Understanding the Issues

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Serving the investing public through transparent information resulting from high-quality financial reporting standards, developed in an independent, private sector, open due process.

Introduction

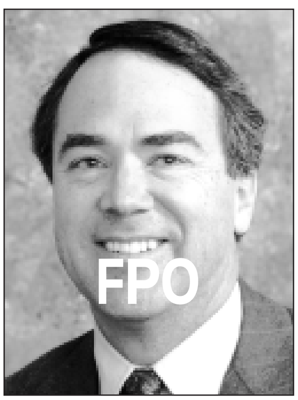
With the May 2001 issue of *Status Report,* we are pleased to launch a new feature, *Understanding the Issues,* that is intended to illuminate and simplify important subjects on which the FASB has published material.

To kick off the initial series of *Understanding the Issues,* we have focused on enhancing the constituent's understanding of measurement issues relating to Concepts Statement 7. The second in a series of four related articles on Concepts Statement 7, this article discusses why fair value is a particularly appropriate measure for a liability and covers its relevance in asset retirement obligations.

We welcome your feedback on this edition and those that are presented in the future.

The Case for Initially Measuring Liabilities at Fair Value

By John M. (Neel) Foster, FASB Member, and Wayne Upton, Senior Project Manager



John M. (Neel) Foster

In February 2000, the FASB issued Concepts Statement No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements.* The Board concluded in Concepts Statement 7 that when using the present value of cash flows, the objective of initial and fresh-start measurements is fair value. Consistent with that conclusion, two recently issued Exposure Drafts[1] that involve the use of estimated cash flows in initial and fresh-start measurements specify fair value as the objective of the measurement. Those proposals have been controversial, as were the conclusions in Concepts Statement 7 when it was issued. Respondents are particularly troubled by the idea that a fair value measurement of a liability, which is a marketplace notion, includes a profit element[2] that any third party would include in the price of a contract to settle that liability. This article addresses that concern and why a fair value measurement objective is appropriate, with particular emphasis on the Board's proposal to initially measure asset retirement obligations at fair value.

Why Fair Value?

Columnist George Will once described *fair* as the "four-letter word" most likely to incite discord in the average family. Certainly, many reactions to the idea of fair values in financial statements have taken on a level of intensity that is unusual in accounting debates. However, the Board's choice of a fair value objective for initial and fresh-start measurements isn't new or especially radical—the notion of initially measuring assets and liabilities at fair value has been around for many years and is entirely consistent with a historical cost model.

Wayne S. Upton

Fair value is the measurement attribute for the vast majority of accounting measurements on the initial recognition of an asset or liability under a historical cost model. Despite the popular label "historical cost," the reason that transactions are recorded at cost is because cost is the best representation of fair value at the time the transaction occurred.

[1] The Exposure Drafts are *Accounting for Obligations Associated with the Retirement of Long-Lived Assets* and *Accounting for the Impairment or Disposal of Long-Lived Assets and for Obligations Associated with Disposal Activities*.

[2] Fair value also includes the recovery of the overhead element that a third party would incur and a premium for accepting risk. For simplicity, this article addresses only the profit element, but the issues discussed are the same for those other items.

Accountants record the cost of transactions because cost represents fair value—a buyer and a seller have agreed on the fair value of whatever goods or services are being exchanged, and that is the most relevant and representationally faithful number to record at the time. Perhaps the current accounting model would be better referred to as the "historical fair value" model.

The FASB didn't introduce the idea of measuring assets and liabilities at fair value on initial recognition—the notion is clearly documented in an article by Professor William Paton, *Cost and Value in Accounting,* published in the March 1946 *Journal of Accountancy*. Professor Paton observed:

> Cost and value are not opposing and mutually exclusive terms. At the date of acquisition, cost and value are substantially the same—at least in most transactions. In cases where the medium of payment is property other than cash, as noted above, cost of assets acquired is measured by the fair market value of such other property. In fact *cost is significant primarily because it approximates fair value at date of acquisition.* Cost is not of basic importance because it represents an amount paid; it is important as a measure of the value of what is acquired. [Emphasis in original.]

Professor Paton's conclusions were embodied by the Accounting Principles Board in APB Opinion No. 21, *Interest on Receivables and Payables,* and again in APB Opinion No. 29, *Accounting for Nonmonetary Transactions.* Presumably, that is because the members of the respective Accounting Principles Boards believed that fair value is the most faithful representation of a transaction.

In deliberating Concepts Statement 7, the Board asked itself whether there was any reason why it should set aside the general principle of fair value on initial recognition, a principle so well established in everyday accounting, in favor of something else. The Board concluded that nothing about assets and liabilities measured using present-value techniques makes them different from the same items acquired or incurred in exchange for cash. In other words, the measurement objective should not differ simply because the fair value can't be observed and must be estimated. Having reached that conclusion for initial measurements, the Board could find no reason for a different measurement attribute in fresh-start measurements, following initial recognition.

The Profit Element

Many accept the Board's conclusions in Concepts Statement 7 when using present values to estimate the fair value of an asset. However, some find certain aspects of the Board's conclusions difficult to accept when they are applied to measuring liabilities. One of the principal concerns with recording liabilities at fair value seems to be embodied in the question, "If an entity is going to settle a transaction using internal resources, why isn't it appropriate to simply reflect the costs that will be incurred by that particular entity?" In other words, why would an entity include in the measurement of its liability the profit that a third party might earn if settlement was contracted to that party? The simple answer is that fair value is the most relevant measurement attribute and fair value of a liability, that is, the price at which a market participant would settle the liability, would include a profit margin. But that conclusion warrants additional discussion.

The Board did consider a cost-accumulation approach[3] in its deliberations of Concepts Statement 7. However, the Board observed there were several problems with such an approach.

- Cost-accumulation measurements are accounting conventions, not attempts to replicate market transactions. Consequently, it may be difficult to discern the objective of the measurement. Is the "cost" based on direct, incremental expenditures or is it a "full-cost" computation that includes an allocation of overhead and fixed costs? Which costs get included in the overhead pool? Individual Board members observed that, lacking a clear measurement objective, any cost accumulation method would inevitably have to be based on rules that are essentially arbitrary.
- Cost-accumulation measurements are inherently intent-driven and thus lack comparability. One entity might expect to meet all of its warranty obligations through its internal service department. Another might expect to handle some repairs internally and outsource others. Still another might expect to outsource all warranty service. All three could describe the resulting measurement as "cost accumulation," but the results would hardly be comparable—each entity would have a different measurement objective for the same liability.
- Cost-accumulation measurements present a "value" on the balance sheet that an entity would not accept in an exchange transaction. No rational manager would willingly assume a warranty obligation at a price equal to the cost-accumulation measure. The manager would include a margin for the risk involved and a profit margin for performing the service.

Of overriding importance, Board members were concerned that identical liabilities (assuming equivalent credit standing) would be measured at different amounts by different entities. The Board believes that the *value* of a liability is the same regardless of how an entity intends to settle the liability (unless the entities have different credit standing), and that the relative efficiency of an entity in settling a liability using internal resources (that is, the entity's profit margin) should be reflected over the course of its settlement and not before.

A profit margin in a liability might seem unusual, but consider the example of a service contract to repair defective products. In

[3] A cost-accumulation approach is a measurement that includes some of the costs an entity would incur to construct an asset or settle a liability.

this example, an entity is in the repair business and sells service contracts for a fixed amount to repair selected products if they become defective during a certain period of time. If the liability under the service contract was recorded using a cost-accumulation approach, all of the profit would be recognized when the sale of the service contract occurs. Few accountants would accept that result—most would readily accept that no profit should be recognized until the services are rendered or the service contract expires. Waiting to recognize profit until the services are performed or until the contract expires, thereby releasing the entity from any obligation, is often referred to as deferring the revenue. This article doesn't address deferred revenue and deferred expenses, but a more appropriate way to view the accounting under the FASB's Conceptual Framework, which is based on the definitions of assets and liabilities, is that the fair value of the liability under the service contract is recognized in the balance sheet when it is sold (initial recognition).

In this instance, the fair value is readily determinable because a transaction that measures the fair value of the *liability* under the service contract at that date has just occurred. This principle of measuring the liability on initial recognition at fair value has an important result—the profit from servicing activities is recognized when the services are performed[4] or the entity is released from the obligation. This same principle is applied when initially measuring an asset retirement obligation at fair value—the efficiency or inefficiency (profit) in performing the activity that settles the retirement obligation should be recognized when that activity is performed.

Some agree with the above-described accounting for the service contract but contend that incurring costs, such as those required to settle an asset retirement obligation, should not involve profit recognition. Certainly, profits do not arise directly from incurring costs. However, if an entity elects to settle an asset retirement obligation using its internal resources, the total cash outflows—no more, no less—required to settle the obligation will, at some time, be included in operating results. The *timing* of when those cash outflows are recognized will affect the profitability of different periods, but when all of the costs of settling the liability have been incurred, the cumulative effect on profitability from that transaction over all periods will be determined only by the total of those cash outflows. The real issue is which period(s) should reflect the efficiencies of incurring lower costs than the costs that would be required by the market to settle the liability. The Board believes it is those periods in which the activities necessary to settle the liability are incurred. Like the service contractor, an entity that chooses to settle its own asset retirement liability should reflect the "profit" on the activities that settle the liability when those activities are undertaken. If the measurement of the liability does not include the full amount of the costs required by the market to settle it, including a normal profit margin, the "profits" will be recognized prematurely.

Others assert that an asset retirement obligation is different from the contract servicing activity because the entity isn't "in the business" of performing those activities necessary to settle an asset retirement obligation. They contend that it is not appropriate to recognize a profit on those activities, even though if settlement of the liability was outsourced, the third party undertaking settlement clearly would demand, and receive, a profit for undertaking the activity. For the reasons set forth in the first part of this paper, the Board believes that fair value is the appropriate measurement attribute for any asset or liability on initial recognition. However, for those that have concerns that a "profit element" is included in measurement of a liability that is expected to be satisfied using internal resources, the following discussion might be helpful. (The issue does not arise in those situations in which the liability is expected to be settled by engaging an outside contractor.)

For most specialized activities, third-party contractors generally can charge less than the costs that would be incurred by an entity that is not in the business of performing those activities, even though the contractor includes a risk premium and a profit margin. That is one of the principal reasons outsourcing is so popular in today's economy. Entities that have expertise that enables them to settle asset retirement obligations using internal resources more cost effectively than engaging a third party must have acquired that expertise through repetitive performance of those activities. Furthermore, that expertise would likely provide them with the capability of successfully competing with third-party contractors. Even if an entity doesn't compete by performing those same services for others, a decision not to outsource effectively puts the entity in competition with those that are "in the business." Whether or not an activity performed by an entity is part of its business is subjective. However, the discussion in this paragraph would likely lead one to conclude that entities having the capability to settle asset retirement obligations internally at less cost than the amount third-party contractors would charge are, in fact, in the business of settling those kinds of obligations that are peculiar to them.

Perhaps more important, setting aside the question of whether an entity is "in the business," it seems illogical that two parties engaged in the same activities would have different patterns of profit recognition, particularly when determination of whether an activity is an entity's business is essentially arbitrary. Moreover, any attempt to divide activities into categories, and to allow those categories to drive different accounting measurements, would

[4]It may be appropriate to recognize some profit element related to obtaining the contract; however, that discussion is outside the scope of this paper.

necessitate creation of a tangle of arbitrary rules to determine when an entity's activities are its "business" and when they are not.

Another way to view the profit element is as a risk premium. Anytime an entity has an obligation for which the cash flows are uncertain, it is in a position that is somewhat like having written an option. It is exposed to the possibility that its cash outflows will be more or less than it expects. When a liability having uncertain cash flows is settled, the effect is similar to the expiration of an option—the uncertainty that the cash outflow will be more or less than expected no longer exists. For a written option, the risk premium is recognized in income when the entity is released from risk, or uncertainty. Likewise, it is an important event, one that should be reflected in financial statements, when the cash flows associated with an obligation are no longer uncertain.

Conclusion

This article provides additional background and explanation of the Board's rationale for concluding that fair value, which includes a profit margin that a marketplace participant would receive for settling a liability, is the appropriate measurement attribute for a liability, with particular emphasis on asset retirement obligations. Additional articles in this series that address concerns about Concepts Statement 7 and its application will be published in future issues of *Status Report*.

The views expressed in this article are those of the authors. Official positions of the FASB are determined only after extensive due process and deliberations.

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