December 21, 2008

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

Re: SEC's Study on Mark-to Market Accounting (File No. 4-573).

Dear Ms. Harmon:

I appreciate the opportunity to provide my comments to the Securities and Exchange Commission (SEC) as it studies the effects of mark-to-market accounting (also known as fair value accounting or SFAS 157), on the current market, as required by the *Emergency Economic Stabilization Act of 2008*.

There is no question that the true economic objective in determining the economic value of an asset is in determining its fair value. However, we do not know as yet how to determine the fair value of a long-term, non-exchange asset in an inactive market. Until these studies are completed and implemented, I recommend the following:

- the acceptance of a dual reporting system.
- the acceptance that the procedure for determining the fair value for long-term, non-exchange assets in an inactive market is still to be developed.
- the acceptance that an alternate "default" value be used until a procedure for determining the fair value for long-term, non-exchange assets in an inactive market can be developed.

The following discussion provides a greater clarification of these items.

Yours Truly

Don Bjerke bjerke@sasktel.net
Regina Saskatchewan
Canada

SEC's Study on Mark-to Market Accounting

The adoption of a dual reporting system

The development of a dual reporting system is the result of having proper reporting objectives. In July 6, 2006 the Federal Accounting Standards Board (FASB) and the International Standards Board (IASB) addressed the need for a reporting objective within their conceptual framework for financial reporting[1]. They wanted to incorporate the stewardship objective within the decision-usefulness objective. This view, however, was a very was contentious issue. Almost 90% of the respondents to the conceptual framework stated that decision-making should not be "the single, overriding objective of financial reporting"[2]. For them, the objective of providing information to help users assess the stewardship of management is not encompassed within the decision-usefulness objective but stated as a separate objective. The adoption of a dual reporting system is based on having two separate reporting objectives. These objectives are referred here as the Financial reporting objective: Stewardship and the Economic reporting objective: Decision-usefulness[3].

The qualitative characteristics of financial reporting system are:

- accrual accounting using the underlying concepts as matching, periodicity, historical cost, recognition, and revenue generation. This avoids the current mixed-attribute model containing a mixture of historical and fair value costs.
- depreciation as a process of historical cost allocation, not of valuation.
- consistent, clear and concise information that is understandable to all users including those in the not-for-profit and for-profit sector entities. Information must be precise, verifiable, transparent, reliable, comparable, and trustworthy.
- reporting financial information to be presented in an accounting income statement and a balance sheet.

The qualitative characteristics of economic reporting are:

- the projection of six future cash flows consisting of revenue, capital expenditure, cash expense, income tax, gross salvage and cost of removal. The fair value of existing assets would be treated as a capital expenditure cash flow.
- use of a study period to reflect viability over a extended period of time.
- use of time value of money operators to present worth the cash flows.
- use of a discount rate based on a corporate cost of capital using a weighted average cost of equity and debt
- a level of risk assessment depending on the importance of the decision to be made. This would include sensitivity and probabilistic analysis.
- faithful representation of real world economic phenomena including a detailed market analysis with an environmental and a social assessment.
- reporting economic information to be presented by Net Present Value (NPV) and pro-forma statements.

It should not be surprising that this approach is used by the World's Greatest Investor, Warren Buffett where he refers to the financial reporting system as Financial Tenets and the economic reporting system as Value Tenets[4]. Financial Tenets are based on a transaction-based accounting statement with adjustments based on historical costs rather than on fair value. Value Tenets are based on present value techniques in discounting future cash flows.

Fair value for a long-term, non-exchange asset in an inactive market must still be developed.

The difficulty in determining the fair value of a long-term, non-exchange asset in an inactive market may be illustrated by the following example:

A person bought a $30,000 car a year ago. Because of a depressed market, he/she can sell this car for only $5,000. What is the fair value of this vehicle if he/she decides to keep it? SFAS 157 defines fair value as the exchange price in an orderly transaction between market participants. If he/she were to sell the car now, the fair value would be the exchange price of $5,000. If he/she decides to keep it, however, I submit, that we do not have the capability as yet to determine the fair value of this car. We know only that the fair value of the car would be worth more than the exchange price of $5,000, or else the owner would simply sell it. The economic rational in determining the fair value of the car while still in the owner's possession has not yet been developed.

The inability to determine the fair value in the above example is what Warren Buffett calls mark-to-myth accounting[5]. This type of accounting, he claims, leads to enormous incentives to cheat, particularly in the derivatives market.

Other problems of fair value accounting are:

- the adoption of fair value accounting in a stressed market leads to an unexpected decrease in fair value. SFAS 157 immediately adds this difference in fair value to the shareholder equity and shows it as an income item. From a depreciation theory perspective, any change in asset value should show up as a change in depreciation expense and not as income. These gains or losses in an asset value should result in a deficiency or surplus in the depreciation reserve and would be corrected by a remaining life adjustment procedure[6]. A change in fair value would therefore be spread over a period of time and hence would not show up as abrupt change in income.
- changes in the value of an asset do not enter in an economic statement as all cash flows in an economic study are perspective. Economic studies are used for decision-making purposes where historical costs are considered sunk and hence are irrelevant.
- depressed asset values in a stressed market lead to government nationalization of assets at artificially low prices. The government then holds these assets for a period of time until values return to normal at which time they are then sold. This process can be avoided by using a more reasonable figure for the fair value of the assets.
- information for determining the fair value of assets may be very difficult to obtain and may require the costly services of external appraisers in a rapidly changing marketplace.
- it places additional requirements on public companies compared to non-public companies. These requirements put an additional unfair burden on the public companies, in the current competitive marketplace.

The use of an alternate fair value "default" value for a long-term, non-exchange asset in an inactive market.

Sufficient evidence now exists to show that fair value accounting is not working properly at this time and additional effort will be required to determine how this form of accounting will work. In the interim I recommend that the financial accounting reporting system be used until proper procedures are in place. Until proper standards are in place, the true economic objective in determining the economic value of an asset's fair value will not be accomplished. The "default" value for fair value in the financial reporting statement is the original investment less the accumulated depreciation. This depreciated value will decline over the life of the asset item from the time it is in service to the time it is retired.
The advantages of this proposal are:

- it contributes to less volatility in the marketplace.
- it can apply to all market situations until a comprehensive set of standards are developed..
- depending on the depreciation schedule selected, the decline in asset value can match the capital recovery schedule for financing the asset.
- it implies that the entity is going-concern and not about to be liquidated or sold.
- the information for determining this value either presently exists or is readily available in an organization.
- disclosures can be made very clear and transparent.
- judgement would basically be limited to the type of depreciation system used (i.e. straight line method, equal life group procedure, whole life technique).

In the case of the above example, the depreciated value the car would be $30,000 less the accumulated depreciation of $3,000 for one year (using a 10 year life) resulting in a value of $27,000.

---

[1] The title of the Conceptual Framework is: Preliminary Views: Conceptual Framework for Financial Reporting: Objective of Financial Reporting and Qualitative Characteristics of Decision-Useful Financial Reporting Information.
[2] Agenda paper 3A. Conceptual Framework - Comment letter summary Chapter 1 and 2 of the Conceptual Framework Discussion Paper, 20 Feb. 2007 item #40.
[3] For more detail refer to my article: *A look at the IASB/FASB Conceptual Framework* published in Fortnightly's SPARK March 2007.
[4] See THE WARREN BUFFETT WAY by Robert G. Hagstrom chapters 7 (page 109) and 8 (page 121).
[5] See Berkshire Hathaway annual report for 2002.
[6] See *Public Utility Depreciation Practices* by National Association of Regulation Utility Commissioners (NARUC) August 1996 pages 187 to189.