

## MINUTES



**To:** Board Members  
**From:** Gibbons (ext. 446)  
**Subject:** Minutes of the September 21, 2005 Board Meeting: Conceptual Framework  
**Date:** September 28, 2005  
**cc:** Leisenring, Bielstein, Smith, Petrone, Mahoney, Polley, Lott, Gabriele, Carney, Sutay, Project Team, FASB Intranet, IASB: Upton, Hickey, GASB: Reese, Patton

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Topics: Process for Assessing Qualitative Characteristics; Reporting Entity Phase: Planning; Draft Invitation to Comment: Assets and Liabilities with Uncertainties; and Prospective Financial Information: Planning

Basis for Discussion: Agenda Papers 15, 15A, 15B and FASB Memo—Invitation to Comment

Length of Discussion: 9:40 a.m. to 11:15 a.m.

Attendance:

Board members present: Herz, Batavick, Crooch, Schipper, Trott, Seidman, and Young

Board members absent: None

Staff in charge of topics: Bullen, Crook, McBeth, and Bossio

Staff at Board table: Bielstein, Johnson, Bullen, Bossio, McBeth, Abbate, Gibbons, and Duke

Other participants: by phone: Willis, Crook, Rees, Hague, and Villmann

Summary of Decisions Reached:

The Board continued its deliberations on the joint FASB/IASB conceptual framework project. The Board discussed issues relating to:

1. The process for assessing qualitative characteristics of financial information
2. Planning issues for the reporting entity phase
3. Whether to issue an Invitation to Comment (ITC) relating to assets and liabilities with uncertainties as prepared by the staff
4. Planning issues for discussion of prospective financial information.

The Board reached the following conclusions:

1. *Process for assessing qualitative characteristics of financial information:*

The Board agreed that the refined process chart for assessing the qualitative characteristics of financial information is an improvement over the process chart discussed at the July 28, 2005 Board meeting. Board members raised some concerns about the staff's depiction and discussion of timeliness and the consequences of what happens when a faithful representation of a relevant phenomenon cannot be achieved. The staff agreed to continue work on refining the depiction and description of these characteristics. The Board agreed that materiality is a factor that should be taken into account in considering qualitative characteristics, but is not a qualitative characteristic itself. Thus, it should not be treated as a separate step in the process. Finally, the Board suggested that the staff further consider whether the process should be described in a different manner when used by standard setters, rather than when used in financial statement preparation.

2. *Planning issue for reporting entity phase:* The Board agreed that it should proceed, as planned, to develop a due process document on objectives and qualitative characteristics (Phase A) before concluding (or substantially beginning) work on the reporting entity phase of the project. The Board also agreed with the project plan for the reporting entity phase.

3. *Invitation to Comment on asset and liabilities with uncertainties:* The Board agreed with the staff's proposal to issue an Invitation to Comment that would seek constituent input on certain issues related to assets and liabilities with uncertainties that the Board will be considering in the next phase (Phase B) of the conceptual framework project. The Board also agreed to a 90-day comment period, which is expected to begin on or about September 30, 2005.

4. *Planning issues for discussion of prospective financial information:* The Board agreed that it should continue with the original plan to issue a due process document on objectives and qualitative characteristics (Phase A) before consideration of prospective financial information. That due process document should indicate that the Board will consider the topic of prospective financial information in the later phase on presentation and disclosure, including the boundaries of financial reporting (Phase E).

Objective of Meeting:

The Board discussed qualitative characteristics of financial information, planning issues for the reporting entity and prospective information, and a draft of an Invitation to Comment prepared by the staff on assets and liabilities with uncertainties. The objective of the meeting was to obtain the Board's decisions on these matters. The objectives of the meeting were met.

Matters Discussed and Decisions Reached:

*Qualitative Characteristics of Financial Information*

1. Mr. Bullen introduced the process chart for assessing the qualitative characteristics (appendix 1), which has been refined from the version presented at the July 28, 2005 Board meeting. Mr. Bullen discussed the following aspects of the refined chart:

- a. The process allows a representation that is not fully faithful to be reported, but the lack of faithfulness should be communicated to users of financial reports.

- b. Materiality is a factor that should be taken into account in assessing qualitative characteristics, but it is not a qualitative characteristic itself. Thus, it should not be treated as a separate step in the process.
    - c. Timeliness remains an aspect of relevance, focusing on when financial information is reported to users.
2. Mr. Trott expressed support for the process flow presented by the staff, but indicated that it should be intended for use by standard setters, not by preparers and users. Mr. Trott proposed that in step 5, assessing whether the depiction is a faithful representation, the standard setter should never reach the lowest box that calls for the financial report to disclose the lack of faithful representation. The *cause* of the lack of faithful representation should be considered in deciding whether to end the process, change the depiction, or add disclosures. He suggested that the process flow chart is too “hard-wired” because it does not seem to allow for such considerations.
3. Mr. Trott agreed with the staff’s assessment of materiality, but disagreed with the suggestion that timeliness is primarily an aspect of relevance. He said timeliness is a component of both relevance and faithful representation and refers to recognizing an event in the period in which it occurs. Ms. Seidman asked Mr. Trott whether he objects to (a) the chart’s depiction of timeliness or (b) the staff’s description of assessing timeliness. Mr. Trott indicated that the chart’s depiction is adequate, but that the staff’s description of timeliness should be changed. Consistent with focusing on the perspective of the standard setter, he said that timeliness, as depicted in step 14, should not be related to the time it takes a preparer to complete bookkeeping.
4. Mr. Bullen suggested that the issue of reporting items as having occurred in the period in which they occur be resolved by enhancing the discussion of faithful representation. For example, the text might make clear that not reporting an item in the period as having occurred when it occurred would render the information incomplete and, thus, it would not be a faithful representation.

5. Mr. Young stated that understandability, as assessed in step 7, is one of the more important characteristics. The ability to “enhance the depiction,” as prescribed in the chart for depictions that are not understandable, fails to indicate that the process should lead back to the beginning of the chart, to require development of a more understandable depiction. The chart seems to suggest that the financial statement preparer should only enhance the depiction, perhaps by providing additional disclosures, rather than consider an alternative accounting treatment that may increase understandability.

6. Mr. Young discussed step 6, which calls for disclosure of the lack of comparability and occurs when a depiction is not comparable and comparability cannot be improved. He questioned how disclosing the lack of comparability may interact with the depiction itself which, as indicated in step 3, may contain disclosures. Mr. Bullen said that if a depiction lacks a fully faithful representation (step 5) or comparability (step 6) and that depiction cannot be improved, the information should not be suppressed—the flawed information should be reported with a warning that the information contains an inadequacy. Mr. Bullen indicated that if a disclosure is part of the original depiction, disclosure of the lack of faithful representation or comparability could be included with the original disclosure. He also noted that this is not a new practice—it is used in current standards, for example FASB Statement No. 5, *Accounting for Contingencies*, that may require non-recognition of a contingency but disclosure about the uncertainty of the outcome. Mr. Young stated that a point estimate of an uncertain amount with disclosure about the uncertainty is a faithful representation, rather than a lack of faithful representation that is compensated with disclosures. Mr. Trott concurred with Mr. Young on this point and reiterated that he is having difficulty envisioning examples.

7. Mr. Bullen suggested that the requirement to report inventory at the lower of cost or market can be thought of as an unfaithful representation—it is a biased, conservative measurement approach. Ms. Seidman indicated that the lower of cost or market notion can be viewed as an alternate depiction that is, perhaps, less relevant. Mr. Bullen indicated that there are currently cautions in financial

reports and that the chart allows for such an outcome. Mr. Bossio suggested that the Board consider how the process may relate to future discussions of prospective information. For example, management's forecasts may be deemed relevant; however, if the forecasts cannot be verified they lack a major aspect of a faithful representation. Nonetheless, the standard setter may want to allow that information to pass through step 5 with appropriate disclosures surrounding the nature of forecasts.

8. Mr. Herz suggested rewording the chart to indicate that a less faithful representation may be chosen, but not a depiction that entirely lacks faithful representation. Ms. Bielstein asked whether the chart is intended to allow deviation from the most relevant depiction if a more faithful representation results. Mr. Trott indicated that it should be allowable to select a less relevant depiction. Ms. Seidman agreed with Mr. Trott and proposed that the chart be changed to reflect that interpretation. Mr. McBeth proposed eliminating the lower rectangles in steps 5 and 6 and providing an enhanced discussion of the process as a possible solution. Mr. Hague stated that Mr. McBeth's proposal is a possibility and that, if retained, the bottom rectangles should only be reached if all relevant depictions have been exhausted. Mr. Batavick asked whether a depiction will always be selected provided the information is relevant. Mr. Bullen said that an item that can be relevantly depicted should always be reported—the process should not end with nothing being reported even if it is a less-than-faithful representation.

9. Ms. Schipper agreed with Mr. Trott's statement that the chart should focus on standard setting and standard setters, as opposed to preparers, auditors and users. She also expressed concern that a chart is inevitably less than complete than the full text description which it summarizes, but because the chart is so salient it may distract people from reading the full text.

10. With regard to the staff's recommendation, she suggested two ways to interpret that recommendation (paragraph 1(a)) which would permit a depiction which is not representationally faithful as long as that fact is communicated (presumably, disclosed):

- a. The chart depicts a strong hierarchy in which representational faithfulness and comparability are subordinated to relevance—representational faithfulness and comparability are neither necessary nor sufficient for an item to be reported. To support the recommendation that comparability is to be subordinated to relevance, the memorandum notes that comparability alone cannot make an item relevant. Ms. Schipper stated that the same assertion can be made about representational faithfulness—it alone cannot make an item relevant.
  - b. Alternatively, the staff recommendation may imply that a relevant depiction that fails the representational faithfulness criterion is discarded and the remaining pool of depictions is considered for adequacy of both relevance and faithful representation. This is the notion of “bargaining,” which the staff purported to eliminate with the process chart.
11. Ms. Schipper stated that the chart leaves questions unanswered. Does the threshold for failing representational faithfulness differ for disclosed and recognized items? Does “reporting” or “depicting” an item refer to recognizing the item, disclosing it, or both? The lower boxes under steps 5 and 6 suggest that the threshold for recognition is higher than for disclosure—is this intended by the staff? Biased items may be verifiable and unbiased items may be non-verifiable—which is preferable for representational faithfulness? How does a decrease in both representational faithfulness and comparability, resulting from subordinating those characteristics to relevance, affect understandability? Does the staff consider that disclosures should be used to ameliorate a lack of faithful representation or comparability, and if so, how?
  12. Ms. Schipper stated that timeliness is an aspect of relevance because the most relevant depictions are those that include the most up-to-date information that is available to the entity. Ms. Schipper agreed with the staff’s treatment of materiality.
  13. Mr. Bullen stated that the staff used the phrase “report the item” with the intention of postponing consideration of whether to recognize or disclose an item

until recognition criteria are discussed in a later phase. Mr. Hague concurred. Mr. Bullen stated that the staff will improve the discussion of timeliness.

14. Mr. Batavick stated that the changes are an improvement and agreed with several other Board members that the chart should not be intended for use by auditors and preparers. He suggested that the bottom rectangle in step 5 is unnecessary because it will not preclude the necessary discussion among standard setters. Qualitative characteristics such as timeliness and materiality may overlap with the other qualitative characteristics and the conceptual framework should clearly define these words so that it is certain how they are being used in the framework. The chart is a starting point and a useful tool.

15. Ms. Seidman also stated that the flow chart is helpful and should be an aid in refining the words used in the conceptual framework. She made several suggestions for further improvement:

- a. In step 3, selection of a depiction should explicitly reference the conceptual framework definitions of the elements of financial statements.
- b. In step 4, the word “most” should be removed so that “other” relevant depictions are possible and the user can loop between the relevance and faithful representation steps.
- c. The bottom rectangle in step 5 (“disclose the lack of faithful representation”) should be dropped because depictions that are not faithful representations should not be reported.

Ms. Seidman agreed with other Board members that the chart should be a tool for standard setters and the wording should be changed to reflect the standard-setter’s perspective. Ms. Seidman did not agree with the use of timeliness in step 14 of the chart because it only appears in assessing whether the financial reports are timely, which is not within a standard setter’s purview. Timeliness from the standard-setter’s perspective means reporting a phenomenon in the appropriate period. Mr. Bossio added that timeliness, as depicted in step 14, may reflect the preparer’s perspective and if the chart is changed to focus on the

standard setter it may be necessary to consider whether timeliness needs to be considered in different places, including as part of the cost-benefit considerations in step 8. Ms. Seidman agreed with the staff's approach to materiality.

16. Mr. Hague questioned whether a preparer would use a fundamentally different process than a standard setter for assessing a depiction. For example, in the IASB framework, the preparer may follow a process similar to that of a standard setter since the preparer is referred to the conceptual framework if guidance in the standards is inadequate for a particular situation. Mr. Trott stated a chart for preparers should be separate because the thought processes may differ; the Boards should focus on creating a tool for their own use and avoid serving too many purposes. Mr. Crooch stated that he agreed with Ms. Seidman in that different terminology and guidance would be appropriate depending on the intended user of the chart.

17. Mr. Crooch supported the staff's process chart and said it is a concise way to remind the Board and others of the different qualitative characteristics that need to be addressed in setting standards. Mr. Herz agreed with Mr. Crooch and the changes made by the staff, with the exception of step 5—assessing faithful representation. Mr. Herz added that more work should be done on determining how to gauge predictive value, that is, what increases or decreases predictive value. Ms. Bielstein asked Mr. Herz if he favors depictions that have predictive value in selecting a “most relevant” depiction. Mr. Herz stated that he has a strong understanding of confirmatory value, but that it may be valuable to learn more about what affects that characteristic.

18. Mr. Bullen summarized the discussion by stating that the Board agreed that the process flow chart is an improvement and that it should be used as a standard-setting tool, but more work should be conducted in the areas of timeliness and faithful representation. The Board agreed with the staff's treatment of materiality

*Reporting Entity*

19. Ms. Crook stated that work is beginning on the reporting entity and that the staff plans to conduct the phase alongside the phase on elements, recognition, and measurement because of the links between the phases and the Board's request to accelerate work on the reporting entity phase. Ms. Crook asked the Board to consider the following planning issues relating to the reporting entity phase:

- a. Are there considerations to be made about the reporting entity phase before issuing the initial due process document objectives and qualitative characteristics (Phase A)?
- b. Is the Board aware of any changes to the cross-cutting issues previously identified that relate to this phase? (Cross-cutting issues for the reporting entity phase are attached as appendix 2).
- c. Is the Board aware of additional literature resources that should be considered in the reporting entity phase of the project?
- d. Does the Board have any comments or feedback on the initial project plan?

20. Ms. Seidman asked whether a decision has been made about the form of an initial due process document for Phase A. Ms. Crook stated that no decision has been made, but the decision to use a discussion paper or an Exposure Draft depends on the extent of the change from the original framework. Since the reporting entity concept is absent from the current FASB and IASB frameworks, a discussion document may be more appropriate. Mr. Bossio stated that the differences in GAAP hierarchy for the two frameworks also should be considered, as a different approach may be needed for each Board. The Board and staff will also need to consider whether to (a) immediately issue a final document for a phase or (b) wait for other phases to be completed. The staff will consider some of these issues of Phase A for discussion in October.

21. Mr. Trott and Mr. Crooch agreed with the project plan to move forward toward issuing a due process document for Phase A before completing the reporting entity phase. Ms. Seidman stated that she agreed with the plan

provided the initial due process document for Phase A is a Preliminary Views—it may be inefficient to issue an Exposure Draft and proceed directly to a final Statement if the Board expects that cross-cutting issues in subsequent phases could cause significant changes to that document. Ms. Bielstein stated that the labeling of the document is a minor consideration. Mr. Bossio stated that when the Boards are ready to issue a document that it will be important to inform constituents about the number of rounds of comments that are expected. The Board unanimously agreed with the project plan.

22. The Board did not identify additional cross-cutting issues or relevant literature sources that relate to the reporting entity phase. The staff encouraged the Board to bring to the staff's attention any such issues of which the Board becomes aware in the future.

*Invitation to Comment*

23. Mr. McBeth stated that in June 2005, the IASB issued an Exposure Draft, *Amendments to IAS 37 Provisions, Contingent Liabilities and Contingent Assets and IAS 19 Employee Benefits*, which addresses issues of probability and uncertainty. The FASB staff drafted an Invitation to Comment, *Selected Issues Relating to Assets and Liabilities with Uncertainties*, (ITC) focusing on some of the issues from the IASB Exposure Draft. Mr. McBeth asked the Board whether the ITC should be issued.

24. Ms. Schipper and Mr. Batavick agreed that the ITC should be issued and noted that it would solicit comments on important issues to be considered in Phase B of the conceptual framework project. Ms. Seidman expressed general support for involving constituents early in the life of a project, but in this case, she would have preferred to learn about the issues raised by the IASB from the comment letters received from IASB constituents. Ms. Seidman indicated that she may not agree with some of the conclusions reached by the IASB but, because the FASB has not deliberated the issues, she is not prepared to articulate why. She expressed concern that FASB constituents likewise might not currently be in a position to develop conceptual reasons against any of the positions taken.

25. Mr. McBeth asked the Board whether a 90-day comment period with a tentative comment deadline of January 3, 2006, is appropriate for the ITC. Mr. Trott supported the 90-day comment period and stated that the deadline will coincide with timing for the Phase B and the Board's discussion of the definitions of elements and concepts for recognition. The Board agreed with the 90 day comment period.

*Prospective Information*

26. Mr. Bossio stated that neither the FASB nor IASB framework addresses prospective information as an objective of financial reporting—a potential omission in the original frameworks. The staff asked the Board whether to proceed with Phase A before considering prospective financial information. Prospective information has not been identified as a cross-cutting issue, and the staff view is that it should be considered in Phase E—presentation and disclosure including the boundaries of financial reporting—as originally planned. If prospective information is discussed in Phase E, the initial due process document on Phase A should inform constituents that prospective information will be considered in a later phase of the project.

27. Mr. Trott agreed with the staff view to consider prospective information in Phase E, as originally planned. Mr. Batavick also agreed that the staff should continue with the original plan and stated that it is important to inform constituents that the Board will consider prospective information in a later phase. Mr. Young stated that prospective financial information, including prospective financial information in financial reports, could significantly change the objectives of financial reporting and the reporting process. He, however, would not object to continuing with Phase A provided the Board has flexibility to consider the topic at a later date. Mr. Herz agreed with Mr. Young's concerns, but expressed support for moving forward with Phase A before considering prospective financial information. Ms. Seidman observed that if Phase E were to result in significant changes to the proposed objectives of financial reporting that could change plans about whether or when to move forward to a final statement for Phase A.

28. Ms. Schipper stated that the discussion in the basis for conclusions of the due process document for Phase A should indicate that by not including forecasted financial information in the objectives of financial reporting at this time, the Board is referring to forecasts of specific outcomes, for example, income, cash from operations, sales. Financial statements already contain considerable information about management's expectations for the future, for example, accounts receivable represents management's assertion that it expects to collect cash in the future.

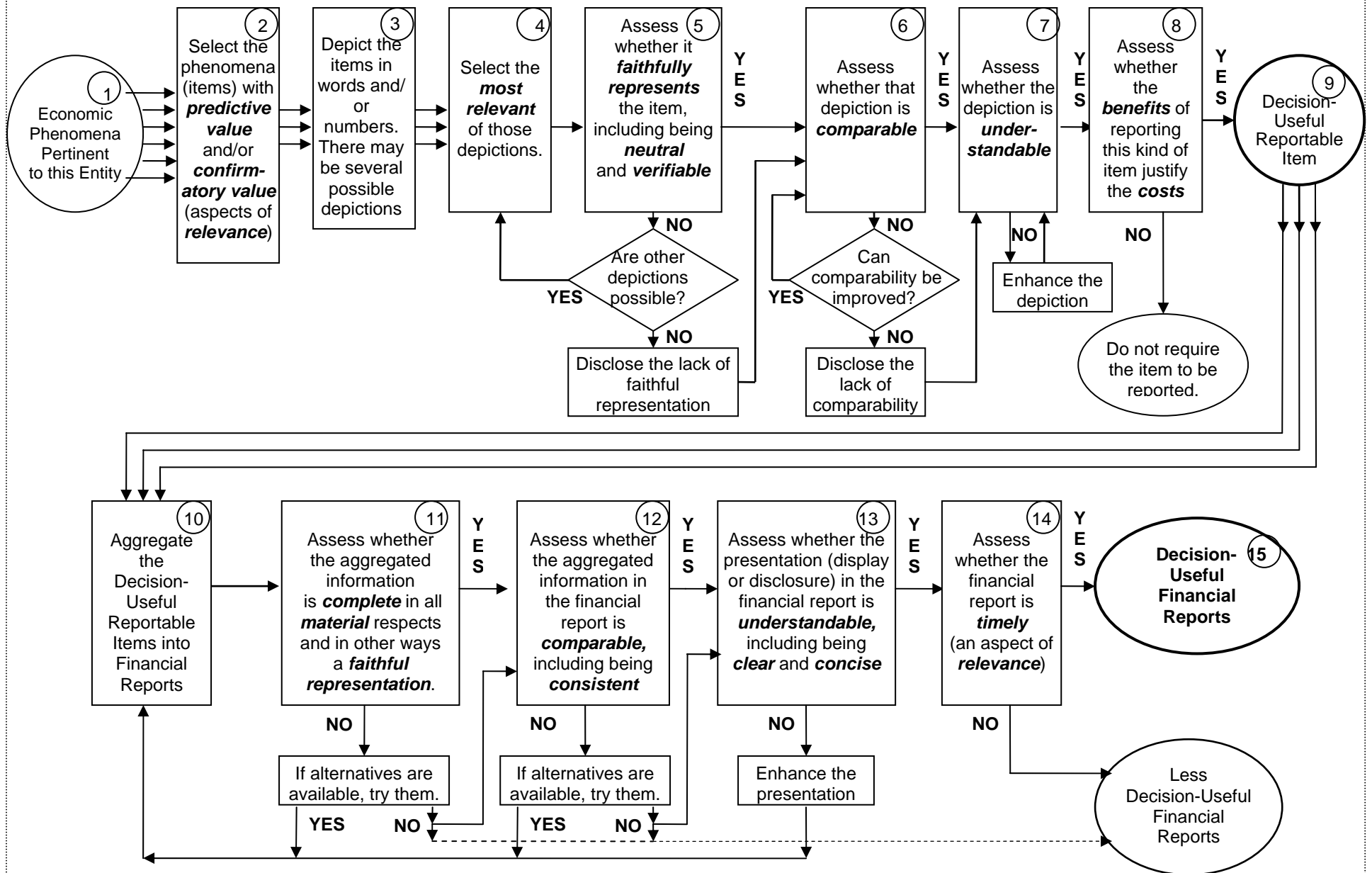
Follow-up Items:

27. Mr. Bullen agreed to further develop the process chart and related discussion, including examples in which additional disclosure may be needed to communicate the lack of faithful representation in a depiction.

General Announcements:

None.

## APPENDIX 1—Illustration 1: Using the Qualitative Characteristics for Standard Setting and to Build Decision-Useful Financial Reports



## **APPENDIX 2**

### **Cross-cutting Issues Relating to the Reporting Entity Concept**

#### Reporting entity concept

- RE1 When is a legal entity, or an economic unit, a reporting entity? (e.g., branch versus entity, business versus entity) Are there two questions—what is an entity and what is a reporting entity?
- RE2 Aggregation versus disaggregation—which is most useful information? For example, when should a legal entity be divided into several reporting entities? When should consolidation occur?
- RE3 What is the purpose of consolidated accounts?
- RE4 Is control the right basis for consolidation?

#### Reporting entity and the concept of control

- RE5 What does control mean? Should this be defined at the concepts level or standards level?
- RE6 Is there a difference between control over an entity and control over assets? Which should provide the basis for consolidation?
- RE7 Joint ventures—concept of joint control; joint control over entity or assets?
- RE8 Does it matter if one has control today but might lose control later (e.g., control today only because of dispersion of other shareholdings)?