithfulness of reported measurements lies in the closeness of their correspondence with the economic transactions, events or circumstances that they represent," and by referring to "....a measure or description and the phenomenon it purports to represent."

Concepts Statement 5, para. 21, states that "Real things and events that affect a...business enterprise are represented in financial statements...."

The Highlights of Concepts Statement 6 states that "The items in financial statements represent in words and numbers certain entity resources, claims to those resources, and the effects of transactions and other events and circumstances that result in changes in those resources and claims."

Some liabilities mandated by the Board since the Concepts Statements 1-6 were issued do not satisfy the criterion that "the information about the item is representationally faithful...." because they do not purport to represent anything. They include the following:

1. Deferred income tox liabilities under the liability method. No reporting entity has a liability for deferred income tax at the reporting date: it does not purport to represent anything, faithfully or otherwise.

The Board went astray in paragraph 79 of its Statement 109, which states in part that "Deferred tax liabilities result from the same past events that create taxable temporary differences." One of the events that creates taxable temporary differences is doing bookkeeping a certain way. (Were bookkeeping done a certain other way, no temporary difference

would be created.) Bookkeeping by a reporting entity cannot result in a liability. (If the financial statements are restated, the so-called liability could be magically eliminated.)

The Board backed itself into a corner concerning deferred taxes by issuing the Conceptual Framework. It tried to extricate itself by pretending that the old outlawed what-you-may-call-it deferred credits had suddenly transformed themselves into real live liabilities, detrimental relationships with other parties, some of them enormous liabilities (Exxon Mobil Corporation reported a deferred tax liability as of December 31, 2000, of \$16.4 billion). They in fact did not transform themselves.

2. Liabilities for nonvested pension benefits. No reporting entity has a liability for nonvested pension benefits at the reporting date: it does not purport to represent anything, faithfully or otherwise.

The Board started to go wrong in paragraph 15 in its Statement 87 by stating that

The assumptions and the attribution of cost to periods of employee service are fundamental to the measurements of net periodic pension cost and pension obligations required by this Statement.

The Board Chairman at the time, Kirk, told us the thinking the Board went through to arrive at that:

The rendering of service by employees is considered the obligating event for pension costs and other postretirement benefits, even if the rights to compensation have not yet vested. ("Commentary on Future Events: When Incorporated into Today's Measurements?" Accounting Horizons, June 1990, p. 89, emphasis added)

The Board thus *considered* when a liability for defined benefit pensions comes into existence rather than analyzing the events that occur under a defined benefit pension contract to determine when they cause a liability of the reporting entity.

In contrast, both the APB and Robert Van Riper, public relations counsel to the FASB, said the events surrounding an issue should be analyzed:

Selecting the events. Events to be accounted for are identified. Not all events that affect the economic resources and the obligations of an enterprise are or can be accounted for when they occur. Analyzing the events. Events are analyzed to determine their effects on the financial position of an enterprise. (APB Statement 4, para. 176) ...after a topic is added to the [FASB] agenda, the emphasis changes...to considering how to do it [which] require[s] understanding of the transactions or events underlying an accounting issue.... (Van Riper, "'Due Process' and the Decision-Making Process," FASB Viewpoints, October 31, 1986, p. 4)

Had the Board analyzed such contracts, it would have realized that, as Kirk said, "employees may have to render future service before they have a right to *any* benefit." (Kirk, *op. cit.*, p. 89) If employees have no right to any benefit before they vest, the reporting entity has no liability to them then.

The Board *considered* what the obligating event is rather than finding out what it is without a preconceived notion to achieve stable income reporting:

The [FASB] believes that the [pension reporting] method should be more effective in reducing income statement volatility than the method proposed in the Preliminary Views. (FASB, "Action Alert," September 19, 1984, p. 3)

At a public hearing on pension reporting that I attended, Chairman Kirk said a concern of the FASB in drafting the pronouncement was to be sure it contained "an adequate amount of smoothing."

The Board thinks there is such a thing as nonvested benefits:

The Board believes that the actuarial measurement of the obligation encompasses the probability that some employees will terminate and forfeit nonvested benefits. (Statement 87, para. 149)

But every employee knows that she doesn't become entitled to benefits before they are vested and that she can't forfeit anything she never had (except for the opportunity she does have of obtaining vesting in the future if she stays that long—that's one of the things that keeps her there—but everyone forfeits an infinite number of opportunities every day, and none of them should affect financial statements, being the difference between what happened and what didn't happen—for example, the employee also forfeits the opportunity to continue to be employed by the reporting entity, to be promoted, and so on)

Just because actuaries believe there are such a thing as forfeitures of nonvested benefits, that does not mean we accountants should be fooled into also believing so.

3. Uninsured liabilities for postretirement health care benefits for other than health conditions existing at the reporting date. No reporting entity has a liability for such benefits at the reporting date: it does not purport to represent anything, faithfully or otherwise.

Again, the Board decided reporting entities have such liabilities to stabilize income reporting. The Board started to go wrong in paragraph 158 in its Statement 106 by stating that

An objective of this Statement is to recognize the compensation cost of an employee's postretirement benefits over the employee's credited service period....

Had it made sure instead that reporting entities have such liabilities, it would have run into the following example: An employee breaks her arm five years after retiring at age sixty-five. Breaking the arm was the result of, for one thing, something that happened after she retired. A liability of the reporting entity to pay for that injury at a reporting date when she was twenty years old, fifty years before she broke her arm, was at most contingent.

FASB Statement 5, paras. 29 and 30, state:

An enterprise may choose not to purchase insurance against risk of loss that may result from injury to others.... Mere exposure to risks of those types...does not mean that...a liability has been incurred. ...Losses of those types do not relate to the current or a prior period but rather to the *future* period in which they occur.

A liability for uninsured postretirement health care benefits for problems that have not yet occurred is one of the old, outlawed, reserves for so-called self-insurance.

4. p. 3. "Aside from the definition criterion, th[e fundamental] criteria [of Concepts Statement 5] are very general and have not provided the Board with the tools needed to develop consistent guidance for liability recognition issues."

As demonstrated in item 3 above, the criterion of representational faithfulness is specific enough to rule out deferred tax liabilities, unvested pension benefit liabilities, and uninsured liabilities for postretirement health care benefits for other than problems existing at the reporting date.

p. 4. "...the Board encountered difficulties...because of issues about...identification of past events that
give rise to liabilities. ...Confusion between present obligations and future obligations. ...Searches for
a single obligating event.

The Board identified past events improperly at least in the three areas discussed in item 3 above. Its basic problem with such identification is that the Board is unclear as to whether a single liability can be "the result of" more than one event. It usually assumes that a liability can be the result of only a single event. As the Proposal states on p. 4:

[One of] the three essential characteristics of a liability: ...(c) The transaction [singular] or other event [singular] obligating the entity has [singular] already happened."

For example, as quoted above, to stabilize income reporting, it assumed that defined benefit pension liabilities are solely the result of "employee service:"

The assumptions and the attribution of cost to periods of employee service are fundamental to the measurements of net periodic pension cost and pension obligations required by this Statement.

In fact, they are the result of at least two events, employees performing service and employees vesting. Before the last event occurs of which they are a result, they are at most a contingent liability.

For another example, as quoted above, to stabilize income reporting, it assumed that a reporting entity has uninsured liabilities for postretirement health care benefits for other than problems existing at the reporting date because they are solely the result of the employee working over her "credited service period:"

An objective of this Statement is to recognize the compensation cost of an employee's postretirement benefits over the employee's credited service period....

In fact, they are the result of at least two events, employees working over their credited service periods and the onset of an illness or the occasion of an injury. Before the last event occurs of which they are a result, they are at most a contingent liability.

For the third example, any income tax liability (except for back taxes), so-called deferred or otherwise, is the result of at least one event that appears in the income tax return for the year of the financial statements, as the Board said in Concepts Statement 6, para. 210:

Transactions or events that result in liabilities imposed by law or governmental units...are often specified or inherent in the nature of the statute or regulation involved. ...For those imposed obligations, as for obligations resulting from exchange transactions, no liability is incurred until the occurrence of an event or circumstance that obligates an entity to pay....

Such an event is in addition to whatever other events the Board assumes result in deferred tax liabilities. That demonstrates that no income tax liability is ever deferred.

Searching for a single obligating event is fruitless. Many if not most liabilities are the result of at least two events. For example, a company manufactures a defective product—one event. It sells the product to a customer—a second event. A liability to the customer is incurred on the sale, the second event. Before then, the liability is, if anything, only contingent. (The customer would also have to discover the defect and put in a claim. Those events would not be causes of the liability; they would merely be causes of the reporting entity having to discharge the liability.)

 p. 5. "The proposed project is closely related to the Board's agenda project on financial performance reporting by business enterprises...."

My understanding of the Board's agenda project on financial performance reporting by business enterprises is that it will be confined to display on financial statements and avoid issues of recognition and measurement. It seems to me that the proposed project deals mostly if not exclusively with issues of recognition and measurement.

7. p. 5. "This project...would amend the conceptual guidance for liabilities."

Although the conceptual guidance for liabilities could stand some improvement, my fear is that once this project gets going, political pressure will be brought to bear to amend it to once again explicitly allow what-you-may-call-its, to appease the desire of the issuers of financial reports for stable income reporting. It is bad enough that the Board has allowed what-you-may-call-its in again by the back door by abusing the current definition of a liability. It would be a disgrace for it to allow them in again by the front door.

8. p. 5. "Work on the project would be undertaken in two...phases. ...The [second] phase would...focus ...on the detailed authoritative guidance and other accepted practices for revenue recognition...."

The problem with that focus is that it starts with the income statement. Whenever the Board has started with the income statement it has, for political reasons, ended with a solution that stabilizes income reporting rather than results in representationally faithful reporting of the assets, liabilities, revenues, and expenses of the reporting entity.

8. p. 7. "The Board seeks comments...particularly on...the following major questions: ...5. Should the proposed project...develop a new, general accounting standard on liability recognition?

Yes. In particular, it should prevent the abuses of the concept of a liability such as those in recent years that resulted in reporting of contingent liabilities as liabilities for the purpose of stabilizing income reporting.

9. p. 9. "4. Should the liabilities definition encompass conditional or contingent obligations?"

I do not know the difference between conditional and contingent obligations. The definition of a liability should not encompass contingent obligations, for the reasons stated above, and, above all, because there would be nowhere to stop. Incorporation of a company could be said to cause contingent liabilities for all the future payments made by the company.

The main problem with the Board's treatment of liabilities is that it wants to keep its Conceptual Framework outlawing of what-you-may-call-its, liabilities contrived solely to stabilize income reporting, while at the same time abusing its Conceptual Framework definition of liabilities to achieve that very result.

I recommend that the Board center its study of reporting on liabilities on Leonard Lorensen, Accounting Research Monograph No. 4, Accounting for Liabilities (New York: AICPA, 1992)

Sincerely,

Paul Rosenfield

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