



Board Meeting Handout
Financial Statement Presentation
January 30, 2007

PURPOSE

The purpose of this Board meeting is to address issues related to disaggregating information on the statement of comprehensive income.

BACKGROUND

In September, the Boards expressed a leaning toward presenting information in the statement of comprehensive income by function (for example, sales; cost of sales; selling, general and administrative), with certain information further broken down by nature (for example, labor, materials, rent, depreciation, and royalties) either on the face or in the notes. In addition, the Boards indicated that the initial discussion document should include general guidance (rather than a bright line, numerical rule) for when items should be presented as a separate line and not aggregated on the financial statements. As most of the items that will be disaggregated on the statement of comprehensive income relate to operating activities, the alternatives addressed below focus only on disaggregation within the operating category. For purposes of discussing disaggregation,

- a. *Function* refers to the primary activities in which an entity is engaged, such as selling a product or providing a service, cost of sales, research and development, marketing, and administrative.
- b. *Nature* refers to the inputs (costs) required to accomplish those functional activities, such as costs related to people (labor and benefits), materials, energy, equipment (depreciation), and occupancy (rent).

POSSIBLE ALTERNATIVES

Each of the alternatives below is rooted in a management approach, which is consistent with the classification criteria developed to date and reflective of the fact that businesses and industries are different. Alternatives A and B are consistent with the Boards' September leanings that information be presented first by function and then be broken down by nature. Alternative C is in response to the Board discussion in December related to financial institutions. The three alternatives are illustrated side-by-side on page 3.

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Alternative A: Pure Management Approach

Under Alternative A, an entity would be required to present the following:

- a. Information based on the primary activities (functions) in which the entity engages
- b. For each of those functions, information about the significant related costs (by their nature) that would provide information useful in predicting future cash flows.

The standard would include examples of functional activities and related costs that an entity might present separately.

Alternative B: Modified Management Approach

Alternative B would be the same as Alternative A except that the following costs would be **required** to be presented separately unless the cost is deemed to be insignificant. Those costs are: (a) salaries and wages, (b) pensions and other benefits, (c) material, (d) depreciation, (e) amortization, (f) rent, and (g) energy.

Alternative C: Permit Nature Only (as exception to Modified Management Approach)

Alternative C would add an exception to Alternative B that would permit an entity to present information only based on the nature of expenses (materials, labor, depreciation, and so forth) if classifying costs (expenses) into functional activities provides information that is not relevant. This alternative is similar to IAS 1, *Presentation of Financial Statements*, which requires an entity to "...present an analysis of expenses based on either the nature of expense or their function within the entity, whichever provides information that is reliable and more relevant" (paragraph 88). That paragraph goes on to state that "entities classifying expenses by function [should] disclose additional information on the nature of expenses, including depreciation and amortization expense and employee benefits expense."

Alternatives A, B, and C

In each of the alternatives, an entity would be required to break out any other cost that is important in understanding its operating results that may not be or relate to a functional line item because it does not relate to what the entity does on a regular basis (not a primary activity). Examples would be a gain or loss on disposal of an asset or impairment of goodwill.

Possible Alternatives—Illustrated

The following examples are for illustrative purposes only and do not purport to provide definitive guidance from the Boards. These examples assume that the entity has no items that would be classified as OCI items and omit some totals and subtotals.

Alternative A			Alternative B			Alternative C		
Statement of Comprehensive Income (in millions)			Statement of Comprehensive Income (in millions)			Statement of Comprehensive Income (in millions)		
	2006	2005		2006	2005		2006	2005
BUSINESS			BUSINESS			BUSINESS		
Operating Income			Operating Income			Operating Income		
Sales	68,222	56,741	Sales	68,222	56,741	Sales	68,222	56,741
Cost of sales:			Cost of sales:			Costs and expenses:		
Salaries & Wages	(12,990)	(9,928)	Salaries & Wages	(12,990)	(9,928)	Salaries & Wages	(20,626)	(16,374)
Materials	(6,474)	(6,100)	Materials	(6,474)	(6,100)	Materials	(7,299)	(7,040)
Other cost of sales	(10,261)	(8,712)	Depreciation	(2,750)	(2,300)	Depreciation	(4,377)	(3,384)
Total cost of sales	<u>(29,725)</u>	<u>(24,740)</u>	Energy and Supply Chain	(2,982)	(2,517)	Pension and other benefits	(3,369)	(3,252)
Selling/Marketing	(8,073)	(6,917)	Technology	(2,677)	(2,260)	Advertising Fees	(3,000)	(2,700)
General & Administrative	(12,949)	(11,544)	Other cost of product sales	<u>(1,852)</u>	<u>(1,635)</u>	Amortization	(1,000)	(800)
Research & Development	(2,075)	(1,940)	Total cost of product sales	<u>(29,725)</u>	<u>(24,740)</u>	Rent	(1,000)	(1,000)
Loss on Asset Disposal	(300)	0	Selling/Marketing:			Energy and Supply Chain	(2,982)	(2,517)
Goodwill Impairment	(200)	0	Salaries & Wages	(3,400)	(2,892)	Technology	(3,777)	(3,360)
Operating income	<u>14,900</u>	<u>11,600</u>	Advertising fees	(3,000)	(2,700)	Other operating expense	<u>(5,392)</u>	<u>(4,714)</u>
Investing Income			Other selling/marketing	<u>(1,673)</u>	<u>(1,325)</u>	Total costs and expenses	<u>(52,822)</u>	<u>(45,141)</u>
Income from minority investment	150	100	Total Selling/Marketing	<u>(8,073)</u>	<u>(6,917)</u>	Loss on Asset Disposal	(300)	0
Investing income	<u>150</u>	<u>100</u>	General & Administrative:			Goodwill Impairment	(200)	0
FINANCING			Pension and other benefits	(3,369)	(3,252)	Operating income	<u>14,900</u>	<u>11,600</u>
Financing income			Salaries & Wages	(3,236)	(2,754)	Investing Income		
Interest income	250	200	Depreciation	(1,627)	(1,084)	Income from minority investment	150	100
Financing expenses			Amortization	(1,000)	(800)	Investing income	<u>150</u>	<u>100</u>
Interest expense	(1,119)	(834)	Rent	(1,000)	(1,000)	FINANCING		
Net financing expense	<u>(869)</u>	<u>(634)</u>	Technology	(1,100)	(1,100)	Financing income		
INCOME TAXES			Other operating expense	<u>(1,617)</u>	<u>(1,554)</u>	Interest income	250	200
Provision for income taxes	(3,729)	(3,058)	Total general & administrative	<u>(12,949)</u>	<u>(11,544)</u>	Financing expenses		
Comprehensive Income	<u>10,452</u>	<u>8,008</u>	Research & Development:			Interest expense	(1,119)	(834)
			Salaries & Wages	(1,000)	(800)	Net financing expense	<u>(869)</u>	<u>(634)</u>
			Materials	(825)	(940)	INCOME TAXES		
			Other research & development	<u>(250)</u>	<u>(200)</u>	Provision for income taxes	(3,729)	(3,058)
			Total research & development	<u>(2,075)</u>	<u>(1,940)</u>	Comprehensive Income	<u>10,452</u>	<u>8,008</u>
			Loss on Asset Disposal	(300)	0			
			Goodwill Impairment	(200)	0			
			Operating income	<u>14,900</u>	<u>11,600</u>			
			Investing Income					
			Income from minority investment	150	100			
			Investing income	<u>150</u>	<u>100</u>			
			FINANCING					
			Financing income					
			Interest income	250	200			
			Financing expenses					
			Interest expense	(1,119)	(834)			
			Net financing expense	<u>(869)</u>	<u>(634)</u>			
			INCOME TAXES					
			Provision for income taxes	<u>(3,729)</u>	<u>(3,058)</u>			
			Comprehensive Income	<u>10,452</u>	<u>8,008</u>			

STAFF RECOMMENDATION

The staff initially preferred Alternative B—besides being consistent with the Boards' leaning toward disaggregation by both function and nature, the approach is easy to understand, relatively straightforward to apply, and should provide for the amount of disaggregated information users are looking for. However, recognizing that there are circumstances in which **not** allocating costs to functions provides more useful information, the staff recommends Alternative C, which would permit an entity to present information on the statement of comprehensive income only by nature when that presentation provides more relevant information.

The staff also recommends that in all cases, the disaggregated cost information be presented on the face of the statement of comprehensive income, not in the notes. The staff is of the view that if “by nature” cost information is important, it should be presented on the face of the statement of comprehensive income. In addition, requiring the disaggregated information to be presented on the face rather than giving entities a choice of disclosing that information in the notes will result in a more consistent presentation by all entities. In other words, analysts will always know where they can find that disaggregated cost information.

Questions for the Board:

1. Which of the three alternatives for presenting information do Board members prefer?
2. Do Board members agree that disaggregated information should be required to be presented on the face of the statement of comprehensive income (rather than be permitted to be included in the notes to the financial statements)?



Board Meeting Handout

POSTRETIREMENT BENEFIT OBLIGATIONS INCLUDING PENSIONS

January 30, 2007

PURPOSE

At today's meeting, the Board will discuss the comment letters received in response to proposed FASB Staff Position (FSP) FAS 158-a, "Conforming Amendments to the Illustrations in FASB Statements No. 87, No. 88, and No. 106 and to the Related Staff Implementation Guides."

SUMMARY

FSP FAS 158-a was issued December 7, 2006 with a 30-day comment period. The staff received eight comment letters from constituents. All eight respondents expressed overall support for the proposed FSP.

Three respondents stated their support for the elevation of the guidance contained in FASB Special Reports on FASB Statements No. 87, *Employers' Accounting for Pensions*, No. 88, *Employers' Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits*, and No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions*, from Level D to Level A in the GAAP hierarchy. No respondents stated opposition to the elevation.

Three respondents stated their support for the incorporation of the updated guidance from the staff implementation guides as new appendixes to those respective statements. No respondents stated opposition to the incorporation.

Six respondents suggested other technical corrections and editorial changes. The staff has evaluated each suggestion and has reflected many of the suggestions in the Ballot draft of the final FSP. However, the staff did not make some changes that exceeded the scope of the proposed FSP—to make conforming amendments to existing guidance to reflect the provisions of FASB Statement No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans*.

QUESTION FOR THE BOARD

Does the Board support proceeding to a Ballot draft for FSP FAS 158-1?



Board Meeting Handout

Agenda Decision: Allowance for Loan Losses

January 30, 2007

PURPOSE

At the January 30, 2007 Board meeting, the staff plans to ask the Board whether it would like to add a project on allowance for credit losses related to financing receivables to its technical agenda and, if so, the objective, scope, and timing of such a project.

OVERVIEW OF CURRENT ACCOUNTING

FASB Statements No. 5, *Accounting for Contingencies*, and No. 114, *Accounting by Creditors for Impairment of a Loan*, provide the general principles a creditor should apply to account for impairment in financing receivable portfolios under U.S. generally accepted accounting principles (GAAP). In providing for losses on loans, the overriding concept in U.S. GAAP is that impairment and/or accrual for losses should be recognized when, based on all available information, it is probable that a loss has been incurred based on past events and conditions existing at the date of the financial statements. Even though it may be probable that losses will be incurred in the future based on past experience, losses are not recognized before it is probable that they have been incurred (incurred model).

In practice, it is difficult to identify the actual event that caused the incurred loss on a financing receivable or a pool of such receivables. Thus, the creditor typically defaults to the date in which the creditor receives information that results in an impairment determination. The staff's concern with the current guidance is that determining the event or events that trigger impairment of loans is difficult in most situations, especially when impairment is calculated on a homogenous pool under Statement 5. The adequacy of the analysis to determine an allowance for losses for a homogenous pool is largely dependent on the consistency and timeliness of individual account write-offs and adjusting the analysis for the estimated time lag between the incurred event and the charge-off.

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Statement 114 states that “a loan is impaired when, based on current information and events, it is probable that a creditor will be unable to collect all amounts due according to the contractual terms of the loan agreement” (paragraph 8). Although an event is identified under this guidance more easily than identifying an event or events for a homogenous pool of financing receivables, the event identified as triggering the impairment can certainly be subject to speculation (such as a borrower losing a critical customer that is unknown to the lender versus the borrower filing for bankruptcy that is known to the lender as the actual triggering event).

STAFF RECOMMENDATION

The staff recommends that the Board add a project to its technical agenda on allowance for credit losses related to financing receivables. In addition, the staff would like the Board to consider the following options related to the project:

Option 1—Continue accounting for the allowance for losses under the current accounting guidance, reconsider all existing disclosure requirements for credit quality of financing receivables and the associated allowance, and develop a package of new disclosures that would replace existing disclosures.

Option 2—Reconsider the current accounting for allowance for losses related to financing receivables (loans and finance leases). This alternative also would reconsider current disclosures required. For example, the staff would research and evaluate whether an incurred loss model, which is currently required under current U.S. GAAP and International Financial Reporting Standards, represents the best measure of an entity’s financial position at a given point in time or if an expected losses model or some derivation thereof should be considered. The staff would attempt to develop accounting that results in consistent and comparable information that is representationally faithful to the users of the financial statements.

Option 3—Require financing receivables to be recognized and measured at fair value. This approach also would require new disclosures. For example, potential new disclosures (which may provide more information than financial institutions are currently required to disclose) may be:

- a. All losses inherent in a financing receivable portfolio that are expected to be incurred over the life of the receivables (potentially segregated by factors to be determined) assuming a steady state economy and other factors
- b. Losses as described in (a), but assuming an entity's projection of what the economy and other factors may do in the future.

Option 3(a)—Require all financial instruments be recognized and measured at fair value. This approach also would require new disclosures. As this option may take a significant amount of time, another consideration would be to address disclosures that enhance a user's understanding of the credit risk underlying their financing receivable portfolio before completion of the overall project.

QUESTION FOR THE BOARD

Would the Board like to add a project on allowance for credit losses related to financing receivables to its technical agenda?



Board Meeting Handout

Agenda Request—Delay of Effective Date of SOP 05-1

January 30, 2007

The purpose of this Board meeting is to ask the Board to consider whether a project should be added to its agenda to delay the effective date of the AICPA Statement of Position 05-1, *Accounting by Insurance Enterprises for Deferred Acquisition Costs in Connection with Modifications or Exchanges of Insurance Contracts*. SOP 05-1 was issued in September of 2005, and is effective for fiscal years beginning after December 15, 2006.

The fundamental purpose of SOP 05-1 is to provide guidance for determining (a) when modifications of insurance contracts are considered not substantial and permit the related deferred acquisition costs (DAC) to be carried forward, and (b) when the modifications are substantial and DAC is required to be written off.

The FASB received several comment letters concerning implementation issues for SOP 05-1. A roundtable was held on January 8, 2007 to discuss with constituents their (a) implementation efforts to date, (b) concerns with certain answers contained in draft AICPA Technical Practice Aids (TPAs), and (c) views regarding the effect on implementation if those draft TPAs are not issued as final.

Accounting Issue

Question 1: Based on input from constituents, including comments received from the Roundtable discussion, does the Board want to delay the effective date of SOP 05-1?

Alternative 1—No, the Board does not believe that the effective date of SOP 05-1 should be delayed.

Alternative 2—Yes, the Board does believe that the effective date of SOP 05-1 should be delayed.