January 3, 2006

Ladies and Gentlemen:

Re: File Reference No. 1235-001

I appreciate the opportunity to express my views on the Board’s Invitation to Comment entitled Selected Issues Relating to Assets and Liabilities with Uncertainties (the “Invitation”). The Invitation asks constituents to comment on issues raised in the IASB’s Exposure Draft issued in June 2005 entitled Amendments to IAS 37 Provisions, Contingent Liabilities and Contingent Assets and IAS 19 Employee Benefits (the “Exposure Draft”).

If adopted by the IASB in its present form, the Exposure Draft would change the required approach for accounting for contingent losses under IFRS from an approach that is largely consistent with Statement 5, Accounting for Contingencies, to an approach that is largely consistent with Concepts Statement 7, Using Cash Flow Information and Present Value in Accounting Measurements.

Fundamentally, the proposal represents the continuation of a trend in both Boards’ recent exposure documents that can be characterized as a philosophical shift from the historical cost model of accounting to the fair value model of accounting. As I have previously communicated to the Board in my comment letters dated October 28, 2005 in response to the joint exposure drafts on business combinations and consolidated financial statements, I am a firm believer in the historical cost model of accounting. I have also communicated my misgivings about the fair value model of accounting in a letter to the Board dated September 7, 2004 in response to the exposure draft on fair value measurements. I will not repeat those comments here.

For the reasons I set forth below, I think that the IASB’s proposed changes are problematic and I do not support them, nor would I support similar changes to US GAAP. My discussion will focus on contingent losses and contingent liabilities, because it appears to me that the guidance in the Exposure Draft would not lead to a significant change in practice in accounting for contingent gains and contingent assets.

First, I believe that contingent liabilities should not be recorded if it is more likely than not that the enterprise will not be required to make payment or otherwise sacrifice assets. In my opinion it is misleading to the users of financial statements to recognize a liability if, in fact, management reasonably expects that no payment will be necessary. By recognizing such a liability, companies
would recognize an expense in one accounting period and income in a subsequent accounting period, when management’s expectation is confirmed to be accurate. In reality, there was no expense or income. Accordingly, to require the recognition of a liability under such circumstances, in my view, is to make financial statements less representationally faithful and less relevant.

Second, I believe the proposed approach would give management of companies greater latitude in recognizing so-called “cookie-jar” reserves. Such reserves may be used – albeit inappropriately – by some companies to smooth earnings results by shifting income from periods with relatively strong earnings to periods where earnings might otherwise fall short of analysts’ expectations. The problem here is two-fold. First, because the threshold for recognizing contingent liabilities would be significantly lowered (to require accrual even if the likelihood of loss is remote, as defined in Statement 5), many more accruals would be available for management to manipulate. Second, because the measurement of such accruals would be based on probability assumptions for a wide range of possible outcomes, management would have ample opportunity to simply adjust its probability assumptions in order to meet earnings targets.

The problem is exacerbated by the incremental challenge auditors would face trying to audit expected cash flow calculations prepared in a manner consistent with Concepts Statement 7. Granted, it is not easy to audit almost any accounting estimate. But the proposed approach would result in a significant increase in the number of management’s assumptions that must be considered as compared to the current approach under Statement 5 and Interpretation 14, Reasonable Estimation of the Amount of a Loss – an interpretation of FASB Statement No. 5. It seems to me, based on my 11 years of experience as an auditor, that it is easier for auditors to rigorously challenge management’s assumptions about the most likely loss amount (in accordance with Interpretation 14) than to challenge why a client assumed one scenario had a 25% probability of occurrence rather than a 35% probability, and why another had a 15% probability rather than a 5% probability. This is the same challenge auditors face today when considering companies’ expected cash flow assumptions for entities that are considered to be variable interest entities under Interpretation 46(R), Consolidation of Variable Interest Entities – an interpretation of ARB No. 51. In my view, based on my experience, many of these assumptions are largely unauditable.

The proposed approach is particularly troublesome in the context of a purchase business combination, as I have observed in my comment letter on the business combinations exposure draft. The initial recognition of a liability in purchase or acquisition accounting does not result in the recognition of an expense. As such, allowing the recognition of liabilities in purchase accounting that management does not expect to incur seems like an open invitation for companies set aside cookie-jar reserves with no negative consequences to the income statement in order to later recognize gains that do not exist.

Finally, I would challenge the theoretical basis for making the measurement objective of such liabilities “the amount that an entity would rationally pay or settle the obligation at the balance sheet date or to transfer it to a third party at that time” (paragraph BC79 of the Exposure Draft). Based on my experience as an auditor, companies do not settle an individual contingent liability by transferring it to a third party in a stand-alone transaction. If this is not the manner in which such liabilities are settled, how could the theoretical amount at which such liabilities could be transferred be relevant to investors? And while the amount that the entity would rationally pay to settle the obligation at the balance sheet date by payment to the counterparty may be relevant to readers of financial statements in some situations, it would not be relevant if settlement is not
being pursued or is not possible under the circumstances. In my view, the most relevant amount for investors is the most likely amount of the loss.

If the Board believes that the current approach under Statement 5 results in the delayed recognition of too many liabilities, perhaps one possible approach would be to amend Statement 5 to change the definition of “probable” for the purposes of applying that Statement to “more likely than not.” Under existing prevalent practice, the word “probable,” as used in Statement 5, is understood to represent a much higher threshold for recognition than “more likely than not,” and therefore such a change would result in the recognition of a greater number of contingent liabilities. In my view, such a change would be consistent with the definition of a liability in Concepts Statement 6, *Elements of Financial Statements*, which is as follows:

Liabilities are *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 the result of past transactions or events (emphasis added, second footnote reference omitted)

*Probable* is used with its usual general meaning, rather than in a specific technical sense (such as that in FASB Statement No. 5, *Accounting for Contingencies*, and refers to that which can reasonably be expected or believed on the basis of available evidence or logic but is neither certain nor proved (Webster’s New World Dictionary of the American Language, 2d college ed. [New York Simon and Schuster 1982], p. 1132). Its inclusion in the definition is intended to acknowledge that business and other economic activities occur in an environment characterized by uncertainty in which few outcomes are certain (pars. 44-48).

The Concise Oxford English Dictionary defines “probable” as “likely to happen or be the case” (Concise Oxford English Dictionary, tenth edition, revised [Oxford, Oxford University Press, 2002], p. 1139). A technical accounting definition of “probable” as “more likely than not” seems consistent with the “usual general sense” of the word “probable.” It is also clear that the definition of a liability in Concepts Statement 6 does not support the recognition of a liability for a loss that has a less than 50% likelihood of being incurred, because such losses cannot be said to be “reasonably... expected or believed on the basis of available evidence or logic…”

I believe that Statement 5 is a practical, common sense approach to a difficult accounting problem that has stood the test of time. I urge the Board not to pursue superseding it with an approach similar to that in the IASB’s Exposure Draft.

In the Appendix, I have included some additional comments on unconditional and conditional obligations.

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Thank you for taking the time to consider my views. If you have questions or comments, do not hesitate to contact me.

Sincerely yours,

David B. Elsbree, Jr.

Appendix
Unconditional and Conditional Obligations

I believe that the distinction between an unconditional obligation to stand ready and a conditional obligation to make payments is not useful and may lead to unintended accounting consequences. The fact is that enterprises have obligations to stand ready to do all kinds of things, whether based on contract or law, with or without appropriate compensation. Accordingly, simply having an obligation to stand ready to deliver cash or other assets, perform a service, or take other kinds of actions does not seem to me to be the best basis for defining when a contingent liability should be recognized.

Consider the following contractual obligations:

- An enterprise enters into an umbrella agreement with a customer to supply widgets over a three year period. The contract may or may not be a "requirements contract" but is assumed to fail the definition of a derivative in Statement 133, Accounting for Derivative Instruments and Hedging Activities, and relevant IFRS standards. An obligation to deliver widgets is created when the customer delivers a purchase order to the enterprise. The enterprise has an unconditional obligation to stand ready to deliver the widgets but only a conditional obligation to actually deliver the widgets if and when the customer delivers a purchase order.

- An enterprise enters into a contract to receive IT support services on an as needed basis and is required to pay a nominal fixed fee for each use of the service. The enterprise has an unconditional obligation to stand ready to pay for the service but only a conditional obligation to pay for the service if and when it actually uses the service.

- Under the German Altersteilzeit programs considered in EITF 05-5, Accounting for Early Retirement or Postemployment Programs with Specific Features (Such As Terms Specified in Altersteilzeit Early Retirement Programs), once an employer has signed a contract with the workers' council, it must allow its employees to participate in the program without restriction until participation reaches 5 percent of the total work force. In such cases, until the 5 percent limit has been reached, the employer has an unconditional obligation to stand ready to pay the bonus feature but only a conditional obligation to pay the bonus feature if and when an employee enrolls in the program and begins to work during the Altersteilzeit work period.

In each of the above cases, it would seem that the Exposure Draft would require the recognition of a liability (calculated at expected present value) upon execution of the contract. Is this the intended result? In each of these situations, the enterprise has conditional rights that go along with those conditional obligations. Should an enterprise also consider whether an intangible (contingent) asset should be recognized for the conditional rights associated with the contract? Is the conclusion that all executory contracts should give rise to assets and liabilities that should be recognized in the balance sheet? Or should a net asset or liability be recognized and calculated at the net present value of the cash and the then fair value of the good or service to be exchanged?

The IASB also considers a non-contractual scenario in paragraph BC46 in which an enterprise is a defendant in a lawsuit. The IASB concluded that the enterprise has an unconditional obligation to stand ready to pay if the court orders it to do so and therefore some liability should be recognized (at expected present value). In paragraph 42 of the Invitation, the Board calls attention to the IASB's observation that a potential obligation that would arise if a new law were enacted does not give rise to an unconditional "stand-ready" obligation, because "...until the new law is enacted, the entity cannot have a present obligation with respect to that law." But consider the following scenarios:
• An enterprise owns land. Under existing law in the jurisdiction where the land is located, an agency of the government has the right to seize the land by invoking eminent domain for a price that is likely to be below its fair value, without any further legislative action. The enterprise has an unconditional obligation to stand ready to deliver the land to the government if the agency decides to seize the land by invoking eminent domain.

• An enterprise has employees. Under existing law in the employees’ home country, all male citizens within a certain age group are required to register for the draft and may be called upon to serve in the armed forces at any time by means of executive order. The enterprise has an unconditional obligation to stand ready to release those male employees from their contractual obligation to perform services for the company if the government calls upon them to serve.

Should companies recognize liabilities for these obligations to stand ready to perform? In my opinion, they should not; however, it appears that under the proposed guidance, they would be required to.

I think that the guidance in Interpretation 45, Guarantor’s Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others – an interpretation of FASB Statements No. 5, 57, and 107 and rescission of FASB Interpretation No. 34, has muddled the issue. Guarantees are transactions that, from the point of view of the guarantor, have both an income component (compensation for the guarantee) and an expense component (the amount, if any, to be paid under the guarantee). Ordinarily, when an enterprise issues a guarantee to and/or on behalf of an unrelated third party in a stand-alone transaction, the enterprise is compensated for that action and should recognize that income over some period of time, typically the term of the guarantee. However, when the guarantee is issued as part of a larger multiple-element transaction, prior to the issuance of Interpretation 45 it was not clear how much consideration should be allocated to the guarantee, and practice was that compensation for the guarantee generally was not recognized. But rather than clarifying that an enterprise that issues a guarantee should recognize a deferred income liability (separate from any contingent loss amount to be recognized in accordance with Statement 5) that should be taken to income over the term of the guarantee, Interpretation 45 blurred the distinction between the income and expense component of the transaction in paragraph 10 by requiring the recognition of one liability amount, namely the greater of the amount to be recorded under paragraph 8 of Statement 5 or under paragraph 9 of Interpretation 45.

I think this example makes clear that “standing ready to perform” is an action that should result in the recognition of a liability only if compensated as part of a stand-alone or multiple element transaction. That liability should be characterized as deferred income and should be recognized separately from any liability for a contingent loss that might result under the arrangement. In my opinion, the proposed guidance in the Exposure Draft only confuses this issue further.