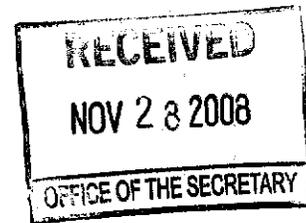


JOHN S. FERGUSON  
1219 Stratford Drive  
Richardson, TX 75080-2918  
Tel (972) 699-8214  
Fax (972) 699-9396

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Florence E. Harmon  
Acting Secretary  
Securities and Exchange Commission  
100 F Street, NE  
Washington, DC 20549-1090



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My interest in the proposed roadmap for substituting International Financial Reporting Standards (IFRS) for U.S. GAAP is a consequence of a career as a management consultant that included providing services to entities practicing the group concept of depreciation accounting. Providing these services required that I understand the accounting practices of these entities, which has made me aware of certain utility asset and depreciation accounting practices that enhance the ability of their financial statements to accurately depict the results of operations and financial status of reporting entities. These practices deserve to survive such a substitution, are consistent with the statement on page 23 of Release 33-8982 that "it is important that the accounting standards produced are capable of improving the accuracy and effectiveness of financial reporting and the protection of investors," and prompt these comments, which (with the exception of the following paragraph) are essentially in response to Request for Comment number 14. If these asset and depreciation accounting practices do not survive, the intended purpose of the substitution will not be accomplished, and regulators, their jurisdictional entities, and the investors in these entities may find the changes disturbing.

The efforts of U.S. issuers and audit firms necessary to substitute international accounting standards for U.S. GAAP will be extensive and expensive, and the requirement for early adopters to reverse the process if the Commission decides against the substitution would make it even more expensive for such entities. Issuers and audit firms are retrenching in reaction to the current state of the U.S. and global economies, and can be expected to be in this mode for awhile. Therefore, early adoption by entities that qualify seems inconsistent with their needs, which suggests that the early adoption option is unlikely to be selected.

A significant aspect of the potential for changes to utility accounting practices from this substitution is the recent recommendation of the Advisory Committee on Improvements to Financial Reporting that accounting guidance not allow industry-specific exceptions. An example of the industry-specific guidance the Committee has in mind is SFAS 71, Accounting for the Effects of Certain Types of Regulation, that allows qualifying entities to utilize accounting practices not available to non-qualifying entities. Qualification requires that prices for service be set by an independent body or its own governing board, be based on cost, and be charged to and collected from ratepayers, which limits SFAS 71 to being applicable to price-regulated entities. SFAS 71 is important, because it is what allows the accuracy-enhancing accounting practices referred to above, and international standards contain no equivalent.

U.S. GAAP is recognized as being rules-based, but this was not always the case, because it shifted from being principles-based as a consequence of the principles not being defined tightly enough for courts to determine whether they are being complied with. Tightening the definitions resulted in rules. International standards are perceived as being principles-based, but are shifting toward being rules-based as a consequence of rules being issued in the form of Interpretations. Principles are recognized as allowing more flexibility than do rules, which makes the judgments behind accounting treatment decisions quite important. The Advisory Committee recognizes the importance of accounting and audit judgments, and has recommended that the Commission and the Public Company Accounting Oversight Board adopt policy statements concerning the exercise of these judgments, in order to provide more transparency into how such judgments will be evaluated for reasonableness. This Committee recommendation is more important with principles than with rules, but this does not detract from its significance, even if international standards are not substituted for U.S. GAAP.

International standards allow the recording of property, plant and equipment (PP&E) to reflect either cost or fair value, whereas U.S. GAAP allows only cost and regulation requires a special version of cost that is known as "original cost" (the cost incurred by the entity that first dedicated the PP&E to public service). However, U.S. GAAP requires certain financial instruments to be recorded at fair value (mark-to-market), and efforts are being made to expand the use of fair value for accounting purposes. The Advisory Committee expressed concern about the use of fair value for financial reporting purposes, even prior to the financial market crisis currently being experienced in the U.S. and elsewhere that is being blamed, at least in part, on the requirement of mark-to-market accounting for financial instruments. The Financial Accounting Standards Board (FASB) and the Commission have reacted to this crisis by limiting (at least temporarily) the application of such accounting, which should lead to questioning the reasonableness of extending fair value accounting to PP&E.

Determining the fair value of PP&E requires an appraisal, and auditors of financial statements will have to judge the validity of claimed fair value amounts. The savings and loan situation of the 1980s and the current sub-prime mortgage situation demonstrate that claimed qualifications do not provide auditors with a sound basis for judging the validity of the work of appraisers. Therefore, judging validity will require addressing appraisals directly. However, the Sarbanes-Oxley Act prevention of audit firms from providing valuation services to their audit clients may keep such firms from having the expertise on-staff needed to judge the validity of claimed fair value amounts. The reality of this situation is demonstrated by Deloitte's 2007 sale of its property tax practice, and valuation services is not the only area of audit firm expertise that is negatively impacted by Sarbanes-Oxley.

Under some circumstances, changes in PP&E fair value amounts under international standards will influence reported income, which might prompt attempts at "earnings management" that auditors would need to be alert for.

The fair value of utility PP&E can be expected to be higher than original cost less accumulated depreciation, so would increase the rate base and annual depreciation expenses of regulated entities – a situation likely to either prompt rejection for ratemaking purposes or, as has been done by jurisdictions required to consider PP&E values reflecting something other than original cost, prompt consideration in a manner that does not influence authorized prices. Therefore,

even though a regulated entity might opt to report fair value, regulation would likely continue to be based on original cost, which would require maintaining both original cost and fair value records. Having to maintain multiple sets of records is cumbersome and a waste of resources.

The Uniform Systems of Accounts promulgated by U.S. regulators require that jurisdictional entities practice the group concept of depreciation accounting for all their PP&E, whereby similar classes of PP&E are grouped for depreciation purposes. Under the component concept required by international standards for PP&E other than mass PP&E, each component is depreciated individually, interim additions and retirements are expensed, gains or losses are recorded for components retired prior to reaching their depreciable life, and depreciation ceases when the depreciable life is reached. International acceptance of the group concept for mass-type PP&E is predicated on its ability to match the recording of depreciation to the life experienced by the group. This matching is interpreted as being sufficient for allowing group depreciation for mass-type PP&E, but is identical to the "rational" requirement of the U.S. GAAP definition of depreciation accounting, which allows group depreciation for all PP&E. Another important aspect of U.S. GAAP is that depreciation accounting is stated to be a process of cost allocation – not of valuation.

Regulated entities have two basic types of PP&E – location-type and mass-type – to which three basic group depreciation approaches are applied – Life Span, Average Life, and Amortization. Life Span is commonly adopted for some classes of location-type PP&E, such as power plants, with interim additions and retirements being recognized in the depreciation rates. Average Life, whereby variation of the age of retirements around the average life is recognized by dispersion patterns, is applied to most classes of location- and mass-type PP&E. Amortization is applied to mass-type PP&E for which lack of retirement reporting has prompted the recording of retirements to be based on attained age rather than field reporting.

The component concept is likely to be practical as a substitute for Life Span, because it is merely Life Span without the recognition of interim additions and retirements through depreciation. However, the component concept would not be practical for location-type PP&E for which Average Life is typically utilized, such as electric transmission lines and substations, gas measuring and regulating stations, and general purpose buildings, because there are too many locations. For example, it is not unusual for an electric utility to have several hundred substations.

Entities practicing the component concept typically adopt depreciable lives that are shorter than are expected, in order to limit or eliminate the recording of gains or losses and differences between book and tax depreciation. While inconsistent with the concept that the recording of depreciation match PP&E usage, depreciation based on such lives is considered conservative and acceptable for financial reporting purposes. When properly applied, Life Span for regulatory purposes more accurately matches the recording of depreciation with PP&E usage than does the component concept, as is explained by the attachment, Group Depreciation is More Accurate, so should not be precluded by international standards.

Life Span applied on a group basis that recognizes future interim additions and retirements is consistent with the purpose of depreciation accounting under international standards, but is not currently allowed. This suggests that the group concept is insufficiently understood, and that a

concerted effort on the part of those having sufficient understanding will be necessary to rectify the situation. I have observed that direct involvement in the determination of depreciation rates for the group concept is required to fully understand the concept, and that those having this involvement tend to be members of the Society of Depreciation Professionals. Therefore, Society members provide a resource of expertise that the accounting profession can draw upon to develop sufficient understanding of the group concept to allow this concept to be applied to all types of PP&E under international standards.

Amortization is commonly adopted in the U.S. for PP&E for which retirements go unreported (most often as a consequence of a capitalization policy that relies on monetary amounts rather than on physical descriptions of PP&E components), thereby improving the match between depreciation and usage. Therefore, Amortization should be acceptable under international standards. However, lack of understanding may get in the way of recognizing this.

The financial statements of entities practicing the component concept disclose the accuracy of their depreciable lives. Having substantial investment in fully depreciated PP&E that remains in service indicates lives that are too short, and recording substantial losses for PP&E retired prior to being fully depreciated indicates lives that are too long.

A special study is required to determine the validity of the depreciation rates of entities practicing the group concept, and the resulting depreciation accruals can be expected to more accurately reflect PP&E usage than will the component concept. There are two basic approaches for determining group depreciation rates, both of which are attempts to predict the future. One approach emphasizes measuring the past and the other emphasizes understanding the past, and both are deemed to be acceptable. Emphasizing measurement is the equivalent of trying to drive by looking only in the rearview mirror, so midcourse corrections must be more frequent than when emphasizing understanding. Therefore, the appropriate interval between reviews of the continued validity of the depreciation rates of entities emphasizing measurement is two or three years, and is about twice that long for entities emphasizing understanding.

International standards require that depreciable lives be reviewed at least annually. When adopting its rules for replacement cost accounting, which led to the FASB issuing SFAS 33, Financial Reporting and Changing Prices, the Commission recognized that reporting entities are likely to have fully depreciated PP&E that remains in service, and provided guidance for how to deal with such PP&E. This recognition suggests that U.S. entities practicing the component concept in the past have not increased the depreciable lives of components expected to remain in service beyond the original estimates. Annual review of depreciable lives seems reasonable for entities practicing the component concept that adopt lives shorter than are expected, so that life can be increased when a component approaches and is expected to exceed its existing life. However, the Commission's recognition of fully depreciated PP&E suggests that making such midcourse corrections would require altering past U.S. practices.

International accounting standards specify that legal and constructive asset retirement obligations be recorded as liabilities, rather than as depreciation. Including constructive obligations is a significant difference from U.S. GAAP. The exposure draft of what eventually became SFAS 143, Accounting for Asset Retirement Obligations, called for liability treatment of both legal and constructive obligations. However, SFAS 143 was limited to only legal obligations when the

FASB concluded that constructive obligations could not be defined tightly enough for consistent application. Limiting SFAS 143 to legal obligations did not prevent inconsistent application, as is evident from the FASB later issuing Interpretation 47, Accounting for Conditional Asset Retirement Obligations (FIN 47). FIN 47 improved the consistency of reporting, but did not eliminate the problem, which I view as being a consequence of the difficulty in applying SFAS 143 by entities practicing the group concept of depreciation accounting.

The liability accounting treatment dictated by U.S. GAAP and international standards is as a prepaid annuity, which is backend loaded. The deferral inherent in SFAS 143 treatment is evident from the obligation for decommissioning a nuclear generating unit, which is the obligation that prompted SFAS 143 to be issued. Such a unit that receives a renewed operating license from the Nuclear Regulatory Commission is likely to have an operating life span of about 55 years. If decommissioning occurs ten years after operations cease and the SFAS 143 discount rate is 8%, 99.3% of the obligation would be recorded as accretion over 65 years, with the accretion amount recorded during the final year being 137 times the amount recorded during the first year and 54% of the total accretion being recorded after the unit ceases to operate and generate revenues and, for a single-asset entity, after the enterprise ceases to be viable. This is really strange accounting that should never have been allowed to exist.

The backend loading inherent in SFAS 143 causes a severe mismatch with the usage of the related PP&E and gains or losses (perhaps substantial) to be recorded if the removal date is not accurately estimated. Therefore, arbitrarily short depreciable lives do not provide a suitable basis for recording asset retirement obligations. If not dispensed with, the degree of backend loading of the accounting for legal (and perhaps constructive) obligations may encourage earnings management, in order to limit the income statement volatility inherent in inaccurate removal date estimates.

Cost of removal not qualifying for liability treatment is expensed under both U.S. GAAP and international accounting standards. This requirement for U.S. GAAP is a consequence of misinterpretation of the meaning of "salvage" in the GAAP definition of depreciation accounting that is partly a consequence of the shift shortly after World War II of the accumulated provision for depreciation from being recognized as a source of capital on the right side of the balance sheet to being a contra-asset on the left side. The attached October 2008 Public Utilities Fortnightly article, *Fixing Depreciation Accounting*, describes this situation and what I believe to be its remedy. The magazine reversed the sequence of two of the pages. The attachment is from the Fortnightly website, and has the correct page sequence.

Adoption of IFRSs in Canada is ahead of the U.S., as a consequence of Canada already deciding to make the substitution for fiscal years beginning on or after January 1, 2011. Canadian financial and regulatory accounting are quite similar to the U.S. – complete with allowing group depreciation for all PP&E, regulated entities recording removal and abandonment costs through depreciation, and there being equivalents to SFASs 71 and 143. Therefore, Canada's substitution experience may prove to be predictive of the extent to which the issues addressed here will impact U.S. enterprises.

Canada does not have an equivalent to the Sarbanes-Oxley Act. However, the provincial rules of conduct for Chartered Accountants preclude performing an audit engagement when a valuation

performed by the auditor would be addressed. Therefore, the potential for Canadian audit firms having difficulty keeping appraisers on-staff seems the same as for U.S. audit firms.

This discussion suggests the following actions be taken to assure the existing utility asset and depreciation accounting practices that enhance the ability of their financial statements to accurately depict the results of operations and financial status will survive a substitution of IFRSs for U.S. GAAP:

Commission and Public Company Accounting Oversight Board adoption of policy statements concerning the exercise of judgment recommended by the Advisory Committee;

Determining whether the effect on audit quality of the limitations by the Sarbanes-Oxley Act on the services that audit firms can provide to their audit clients is acceptable, and, if not, recommending modifications to the Act;

Prohibiting fair value accounting for PP&E;

Allowing group depreciation accounting for all classes of PP&E;

Affirming that depreciation accounting is a process of cost allocation – not of valuation;

Recording all removal or abandonment costs ratably through depreciation over the life of the related PP&E; and,

Recognizing the accumulated provision for depreciation as a source of capital on the right side of the balance sheet.

These actions will allow regulated entities to retain their asset and depreciation accounting practices and allow other entities to adopt practices that will enhance the accuracy of their financial statements, are consistent with the stated purpose of the substitution, and are appropriate even if international standards are not substituted for U.S. GAAP. If these actions cannot be taken for international standards, the substitution should be rejected.

I have mixed feelings about whether SFAS 71 should be rescinded. On one hand, SFAS 71 allows qualifying entities to utilize certain accounting practices that enhance the ability of their financial statements to accurately depict the results of operations and financial status. On the other hand, SFAS 71 can encourage regulators to overemphasize the near-term by taking actions that are detrimental to ratepayers and the economic viability of utility service territories in the long-term, and that may not be sufficiently visible to users of financial statements.

Sincerely,



John S. Ferguson

Enclosures: (2)

## **Group Depreciation is More Accurate**

Power plants are typically treated as Life Span PP&E for regulatory depreciation accounting purposes. Uniform Systems of Accounts specify six primary (three digit) plant accounts for steam generating stations, five of which are fully depreciable and one (Land and Land Rights) is partially depreciable, and the most common grouping of steam stations for depreciation purposes is into these six accounts. Therefore, an entity having 20 steam generating units would include all 20 of its turbine-generators in the same depreciable property group.

Uniform Systems of Accounts dictate that the capitalization policy of jurisdictional entities be based on "retirement units" that for the most part are physical descriptions of PP&E components, which leads to the addition, removal, or replacement of one or more retirement units being a capital transaction and to the addition, removal, or replacement of a portion of a retirement unit being an expense transaction. The capital transactions for removals or replacements are specified to include removing removed or replaced components from accounting records and segregating removal labor from construction labor, so that removal costs can be charged to the accumulated provision for depreciation. Use of physical descriptions for this purpose assures that PP&E accounting records are accurate, because such descriptions allow all involved to easily distinguish capital transactions from expense transactions.

Consider turbine-generator units, each of which is likely to be comprised of 30 or more distinctive retirement units for regulatory accounting purposes. Some of these retirement units will be replaced during the unit's lifetime, but which ones and for which generating units will be unknown until the units have gotten old enough for the replacement need to be recognized. When dealing with a group of turbine-generators, which retirement unit and which generating unit is not significant, because the past experience of the group or of a similar group will disclose the extent of the depreciation rate increase needed to recognize the expected level of future interim additions, removals, or replacements. Further, these expectations are subject to mid-course correction each time the continued validity of the existing depreciation rates is reviewed.

For the component concept of depreciation, the practical number of generating unit components is limited, in part by an inability to accurately estimate component lives. For example, the life of a turbine-generator can be accurately estimated, but the life of its individual components cannot be. Therefore, life estimates for large items, such as a boiler or a turbine-generator, can be accurate, but they are the same as for the generating unit, so component segregation beyond the generating unit in total is unlikely to make sense. Defining only a few depreciable components means that some station component replacements will be quite expensive and have to be recorded as period expenses. This situation encourages earnings management, whereby a large hit on earnings prompts recording the replacement item as a new depreciable component, which would cause the removal cost of the replaced item to be considered as a construction cost of the replacement item, and both the replaced and replacement items to be recorded in accounting records. This double counting is highly unlikely under the group concept.

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