11-13-1997

Comment Letter on the FASB's June 11, 1997 Exposure Draft of a Proposed Statement of Financial Accounting Concepts, Using Cash Flow Information in Accounting Measurements.

American Institute of Certified Public Accountants. Accounting Standards Executive Committee

Miscellaneous Documents - AcSEC Comment Letter to FASB

AICPA

SKCL 32601

November 13, 1997

To the Accounting Standards Executive Committee
Financial Instruments Task Force

File 2647

Enclosed for your information is a copy of AcSEC's comment letter on the FASB's June 11, 1997 exposure draft of a Proposed Statement of Financial Accounting Concepts, *Using Cash Flow Information in Accounting Measurements.*

Sincerely,

Fred

Frederick Gill, CPA
Senior Technical Manager
Accounting Standards

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Enclosure

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November 13, 1997

Mr. Timothy S. Lucas
Director of Research and Technical Activities
File Reference No. 176-B
Financial Accounting Standards Board
401 Merritt 7
P. O. Box 5116
Norwalk, Connecticut 06856-5116

Dear Mr. Lucas:

The Accounting Standards Executive Committee (AcSEC) of the American Institute of Certified Public Accountants has considered the Financial Accounting Standards Board's (FASB's) Proposed Statement of Financial Accounting Concepts *Using Cash Flow Information in Accounting Measurements* (No. 174-B; June 11, 1997) and is pleased to offer its comments. AcSEC supports issuance of a final Concepts Statement provided that our significant comments are addressed.

AcSEC has the following comments on the exposure draft:

Interest Rates and Expected Cash Flows

The proposed Concepts Statement acknowledges that uncertainty can be embedded in (1) an entity's estimate of a discount rate or (2) an entity's estimate of expected cash flows. Some members of AcSEC observe that financial markets tend to look first to market discount rates and that the expected cash flows approach is more often used in capital budgeting and in complex options valuation.

AcSEC believes that the Board should acknowledge that applying in practice the concepts discussed in paragraphs 22 to 26 (relating to reflecting uncertainty and risk in the measurement of assets) will be demanding and that the Board should attempt to articulate more clearly how the concepts would be applied. The Concepts Statement should clarify that, where observable market rates for items with similar characteristics exist, they should be used without going through the complex explicit approach included in these paragraphs. The factors that would be taken into account in determining whether a particular observable rate is suitable should be discussed.

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Paragraphs 33 to 39 discuss the expected cash flows approach. Those paragraphs suggest that the expected cash flows approach is superior to other methods of determining the single amount that will be used in accounting measurements. AcSEC agrees that the expected cash flows approach provides a conceptually superior result in most cases, especially where the shape of the probability distribution of alternative cash flow approaches normal and there is a large number of items in the population. AcSEC believes, however, that there may be instances where expected cash flows is not the best approach. For example, a cash flow might be either $100 or $10,000 with probabilities of 95 percent and 5 percent, respectively. The usefulness in financial reporting of the expected value ($595) of this binary cash flow estimate related to a single transaction is not apparent. The final Concepts Statement should acknowledge that there may be situations in which a "best estimate" might provide more useful information.

The proposed Concepts Statement acknowledges, but does not address directly, the concept of aversion to risk. AcSEC believes this concept is an integral part of an individual's or a market's valuation of uncertain cash flows. For example, AcSEC believes that a market would likely place a lower value on a set of possible cash flows whose distribution is very broad than it would place on a set of possible cash flows whose distribution is narrow, even though the two sets of possible cash flows may have equal expected values. The reason is risk aversion. For example, assume that an entity is presented with two choices. Under the first choice, a coin will be tossed. If heads, the entity receives $5,000. If tails, the entity receives $15,000. Under the second choice, the entity will receive $10,000 with absolute certainty. Under both choices, the expected cash flow approach results in a single amount of $10,000. AcSEC believes that, despite the equal expected cash flows, because of risk aversion, a market would likely place different values on the two choices due to the substantial difference between levels of uncertainty inherent in those choices. AcSEC believes the concept of aversion to risk should be addressed directly.

Other Observations

Following are miscellaneous observations on the exposure draft.

- The title of the document should include the descriptive words "present value" or "discounting" so readers do not misunderstand the subject to involve the statement of cash flows.

- Paragraph 58 argues that the interest method is arbitrary and cannot be demonstrated to be superior to other methods. We disagree. Various pronouncements have demonstrated and recognized the superiority of the interest method to the sum-of-the-years-digits, straight-line, and other methods in specific circumstances.

- Paragraph 62 states that the "catch-up" method is a superior way to alter an amortization scheme for changes in the estimated amount or timing of future cash flows. AcSEC is not convinced that a catch-up approach is necessarily better conceptually than a prospective approach. Moreover, AcSEC believes that prospective approaches may have practical advantages in some circumstances. AcSEC believes that the Concepts Statement should, at a minimum, acknowledge that prospective approaches may have practical advantages.

- FASB Statement No. 5, *Accounting for Contingencies*, and FASB Interpretation No. 14, *Reasonable Estimation of the Amount of a Loss*, should be listed in the appendix. Though Statement No. 5 does not address present values, AcSEC believes that issues related to measurement of liabilities recognized in accordance with Statement No. 5 are pervasive in the proposed Concepts Statement.

Understandability

AcSEC believes that readers' understanding of this Concepts Statement will likely be less intuitive than it has been for the Board's other Concepts Statements. The understandability of the Concepts Statement would be greatly enhanced if it included examples of accounting for future cash flows in the existing authoritative literature and how the Board's conclusions in the proposed Concepts Statement differ, similar to paragraphs 229 through 255 of FASB Concepts Statement No. 6.

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We appreciate the opportunity to comment on this proposed Concepts Statement. Representatives of AcSEC would be pleased to discuss these comments with the Board or FASB staff.

Sincerely,

David B. Kaplan HEF

David B. Kaplan, Chair
Accounting Standards Executive Committee

James A. Johnson HEF

James A. Johnson, Chair
Financial Instruments Task Force