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Ms. Nancy M. Morris
Federal Advisory Committee Management Office
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: File Number 265-24

Dear Ms. Morris:

These comments are prompted by version 2 of the draft progress report of the Advisory Committee on Improvements to Financial Reporting that is dated February 11, 2008. My interest in the work of the Committee is prompted by much of my management consulting career involving entities that practice the group concept of book depreciation accounting. While both regulated and non-regulated enterprises practice group depreciation, my involvement has been with regulated enterprises – primarily electric and gas utilities, and I have found it common for regulators to impose depreciation deferral mechanisms on their jurisdictional entities. The group concept is a necessity for such enterprises, because they have very large numbers of depreciable property, plant and equipment (PP&E) items. For example, a utility serving 1 million customers will have 1 million billing meters for which it is impossible for depreciation accounting to deal with individually. Even though involving large numbers of depreciable items, the PP&E investment records of enterprises practicing the group concept faithfully reflect their capitalization policy, because physical descriptions are utilized as the basis for distinguishing between capital transactions and expense transactions.

I have long believed that U.S. GAAP should have only one set of rules for depreciation accounting, so support the Committee's decision to recommend that industry-specific rules be eliminated. In theory, SFAS 71 allows regulatory depreciation accounting that is in conflict with GAAP to be reflected in the income statement, with the difference recorded on the balance sheet as a regulatory asset or liability. In practice, I have observed that regulatory depreciation accounting in conflict with GAAP is sometimes reflected in the income statement without the difference being recorded on the balance sheet. If regulatory depreciation accounting in conflict with GAAP is not disclosed, users will be led to incorrectly believe that the financial statements are consistent with GAAP.

The GAAP definition of depreciation accounting and some of the Uniform Systems of Accounts imposed by regulators state that depreciation accounting is to be "systematic and rational," with rational meaning that the pattern of depreciation is to match the pattern of usage of the related PP&E. Entities practicing the item concept of depreciation accounting accomplish this by recording depreciation ratably over the depreciable life of each item, by ceasing depreciation when the depreciable life is reached, and by recording a gain or loss when retirement occurs prior to reaching the depreciable life. Entities practicing the group concept accomplish this by determining the average depreciation rate(s) that will cause the recorded depreciation for each PP&E group to match the usage of the group over its lifetime, and by recording retirements on the premise that all PP&E is fully depreciated at the time of retirement, even though the age at retirement may be less than or more than the average depreciable life of the group.

In addition to being in conflict with GAAP, depreciation deferral mechanisms imposed by regulators increase the costs imposed on ratepayers over the PP&E lifetime. This situation is a consequence of the typically long life of the PP&E of regulated enterprises and of rate base regulation causing the initial ratepayer-impact of any depreciation change to reverse in just a few years for reasons that are beyond the scope of these comments. The deferral mechanisms I have observed to be imposed are also beyond the scope of these comments.

I note the Committee's recognition of the controversy concerning whether the "increased use of fair value measurements will better portray the current valuation of past transactions and improve financial reporting." Such measurements add to complexity, and I view departure from the matching principle with considerable trepidation. The savings and loan debacle of the 1980s and the current mortgage loan situation demonstrate the potential for fraudulent appraisals. The Sarbanes-Oxley Act that precludes audit firms from providing valuation services to their audit clients makes it difficult, if not impossible, to keep qualified appraisers on-staff. Therefore, I question whether audit firms will have the expertise needed for judging the validity of claimed fair values. Audit firms regularly rely on outside expertise. However, what does a lack of in-house expertise for judging the validity of appraisals say about the ability to judge the outside experts?

I view my concern for the ability of audit firms to adequately judge the validity of fair value measurements as being best addressed by limiting the use of such measurements for financial reporting purposes, which seems to be where the Committee is headed.

An issue that the progress report suggests is not being addressed by the Committee is what I believe to be a misinterpretation by the FASB and the SEC of an aspect of the GAAP definition of depreciation accounting – the recognition of "salvage." I urge the committee to address this issue.

GAAP states that depreciation accounting "... aims to distribute cost or other basic value of tangible capital assets, less salvage (if any) ... in a systematic and rational manner." The FASB and SEC interpret this reference to "salvage" to mean "gross salvage" (salvage proceeds), but it was intended to mean "net salvage" (salvage proceeds less removal costs). Regulators were well ahead of the accounting profession in shifting from the concept known as "retirement accounting" to the concept known as "depreciation accounting." Under retirement accounting, all three components of depreciation (investment, salvage, and removal cost) are recorded as expenses at the time PP&E is retired and removed or safely abandoned in place. Under depreciation accounting, a known investment amount is accrued to expense after being incurred, an estimated salvage amount is accrued prior to receipt, and an estimated removal cost amount is accrued prior to expenditure. I am aware that this depreciation concept was in use for regulatory purposes prior to World War I, and believe the current GAAP definition that was issued after World War II was intended to recognize the validity of the regulatory accounting that had been adopted more than 40 years previously.

In addition to recognizing the validity of the regulatory precedent, other reasons why the GAAP definition is intended to mean "net salvage" include;

> At the time the GAAP definition was issued, "salvage" was commonly utilized to mean "net salvage," and some still do so. If the GAAP definition was meant to exclude removal cost, it would have stated "gross salvage."
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> It is inconsistent to abandon the concept of "retirement accounting" for investment and salvage, but not for removal cost.
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> It is inconsistent to abandon cash treatment for one of the terminal transactions (salvage) and to retain cash treatment for the other transaction (removal cost).
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> Treating removal costs differently from investment and salvage conflicts with the premise that accounting be reliable and relevant. The removal cost estimate for accrual purposes is just as reliable as is the salvage estimate, and perhaps more so, for reasons that are beyond the scope of these comments, and ratable treatment through depreciation makes it just as relevant.
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> Financial reporting that defers the recording of removal cost until after the related PP&E ceases to exist provides a misleading indication of the results of operations and the current financial position of the reporting enterprise.

In addition, the Uniform Systems of Accounts imposed by most regulators are specific in requiring that jurisdictional entities practice accrual accounting.

Removal costs are the expenditures for either the physical removal of PP&E or its safe abandonment in place, and are not trivial for regulated enterprises. The distribution lines and piping of energy and water utilities are long-lived, so it is common for their removal costs to be in excess of the depreciable investment of the related PP&E.

Recognizing that the GAAP definition was meant to include removal cost in depreciation would assure consistency in how enterprises treat removal cost, thereby allowing SFAS 143 to be rescinded. SFAS 143 is an abomination, because it is backend loaded, thereby causing a severe mismatch between the recording of removal costs and the usage of the related PP&E. The backend loading inherent in SFAS 143 treatment is particularly ridiculous for nuclear decommissioning costs, because it causes a substantial portion of the legal liability to be recorded as an expense after the related PP&E has been retired and ceased to produce revenues.

I understand that some are concerned that incorporating removal cost into depreciation could cause the net book value of the related PP&E to eventually become negative. If valid, this concern can easily be addressed by shifting the entire book reserve or that portion related to removal costs to the liability side of the balance sheet, where the entire reserve resided until about the time of World War II. I understand that changing the reserve to be a contra-asset was controversial.

A thorough understanding of the group concept of depreciation accounting requires in-depth involvement in its technical aspect, which is the development of depreciation rates consistent with GAAP and/or regulatory accounting rules. I have observed that merely being involved in the application of such rates is insufficient, and that depreciation accounting rules demonstrate little understanding of the group concept. Depreciation accounting rules would be less complex and more meaningful for all enterprises and would be less difficult for enterprises practicing the group concept to implement, if those charged with writing such rules would involve (and listen to) people with a thorough understanding of the concept.

Sincerely,

John S. Ferguson

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