Dear Sir or Madam

Reference No. 1235-001
Financial Accounting Series
Selected Issues Relating to Assets and Liabilities with Uncertainties

Attached are my comments on the above topic.
My name is Don Bjerke. I am a Canadian citizen and I am concerned about the misrepresentation of accounting statements using the fair value measurement in its standards. As the Canadian Accounting Standards Board (AcSB) harmonizes with the FASB accounting directives, these comments are being sent to both the FASB and AcSB.

I am a member of the Society of Depreciation Professionals and thanks to Mr. John Ferguson of the society am kept informed about current issues relating to depreciation. The Society also issues a periodic journal in which my brother Ralph and I have published many articles over the years. Two articles that relate to this subject are:

  Comments on Asset Retirement Obligations  
  Volume 11, Number 1 2002-2003 pages 49 to 55

  Modeling ARO Financial Statements  
  Volume 12, Number 1 2004-2005 pages 21 to 28

Both of us were employed as Professional Engineers in the telecommunications industry with particular job responsibilities in the area of economic analysis and depreciation. Prior to retirement, Ralph was employed by Telus, and I was employed by SaskTel. We continue to maintain an interest in Economic Analysis and Financial Analysis. We both feel that there are deficiencies in the economic perspective in the conceptual framework project that we reviewed.

Yours Truly

Don Bjerke  
178 Deergrove Crescent  
Regina Saskatchewan  
S4S-5M1  
E-mail  bjerke@sasktel.net  
Phone no. (306) 584-5001
Introduction
It is evident that FASB and IASB have embarked on a conceptual framework where they want to report fair values for fixed assets in the balance sheet. By embarking in this direction, I find the Invitation to Comment depicting the frameworks and standards extremely complicated and confusing. The confusion comes as the result of a lack of understanding between the two distinct disciplines, Economic Analysis and Financial Analysis. A clear understanding of these disciplines and the roles they play in the areas of risk & uncertainty, terminology, and measurement, would help sort out this confusion.

The conceptual framework essentially has one overriding objective: decision-usefulness. But decision-making is an economic objective and not a financial objective. Decision-making requires that outgoing cash flows be stated in fair values. Rather than to redefine the discipline of financial analysis to accommodate the process of fair value, it is suggested that FASB make use of an already defined discipline – Economics Analysis.

Defining Economic Analysis and Financial Analysis
Economic Analysis is used for decision-making purposes and includes the fields of managerial and engineering economics. It includes cost comparative studies, profitability studies and cost studies for pricing decisions. The characteristics of this discipline are shown in Exhibit A. It is prospective and can relate to individual activities within the firm and to the overall firm.

The discipline of Financial Analysis, on the other hand, relates to the company or company segment performance and constitutes a different set of characteristics to that of Economic Analysis as shown in Exhibit A. Performance compares what the company or company segment actually did to what it should have done. It is both prospective (i.e. budgetary) and retrospective and can also relate to activities within the firm and the overall firm. It encompasses the fields of cost accounting, financial accounting and management accounting. Although there are some commonalities such as the use of time value of money and the use of future cash flows, economic analysis and financial analysis are two distinctly separate disciplines. The information from financial statements should only be used for judging performance. These statements should not be used for decision-making purposes. Decisions regarding credit, buying, selling, securities etc. would be better served by set of pro-forma statements such as a pro-forma contribution (income) statement and a pro-forma balance sheet. These can be generated as required from economic study cash flows where fair values are used. These statements are illustrated in Exhibits B and C.

Risk and Uncertainty
The Invitation to Comment states on page 1 that “the framework only considers the use of probability and uncertainty in measurement in the context of a present value calculation.” I take this to mean that the uncertainty would be conducted within the context of an economic Net Present Value (NPV) study. In economics this would fall
under the subject of *Decision Making under Risk and Uncertainty*\(^1\). Decision making is choosing, amongst all possible alternatives, the best course of action under:

a) *Certainty* if each action is known to lead invariably to a specific outcome;

b) *Risk* if each action leads to one of a set of possible specific outcomes, each outcome occurring with a known probability;

c) *Uncertainty* if each action has as its consequence a set of possible specific outcomes, but where the probabilities of these outcomes are completely unknown or not even meaningful.

There are many ways of incorporating risk into the decision-making process. One common way is using a simulation approach. When simulation is used in an NPV study, it requires that estimates be made of the probability distribution of each cash flow (capital expenditure, cost of removal, gross salvage, cash expenses, and revenue). These probability distributions are then put into the simulation model to compute the project's NPV probability distribution. This information then provides the decision-maker with an estimate of a project's expected returns and risk.

Once the decision is made governing the operation of a business, financial accounting now measures and reports the results of the business operations. Risk and uncertainties should play no role as it relates to assets, liabilities and equity in a balance sheet.

**Terminology**

*Defining Assets*

Accounting has already defined assets as “valuable resources owned by a business which were acquired at a measurable cost”\(^2\).

FASB has redefined assets as the “probable future economic benefits obtained or controlled by a particular entity as the result of past transactions or (other) events”\(^3\).

This definition looks similar to the economic definition of capital expenditure as: “the cash outlay that is expected to generate a flow of future cash benefits”\(^4\).

Why wouldn't the assets be the resources involved rather than the “probable future economic benefits”? Benefits are usually revenues. Assets are not revenues! The word “control” should also not be used. Control means the possession of an item. But possession or control, without substantial ownership, is not enough to qualify the item as an asset\(^5\).

Why are past transactions included in the definition? Do they have to be from a transaction, be it past or future? A study of future benefits is included in an economic study without a transaction.

Since a financial statement can be prospective, I suggest the accounting definition to be: **Assets are valuable resources owned or will be owned by a business having a measurable cost.**

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\(^1\) See *Managerial Economics* Fifth Edition Chapter 3, *Decision Making under Risk and Uncertainty* by McGuigan/Moyer

\(^2\) See *Management Accounting* Text and Cases Robert N. Anthony page 36

\(^3\) FASB Concepts Statement No. 6, *Elements of Financial Statements*, paragraph 25

\(^4\) See *Managerial Economics* by McGulgan & Moyer page 572

\(^5\) See *Management Accounting* Text and Cases Robert N. Anthony page 37
The definition of the asset should include the following qualifications:

- ownership as a legal concept which is binding through a contractual agreement.
- having three tangible elements; the initial capital expenditure, its gross salvage (if capitalized), and its cost of removal (if capitalized).
- having all elements recognized at the time the capital expenditure is acquired and depreciated from this point in time (i.e. the present worth of the Asset Retirement Obligation cost of removal be recognized and depreciated at the time the initial capital expenditure is acquired).
- measurement of the capital expenditure depending on whether it is used in an economic study or in a financial study. Fair value for the capital expenditure would be used in an economic study while historical costs would be used in a financial study. The gross salvage and the cost of removal will both be measured at fair value in both studies.
- belonging to a homogeneous property grouping (i.e. mass property or life cycle property) having a set of life characteristics (i.e. life and dispersion). The grouping defines the “method of settlement” and the dispersion defines the “probabilities associated with the potential settlement dates” since dispersion is a statistical measurement. A grouping of a single item would have a rectangular dispersion.
- containing a “purchase to disposal” condition that applies over the total life of the asset (i.e. site life and reuse are not recognized). Hence it is not contingent nor is it conditional.

Once an item is defined as an “asset” all the above qualifications automatically apply.

**Defining Liabilities**

Similarly accounting has already defined liabilities as being “claims of outsiders against the business, or, the amounts that the business owes to persons other than the owners”.

FASB has redefined liabilities as the “probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events”.

This definition, again, looks similar to the economic definition of opportunity cost which is defined as “the sacrifice that is made whenever an exchange or transformation of resources takes place”.

A good example of an opportunity cost is a positive net salvage (defined as the gross salvage less the cost of removal). If a present obligation uses existing equipment then the opportunity cost associated with the equipment is the positive net salvage which could have been obtained if the equipment was sold.

This example of opportunity cost, however, does not apply to the cost of removal. No sacrifice is being made because the cost of removal is the labour not the equipment that could be sold. Labour is a sunk cost and can not be sold. The same can be said about

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6 see Management Accounting Text and Cases Robert N. Anthony page 40
7 FASB Concepts Statement 6 paragraph 35
8 See Managerial Economics by McGulgan & Moyer page 371
Asset Retirement Obligations. An ARO is a cost of removal containing labour not equipment. Hence if liabilities are defined in the context of Asset Retirement Obligations, no sacrifices would be made.

Since a financial statement can be prospective, I suggest a better accounting definition to be: **Liabilities are legal obligations that outsiders claim against the business, or, the amounts that the business owes or will owe to persons other than the owners**

**Defining Equity**

It seems that FASB has adopted certain economic concepts where they shouldn’t have and have not adopted others where they should have. A case in point is the cost of equity. Robert N. Anthony has stated in his book 9:

“I propose that accounting adopt the concept of interest used in economics. Specifically, interest on the use of both debt and equity capital should be accounted for as an item of cost - the cost of using capital - and should be reported in the same way other items of cost are reported”.

Since a financial statement can be prospective, I suggest a better accounting definition to be: **Equity are legal obligations that the owners claim against the business, or, the amounts that the business owes or will owe to the owners**

Since the Assets = Liabilities + Equity, liabilities and equity contain the legal and financing obligations for the assets.

The Debt Interest and the Equity Interest are calculated by multiplying the remaining capital balance by the debt interest rate and by the equity interest rate.

The Contribution Statement in Exhibits B and the Balance Sheet in Exhibit C illustrate the relationship amongst Assets, Liabilities, Equity, Debt Interest and Equity Interest.

**Measurement**

Measurement will depend on the whether the asset will be used in an economic study or in financial statements. Capital expenditures in historical costs are the only meaningful measurement in retrospective financial statements. Prospective (budgetary) financial statements should show capital expenditure values in which they occur. Only Economic studies will state capital expenditures at fair value. Gross salvage and cost of removal cash flows will be stated at fair value in both studies. Liabilities and equity are the legal and financing obligations for the asset and they, as equities, are equal to the asset costs. Financial statements use deterministic values. Economic studies may be deterministic or probabilistic.

To solve the problem of using fair value in financial statements, it is suggested economic studies be used to generate a Pro-Forma Contribution Statement as shown in Exhibit B and a Pro-Forma Balance Sheet as shown in Exhibit C. These statements can be

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10 based on Robert N. Anthony's definition of equity in his book: *Management Accounting* Text and Cases page 40
generated using the cash flows in an economic study. Note that economic studies are conducted as required while financial statements are generated on a periodic basis.

The following are my input on the questions presented in Invitation to Comment:

**Question 1:** Do you agree with eliminating the notion of contingent asset? If not, why not.

**Answer:** The notion of "purchase to disposal" which encompasses the same idea should automatically be one of the qualifications of an asset. It is included by definition.

**Question 2:** Do you agree with the IASB’s analysis of unconditional and conditional rights in contractual settings, as summarized in paragraphs 30 and 31 of this Invitation to Comment and paragraphs BC10-BC13 of the IASB Exposure Draft? If not, why not?

**Answer:** The notion of "purchase to disposal" which encompasses the same idea should automatically be one of the qualifications of an asset. The definition states ownership is a legal concept and is contractual. It applies to all assets.

**Question 3:** If you answer yes to Question 2, do you agree that the IASB has appropriately applied the notion and supporting reasoning referred to therein in the analysis of Examples 1-3 in paragraphs 33-35 of this Invitation to Comment? If not, why not?

**Answer:** The definition of an asset includes ownership. It is a legal concept and is binding through a contractual agreement.

**Question 4:** Do you agree with the IASB’s proposal to classify as intangible assets those unconditional rights that are associated with conditional rights and that satisfy the definition of an asset, without shifting the consideration of the uncertainty surrounding the conditional rights from recognition to measurement?

**Answer:** The proposed definition of an asset clarifies this situation. Uncertainty plays no role in financial statements.

**Question 5:** Do you agree with eliminating the notion of contingent liability? If not, why not?

**Answer:** The notion of "purchase to disposal" which is associated with the idea of contingency is one of the qualifications of an asset. Liabilities and equity are the legal and financing obligations for the asset. The notion of contingency does not apply to liabilities.

**Question 6:** Do you agree with the IASB’s analysis of unconditional and conditional obligations in contractual settings, as summarized in paragraphs 39 and 40 of this Invitation to Comment and paragraphs BC24-BC28 of the IASB Exposure Draft? If not, why not?
Answer: Liabilities and equity is bound by the asset’s contractual arrangements. Liabilities and equity are the legal and financing obligations for the asset. The notion of conditions does not apply to liabilities.

Question 7: If you answer yes to Question 5, do you agree that the IASB has appropriately applied the notion and supporting reasoning referred to therein in the analysis of the example in paragraph 41 of this Invitation to Comment? If not, why not?
Answer: My answer is no. This notion does not apply to liabilities or equity.

Question 8: Do you agree with omitting the probability criterion for recognition of nonfinancial liabilities? If not, why not?
Answer: Probability relates to Decision Making under Risk and Uncertainty or used to describe a dispersion associated with the homogeneous property grouping for an asset. This criteria does not apply to the liabilities or equity.

Question 9: Do you agree with the proposed measurement requirements for nonfinancial liabilities? If not, why not?
Answer: The measurement of liabilities and equity is governed by the equation:

\[ \text{Assets} = \text{Liabilities} + \text{Equity} \]

Liabilities and equity fulfill the legal and financing obligations for the asset. Liabilities and equity is governed by the measurement of assets.

Summary
Decision-making is an economic objective. Performance is a financial objective. Economics involves decision-making under risk and uncertainty. Uncertainty plays no role as it relates to assets, liabilities and equity in financial statements. Probability in financial statements should only relate to assets when it is used to express retirement dispersion patterns. Clear definitions for assets, liabilities and equity will eliminate the seemingly endless legal jargon used in the conceptual framework project. An item either qualifies as an asset or it does not. The output of an economic study can provide a measurement of fair value in a form of a Pro-Forma Contribution Statement (Exhibit B) and a Pro-Forma Balance Sheet (Exhibit C).

I hope that the above comments will be of some assistance in the review process of FASBs frameworks and standards and not result in what Robert N. Anthony has stated in his book:

"Unlike many other standard-setting bodies, especially the IASB, the FASB has never conducted an overall review of its standards."

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Exhibit A

**Financial Analysis**
Considers the performance of financial statements over a short term
Viewed on a company or business segment basis
Uses historic and projected financial information
Does not relate to valuation or appraisal
Factors Considered:
- Earning impact
- Legal and tax requirements
- Full cost recovery
- GAAP
- Allocation of common costs
- Financial regulatory requirements
Uses:
- Determining profitability on an accounting basis
- Constraint on economic decision-making
- Operational goal setting on a corporate and segment basis
- Determining full costs
- Setting revenue requirements on a segment or company basis
Capital Recovery:
- Depreciation + Interest + Equity
Indicators:
- Net Income
- Return on Capital Employed
- Return on Equity
- Contribution
- Return (pre-tax, conventional, after-tax)
- Financial statements

**Economic Analysis**
Considers viability over the long term
Viewed on a company, product, or service basis
Uses current and future “fair value” cash flows
Does relate to valuation or appraisal
Factors Considered:
- Opportunity costs
- Elasticity
- Differential Costs
- Price/quantity relationships
- Causal cash flows
- Economic regulatory requirements
Uses:
- Determining profitability on an economic basis
- Decisions to accept - reject or continue - discontinue
- Choosing the best of all possible alternatives
- Determining causal costs
- Determining minimum revenue requirements for pricing
Capital Recovery:
- Annuity \( \frac{r}{(a/p) \text{ or } (a/f)} \)
  where \( r = \) cost of capital
Evaluators:
- Net Present Value
- Rate Of Return on Capital
- Present Worth of Annual Costs
- Annual Equivalent Costs
- Discounted Pay Back
- Pro-forma statements
Exhibit B

Pro-Forma Contribution Statement

For a $422,500 Asset Retirement Obligation

<table>
<thead>
<tr>
<th>Year</th>
<th>Revenues</th>
<th>2006</th>
<th>2007</th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>$424,228</td>
<td>$431,251</td>
<td>$429,437</td>
<td>$427,569</td>
<td>$425,590</td>
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<tr>
<td>Expenses:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash Expenses</td>
<td>400,000</td>
<td>400,000</td>
<td>400,000</td>
<td>400,000</td>
<td>400,000</td>
<td>400,000</td>
</tr>
<tr>
<td>ARO Depreciation</td>
<td>8,820</td>
<td>17,605</td>
<td>17,545</td>
<td>17,419</td>
<td>17,156</td>
<td></td>
</tr>
<tr>
<td>ARO Debt Interest</td>
<td>7,704</td>
<td>6,823</td>
<td>5,946</td>
<td>5,075</td>
<td>4,217</td>
<td></td>
</tr>
<tr>
<td>ARO Equity Interest</td>
<td>7,704</td>
<td>6,823</td>
<td>5,946</td>
<td>5,075</td>
<td>4,217</td>
<td></td>
</tr>
<tr>
<td>Total Expenses</td>
<td>424,228</td>
<td>431,251</td>
<td>429,437</td>
<td>427,569</td>
<td>425,590</td>
<td></td>
</tr>
</tbody>
</table>

Contribution: 0 0 0 0 0

Net Income: 7,704 6,823 5,946 5,075 4,217

Exhibit C

Pro-Forma Balance Sheet

For a $422,500 Asset Retirement Obligation

<table>
<thead>
<tr>
<th>Year</th>
<th>Assets</th>
<th>2006</th>
<th>2007</th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>PW of ARO</td>
<td>$162,892</td>
<td>$162,892</td>
<td>$162,892</td>
<td>$162,892</td>
<td>$162,892</td>
</tr>
<tr>
<td></td>
<td>Less Retirements</td>
<td>11</td>
<td>67</td>
<td>235</td>
<td>714</td>
<td>1,877</td>
</tr>
<tr>
<td></td>
<td>ARO Costs</td>
<td>162,881</td>
<td>162,825</td>
<td>162,657</td>
<td>162,178</td>
<td>161,015</td>
</tr>
<tr>
<td></td>
<td>Less ARO Acc. Dep.</td>
<td>8,809</td>
<td>26,360</td>
<td>43,736</td>
<td>60,676</td>
<td>76,669</td>
</tr>
<tr>
<td></td>
<td>Total ARO Assets</td>
<td>154,072</td>
<td>136,465</td>
<td>118,921</td>
<td>101,502</td>
<td>84,346</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Equities</th>
<th>2006</th>
<th>2007</th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
</tr>
</thead>
<tbody>
<tr>
<td>ARO Liabilities</td>
<td>77,036</td>
<td>68,232.5</td>
<td>59,460.5</td>
<td>50,751</td>
<td>42,173</td>
</tr>
<tr>
<td>ARO Equity</td>
<td>77,036</td>
<td>68,232.5</td>
<td>59,460.5</td>
<td>50,751</td>
<td>42,173</td>
</tr>
<tr>
<td>Total ARO Equities</td>
<td>154,072</td>
<td>136,465</td>
<td>118,921</td>
<td>101,502</td>
<td>84,346</td>
</tr>
</tbody>
</table>

Return On Equity: 10% 10% 10% 10% 10%

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12 The Asset Retirement Obligation (ARO) occurs in year 10
13 The Present Worth of the ARO is depreciated over 10 years using a S3 Iowa survivor curve
14 The cost of debt is equal to the cost of equity with a 50-50 debt-equity ratio.

Weighted average debt interest and equity interest costs are equal to 10% of the ARO Assets.