Dear Director:

This letter represents my comments on the Invitation to Comment, “Selected Issues Relating to Assets and Liabilities with Uncertainties.” I am pleased to see that the Board is interested in looking at these vexing issues in connection with the reconsideration of its (and the IASB’s) conceptual framework. While the questions in the Invitation are asked in the context of decisions that have already been made in individual standards and interpretations issued by the Board, and in the context of the proposed revisions to IASB 37, I hope that Board members will have an open mind and seriously consider the shortcomings of recent decisions as they evaluate responses to the Invitation.

Please note that I have devoted my comments mainly to liability matters. I have chosen to do so because I have commented on several recent proposals that involved liability recognition and measurement matters. I can certainly understand concerns about the lack of evenhandedness in the current treatment of contingent assets and liabilities in SFAS No. 5. The overly conservative bias in that Statement toward contingent assets ought to be reconsidered.
Recent Decisions Based on Concepts Statement 7 are Flawed

As stated in earlier letters to the FASB, I have disagreed with decisions made by the Board in Statement 143, Interpretation 45, and Interpretation 47, all of which are cited in paragraphs 18-21 of the Invitation. The net result of these pronouncements is that companies are now required to record liabilities in many cases where it is highly unlikely that any future expenditure will be made, let alone the amount that must be accrued. This, in my opinion, has damaged the credibility of financial reporting and has led to implementation problems that confound affected companies and their auditors. Other decisions not cited in the Invitation (e.g., the requirement to record certain exit liabilities at fair value according to Statement 146 and the proposed requirement to record many contingencies at fair value according to the business combinations exposure draft) only exacerbate the situation. I urge the Board to hold off on the business combinations exposure draft and other applications of the uncertainty issue until it has a chance to thoroughly consider the responses to this Invitation and re-debate the matter.

My concern about this general matter can be traced back to Concepts Statement 7, issued in February 2000. As noted in Concepts Statement 7, the FASB project on using present value in accounting began in 1988. At the time, many in the accounting profession were concerned that some accounting rules required the use of present value measures while other rules did not -- in arguably similar circumstances. However, as the project evolved, and due to differences of opinion among Board members about how the matter should be resolved, it was decided that the final concepts statement should focus mainly on how to make present value calculations when the Board decided that they were appropriate. The concepts statement would not try to resolve when present value measures were appropriate and that was to be left to individual standard setting projects. While the final version of Concepts Statement 7 is less than crystal clear on this matter, I cite the following from paragraph 13:

While the Board decided that its work on present value should focus on measurement, leaving recognition questions for other projects, it observes that recognition and measurement are related to one another. For example, a decision to change the measurement attribute (for example, a change from amortized cost to fair value) also raises recognition questions. In some cases, a measurement governs whether or not a change in the carrying amount will be recognized and
provides the basis for the subsequent carrying amount. Lower-of-
cost-or-market rules are one example. However, the convention that
governs recognition and the measurement attribute need not be the
same. For example, FASB Statement No. 121, Accounting for the
Impairment of Long-Lived Assets and for Long-Lived Assets to Be
Disposed Of, uses a recognition convention based on undiscouned
cash flows. The measurement of impairment is based on fair value.
(emphasis added)

Notwithstanding that decision, the Board’s actions on several recent projects
(particularly the ones I disagree with that are enumerated above) have
followed a pattern of adopting a fair value approach to both recognition and
measurement under the rationale that Concepts Statement 7 requires that
treatment. Rather than making a case in each pronouncement that such an
approach will produce superior financial reporting and will be sufficiently
practical to implement, the Board seems to be saying that Concepts
Statement 7 leaves us no choice but to adopt a fair value approach. This
situation seems similar to the current debate over whether Supreme Court
justices should be strict constructionists and interpret the Constitution as it is
written or whether they should be allowed to apply a more liberal
interpretation that they believe will result in decisions that are “better” for
the nation. It appears that the latter approach is what FASB Board members
have been doing for the past several years with extremely liberal
interpretations of Concepts Statement 7.

The FASB certainly has the right to revise its own constitution (i.e.,
conceptual framework) and presumably that is the purpose of the current
project that includes this Invitation. So I support the Board in seeking input
in this Invitation but I disagree with the present positions taken by the IASB
and FASB on most of the questions raised in the Invitation. Rather than
communicating a fully open minded attitude on these questions, it appears
that the Boards are seeking to gain ex post agreement with decisions on
specific standards that were based on overly liberal interpretations of current
concepts.

Use of Probability

The Invitation does point out one key matter that has perplexed both the
Board and its constituents for some time. That is the different use of
probability in Statement 5 on accounting for contingencies and in Concepts
Statement 6. This is an example of a failure to communicate as most constituents have paid little attention to the FASB’s position in Concepts Statement 6 that “probable” means only not certain or proved. Instead, constituents focus on the use of the term in Statement 5 where it means something that is likely to occur. While neither of these uses represents a precise measure of expected outcome, the Statement 5 usage is considered to be a high percentage while the Concepts Statement 6 usage means a percentage that may be at the extreme other end of the range. In large part because of the emphasis in practice on the use of probability in Statement 5, it is illogical to most practitioners to require recognition of an amount that has only a very low chance of resulting in a cash flow.

This failure to communicate is made worse by statements such as the following in paragraph 52 of the Invitation: “… the IASB also notes that the amount an entity would expect to pay to settle or transfer the stand-ready obligation would reflect the likelihood, amount, and timing of the expected cash flows related to the associated conditional obligation.” The problem is that most business people look at what are presently called contingent liabilities as one potential obligation that will either result in some cash payment or not. When it is highly unlikely that any payment will be made, business people don’t see the sense of recording a liability. They are not oblivious to the fact that there is some economic exposure but they question the relevance of recording a liability that they do not expect to pay and that they cannot reasonably measure. When words like “expected cash flows related to the associated conditional obligation” are used, those business people simply state in response “we don’t expect any!” And in those cases where some payment is expected, they would record an amount representing the costs they actually expect to incur rather than a hypothetical settlement amount in a transaction with a third party.

As noted in paragraph 37 of Concepts Statement 2, “Thus, financial reporting should provide information to help investors, creditors, and others assess the amounts, timing, and uncertainty of prospective net cash inflows to the related enterprise.” While the traditional approach of accounting for contingent liabilities based on reasonable estimates of amounts that are likely to be paid may not be perfect, it seems far more likely to achieve this principal purpose of financial reporting of assessing actual future cash flows than the approach in the Invitation.
Contingent vs. Conditional

The FASB and IASB apparently believe that financial accounting concepts can be improved by changing terminology for contingent liabilities (and assets) to call them conditional and by dividing what has been traditionally considered as one amount into conditional and unconditional components. The problem with the terminology issue is that there is no obvious difference between contingent and conditional. For example, in my office dictionary, one of the definitions for “contingent” is “dependent on; conditional.” Accounting concepts that rest on whatever semantical distinctions the Board members see in these two terms are unlikely to result in clear guidance for future standard setting activity.

The division of amounts into conditional and unconditional rights is overly theoretical and ignores the practical way in which these items are evaluated in the business world. The examples in paragraphs 33-35 of the Invitation of supposed unconditional rights in contract settings are not assets or liabilities in any conventional use of those terms. While I didn’t find a definition of “unconditional” in the body of the Invitation, paragraph BC11 of Appendix A explains that the IASB believes that unconditional means “nothing other than the passage of time is required to make its performance due.” That is not the case for any of the three examples offered in the Invitation as explained in the following paragraphs.

Example 1 – paragraph 33 – While the filing of a lawsuit may eventually lead to a claim being heard by a court, there is no “unconditional right” to the claim being heard by a court until after many months or even years of legal procedures have occurred. Why is that any more of an “unconditional right” than another company that believes it has been damaged and plans to file a lawsuit tomorrow? The second company has substantially the same legal opportunities as the first company, and neither has fully exercised them yet. Each of these companies would have substantial hurdles to clear before their case would be heard by a court.

Example 2 – paragraph 34 – The Invitation states that an application for an operating license is “an unconditional right to participate in the process of applying for the license that does qualify as an asset.” Is nothing else required other than the passage of time in this case? Or might the applicant have to appear at a public hearing to address questions about the application or do other things before a license is or isn’t granted? As an analogous
example, if I have applied for a job, somehow it doesn’t strike me that I have an asset that should then be recorded on my personal balance sheet because I have an “unconditional right” to have my application considered by the human resources department. Presumably, I would have to go through interviews, submit additional references, undergo background checking, or do other things before I could be officially considered for employment. If 500 individuals have all applied for this same job, does each of them have an asset?

Example 3 – paragraph 35 – Likewise, an “unconditional right to the economic value of the developing contractual relationship with the customer” at the time of negotiating a contract with a potential new customer isn’t dependent solely on the passage of time. Before this “relationship” will have any value, it has to develop over time through further efforts by the potential seller.

Board members may or may not agree with my arguments that the examples are not clear illustrations of unconditional rights. I used my explanations to illustrate that trying to break what we have traditionally called contingent liabilities into conditional and unconditional elements is not only overly theoretical but it also is not likely to be applied in any sort of practical way. And even if we accept the Board’s distinction between conditional and unconditional elements, how in the world are we to determine amounts to be assigned to “assets” such as the right for a claim to be heard, the right for a license application to be considered, or the developing relationship with a potential new customer?

I am also curious as to how the conditional/unconditional analysis would work for a transaction in which cash is exchanged on the front end. For example, if a company sells a one-year warranty to a customer for $200, would the Board require that only a small amount representing the unconditional obligation to stand ready be recorded as a liability? Would the remaining major portion of the contract representing the conditional warranty coverage if and when something actually goes wrong with the product be recognized as “income” when the warranty is sold?

In paragraph BC26 (taken from IASB literature) the Invitation states, “Nonetheless, the Board observed that in practice the conditional obligation is sometimes the more readily identifiable obligation. Thus, it can be used as a pointer to any associated unconditional obligation.” I would probably
change “sometimes” to “usually” or “almost always” in the quotation above. The so-called conditional obligation is the essence of these transactions and it appears that Board members are stretching their imaginations to find “unconditional obligations” hidden in these transactions in order to support the theoretical approach they espouse.

As a final comment on the conditional/unconditional approach, how would what are now known as executory contracts be accounted for? Should we assume that there is some unconditional element of these contracts that must be recorded in all cases? For example, I have a letter of understanding that the University of Georgia intends to employ me for the 2006-07 school year. While I doubt that the University could force me to work, and I also doubt whether I could force the University to employ me if, for example, a budgetary crisis ensues, does the University have a liability and do I have an asset at this time? What is its nature? At what amount should it be recorded?

A Final Note

Obviously, it is the FASB’s responsibility to improve financial accounting standards, not just change them. When making such radical changes to accounting models that have existed for 30 years or more, it seems to me that the Board needs to provide convincing evidence that the information produced by the new approach will be clearly superior to the information provided by the old model. Rather than continuing to impose the Concepts 7 model in ever more creative ways, I suggest that it is time for the Board to step back and objectively examine whether what it has done to date (see specific examples cited above) is truly an improvement. This Invitation gives the FASB an opportunity to do so and I sincerely hope that it will be taken seriously.

If you have any questions on my comments, please let me know.

Sincerely,

Dennis R. Beresford
Ernst & Young Executive Professor of Accounting