



## FINANCIAL ACCOUNTING STANDARDS ADVISORY COUNCIL

September 22, 2005 - - - - 9:00 A.M.

FASB Offices - - - - Norwalk, Connecticut

### Agenda

1. Introductory Remarks  
(Mr. Swift)
  2. Approval of Minutes Attachment A
  3. Report of the FASB Chairman (Mr. Herz) Mr. Herz will comment on Board activities not otherwise on the meeting agenda. (Attachment B)
  4. Report of the SEC (Mr. Taub) The SEC Deputy Chief Accountant will comment on accounting and related matters at the SEC.
  5. Report of the PCAOB (Mr. Carmichael) The Chief Auditor will comment on Public Company Accounting Oversight Board matters.
  6. Preliminary FASAC Survey Results (Ms. Polley) Council members will discuss preliminary results of the 2005 FASAC survey. (Attachment C)
- B R E A K**
7. Pension Accounting Issues (Mr. Proestakes) Council will discuss issues concerning accounting for postretirement benefits and possible alternatives for Board action. (Attachment D)
  8. Conceptual Framework (Messrs. Crooch and Bullen) Council will discuss the qualitative characteristic of understandability, and materiality as a filter of financial information. (Attachment E)
- L U N C H**
9. Fair Value (Ms. Seidman) Council members will discuss fair value measurement, specifically differences between a transaction price and a model-based estimate. (Attachment F)
- B R E A K**
10. Closed Small Group Session Members of the FASAC Steering Committee will meet with the Board to discuss strategic matters.

**A D J O U R N M E N T**

**FASAC MEETING  
SEPTEMBER 22, 2005  
FASB CHAIRMAN'S REPORT**

- **TECHNICAL ACTIVITIES**
- **INTERNATIONAL**
- **PRIVATE COMPANY/SMALL BUSINESS  
REPORTING**
- **OTHER MATTERS**

## REPORT OF THE CHAIRMAN OF THE FASB

TO THE FINANCIAL ACCOUNTING FOUNDATION

July 1 through August 31, 2005

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### ITEM 1: TECHNICAL ACTIVITIES

#### BOARD AND STAFF ACTIVITIES

- a. The following documents were issued and posted to the website:
  1. FASB Proposed Interpretation, *Accounting for Uncertain Tax Positions* (July 14, 2005). Comments are requested by September 12, 2005.
  2. FASB Exposure Draft, *Accounting for Certain Hybrid Financial Instruments* (August 11, 2005). Comments are requested by October 10, 2005.
  3. FASB Exposure Draft, *Accounting for Servicing of Financial Assets* (August 11, 2005). Comments are requested by October 10, 2005.
  4. FASB Exposure Draft, *Accounting for Transfers of Financial Assets* (August 11, 2005). Comments are requested by October 10, 2005.
  5. Milestone Draft on liabilities and equity project, *Proposed Classification for Single-Component Financial Instruments and Certain other Instruments* (July 20, 2005).
  
- b. The following FSPs were posted to the FASB website:
  1. FSP APB 18-1—"Accounting by an Investor for Its Proportionate Share of Accumulated Other Comprehensive Income of an Investee Accounted for under the Equity Method in Accordance with APB Opinion No. 18 upon a Loss of Significant Influence" (Posted: July 12, 2005)
  2. FSP SOP 78-9-1—"Interaction of AICPA Statement of Position 78-9 and EITF Issue No. 04-5" (Posted: July 14, 2005)
  3. Proposed FSP FAS 13-a—"Accounting for a Change or Projected Change in the Timing of Cash Flows Relating to Income Taxes Generated by a Leveraged Lease Transaction" (Posted: July 14, 2005) (Comment Deadline: September 12, 2005)
  4. Proposed FSP FAS 13-b—"Accounting for Rental Costs Incurred during a Construction Period" (Posted: July 19, 2005) (Comment Deadline: August 18, 2005)
  5. Proposed FSP FAS 140-c—"Clarification of the Application of Paragraphs 40(b) and 40(c) of FASB Statement No. 140" (Posted: July 21, 2005) (Comment Deadline: August 22, 2005)
  6. Proposed FSP AAG INV-a—"Reporting of Fully Benefit-Responsive Investment Contracts Held by Certain Investment Companies Subject to

- the AICPA Investment Company Guide” (Posted: August 4, 2005)  
(Comment Deadline: September 19, 2005)
7. Final FSP FAS 123(R)-1—“Classification and Measurement of Freestanding Financial Instruments Originally Issued in Exchange for Employee Services under FASB Statement No. 123(R)” (Posted: August 31, 2005)
- c. On August 17, 2005, related to its effort to develop an authoritative codification of U.S. GAAP, the Board added a project to its agenda to establish general standards of accounting for and reporting of events that occur subsequent to the balance sheet date. The Board decided not to undertake a fundamental reexamination of this area. Rather, it plans to develop standards that reflect the principles underpinning current subsequent events guidance in existing accounting standards and in the auditing requirements contained in AICPA Codification of Statements on Auditing Standards, AU Section 560, *Subsequent Events*.
  - d. At the August 3, 2005, Board meeting, the Board met with representatives of AcSEC and cleared the AICPA final SOP, *Accounting by Insurance Enterprises for Deferred Acquisition Costs in Connection with Modifications or Exchanges of Insurance Contracts*. The SOP is in the process of being published by the AICPA.
  - e. All personnel assigned to the codification project attended an all-day training session in Norwalk related to the project.
  - f. The EITF appointed Matthew Schroeder, Managing Director, Accounting Policy at The Goldman Sachs Group Inc., and Carl Kampel, Director in Charge of Professional Standards at Ellin & Tucker, to open seats on the EITF.
  - g. The Statement 123(R) Resource Group met to discuss implementation issues related to accounting for tax effects of share-based compensation awards and private company matters associated with Statement 123(R).
  - h. One Board member met with leading institutional investors in Baltimore, Boston, and New York to recruit charter members of the Investor Task Force (ITF). We anticipate a late September launch of the ITF with Capital Group, Mellon/Dreyfus, Fidelity Investments, Putnam, T Rowe Price, and Wellington Management as founding members.
  - i. We initiated discussion with the top institutional investors to locate our first Investment Fellow. We are at the early discussion stage with Fidelity and Dreyfus on their providing a candidate for this fellowship.
  - j. As part of reconstituting the User Advisory Council (UAC) we have secured the nomination of Bill Miller, Chief Investment Officer from Ohio Public

Employees Retirement System, which would be the first time the state retirement systems participated in the UAC.

- k. We recruited new members for the UAC with the goal of reconstituting the UAC to be more representative of the user community. We have added Ira Malis, Director of Research at the new merged Leg Mason/Citi Asset organization to the UAC. We have also received tentative agreement from Fidelity Investments and Wellington Management to nominate candidates to the UAC.
- l. The chairman and one IASB Board member met with representatives of the International Monetary Fund to discuss fair value accounting.
- m. Five staff members and the TA&I director met with representatives of the financial guarantee industry to discuss issues related to the financial guaranty project and to obtain an overview of the industry and current accounting practices.
- n. Four staff members attended the Appraisal Issues Task Force quarterly meeting to discuss the business combinations Exposure Draft.
- o. Six staff members attended or observed (by phone) the Accounting Standards Executive Committee meeting.
- p. The Board met in public meetings with representatives of the following organizations and discussed matters of mutual interest:
  - 1. Edison Electric Institute
  - 2. Financial Managers Society.

#### INTERNATIONAL ACTIVITIES

- a. The Board, senior staff, FASB staff monitoring IASB projects, and the IASB liaison Board member met after each IASB meeting to discuss IASB agenda and research projects with a focus on recent decisions by the IASB and areas of potential divergence.
- b. The Board and staff continue to work closely with the IASB and staff on their joint projects on purchase method procedures, revenue recognition, performance reporting, conceptual framework, short-term convergence, and liabilities and equity (modified joint). FASB staff members participated in the July IASB Board meeting related to the joint conceptual framework project and the education session on the IASB's insurance contracts project. For joint projects, the FASB staff generally participates in IASB meetings by video conference or telephone. The IASB staff participates in FASB meetings by phone.

- c. A staff member presented via video conference an educational session to a public IASB Board meeting in London updating the IASB on current insurance-related projects at the FASB, principally addressing the FASB project on risk transfer in insurance and reinsurance contracts.
- d. The chairman met with representatives of the French Senate Committee to discuss international convergence.
- e. The chairman met with representatives of the Institute of Chartered Accountants Scotland about a study they are conducting on the future of financial reporting.
- f. The chairman, a Board member, and the MP&T director had various discussions with representatives from the SEC and the IASB about international convergence.

#### OTHER ACTIVITIES

- a. The following professional development sessions were presented to the Board and staff:
  - 1. Practice fellows James Geary, Randall Sogoloff, Steven Belcher, Paul Laurenzano, Stuart Moss, Amie Thuener, and Reginald Oakley updated the staff on EITF Issues 04-5, 04-6, 04-7, 04-13; 05-1 through 05-6; 05-F; and 05-G.
  - 2. Stefanie Tamulis, FASB project manager, provided an update on the Board's proposed Statements relating to business combinations and accounting and reporting of noncontrolling interests. In particular, her presentation provided an overview of how the proposed Statements will affect current practice.
  - 3. Jeff Johnson, FASB project manager, and Rebecca Goodman, FASB postgraduate technical assistant, provided an update on Statement 154. In particular, the presentation provided insight as to how Statement 154 should be considered when deliberating transition provisions in future projects.
  - 4. Halsey Bullen, FASB senior project manager, Kevin McBeth, FASB project manager, and a Board member led a professional development session related to a process for analyzing financial reporting issues that is under development in the conceptual framework.

#### **ITEM 2: ADMINISTRATIVE AND STRATEGIC ACTIVITIES**

- a. A staff member attended a meeting at the IASB in London to explore the possibility of developing a convergence taxonomy between the FASB and the IASB.

- b. The chairman, two Board members, the PD&S director, and the XBRL fellow participated in a meeting with members of the XBRL consortium and the SEC staff to discuss the FASB's XBRL involvement over the next 2-5 years. The meeting involved a discussion to obtain the XBRL consortium members' views on where they see XBRL headed and how they envision the FASB's future role.
- c. The Board and senior staff participated in three strategic planning meetings to develop long-term goals for standard-setting activities, the financial reporting model, and related objectives.
- d. The Board and staff directors participated in an administrative meeting to discuss various operating and process issues.
- e. Several new staff members participated in training sessions covering the following topics: processes and procedures, effective writing, project planning and communications, and staffing/personnel issues.
- f. Staff members attended a seminar on critical thinking and public speaking.
- g. Three Board members and the PD&S director attended an FAF Trustees meeting in New York City.

### **ITEM 3: WASHINGTON ACTIVITIES**

- a. The chairman, the MP&T director, and three staff members met with a representative of the Independent Sector and the Panel on the Nonprofit Sector to discuss nonprofit organizations and accounting. The Panel recently issued a final report to Congress that contains recommendations to strengthen the transparency, governance, and accountability of charitable organizations.
- b. Three staff members participated in a conference call with the U.S. Senate staffers to discuss accounting and financial reporting for income taxes.
- c. Two staff members participated in a conference call with representatives of the National Grain Trade Council to discuss the financial accounting and reporting for derivatives and hedging activities.
- d. A staff member met with representatives of a number of associations, staff to Members of Congress, Congressional committees, government agencies, and other entities and organizations to discuss current FASB activities and other issues.

### **ITEM 4: SPEECHES DELIVERED**

Principal platforms addressed by the Board and staff members during the July 2005 and August 2005 period include:

- - American Accounting Association
- - American Financial Services Association
- - American Gas Association
- - American Institute of Certified Public Accountants
- - Beta Alpha Psi
- - Information Management Network
- - International Conference of the Institute of Auditors
- - Louisiana Accounting and Auditing Conference
- - National Advanced Accounting and Auditing Technical Symposium
- - National Economic Research Associates
- - National Society of Accountants for Cooperatives
- - The Directors' Symposium

#### **ITEM 5: ADDITIONAL PUBLIC RELATIONS ACTIVITIES**

- a. The FASB, in conjunction with the Public Relations Department, issued two press releases this period for the following: three FASB Exposure Drafts titled *Accounting for Transfers of Financial Assets*, *Accounting for Servicing of Financial Assets*, and *Accounting for Certain Hybrid Financial Instruments*, and an FASB Exposure Draft of a proposed Interpretation, *Accounting for Uncertain Tax Positions*.
- b. Media inquiries focused primarily on accounting for business combinations, accounting for uncertain tax positions, and accounting for financial assets.
- c. The FASB continued its frequent contact with the major press including the *Wall Street Journal*, *New York Times*, *Financial Times*, and *Washington Post*.
- d. FASB staff members and the Public Relations Department were interviewed by reporters from *Financial Executives International*, *the International Monetary Fund*, and *Reuters*.
- e. As part of the FASB's strategy to reach CEOs, the Public Relations Department arranged for two Board members to participate in an editorial board meeting with *Chief Executive Officer Magazine*. A day-long session for a reporter from the *Wall Street Journal* was also arranged to familiarize the reporter with the FASB and current accounting and reporting issues. The reporter met with two Board members, several FASB project managers, and other FASB staff members.
- f. Two issues of *The FASB Report*, the FASB's monthly newsletter, were produced and distributed. Topics included the Small Business Advisory

Committee meeting, the FASB's technical plan, the conceptual framework, and the FASB's milestone draft for liabilities and equity.

- g. In conjunction with the Public Relations Department, a visit was conducted for a group from PricewaterhouseCoopers Japan who observed an FASB Education Session, received a post session briefing from Bob Herz, were given a tour of the FASB facilities, and finally, met with Larry Smith, who spoke about the EITF and current Board activities.
- h. The Public Relations Department met with the FASB Board members to develop key themes and messages that will effectively communicate information about the FASB's mission and activities.

#### **ITEM 6: GASB LIAISON ACTIVITIES**

- a. FASB meeting minutes were sent to the GASB RTA director and certain GASB staff.
- b. GASB meeting minutes were sent to the FASB chairman and the staff directors.
- c. The GASB RTA director and the FASB PD&S director held monthly meetings and met quarterly with the FASB and GASB chairmen.
- d. The FASB staff distributed the following draft to the GASB for review:  
--FASB Exposure Draft, *Accounting for Transfers of Financial Assets*
- e. The chairman, an FASB Board member, and a senior staff member met with the GASB chairman and senior staff members to discuss differences between the objectives and key corporate underlying governmental and nongovernmental accounting.

## **2005 FASAC Survey on the Priorities of the FASB**

Financial Accounting Standards Advisory Council  
September 2005

### **Background**

The annual survey of the views of FASAC members on the priorities of the FASB provides valuable perspectives and observations about the Board's process and direction. The 2005 survey asked Council members, Board members, and other interested constituents for their views on:

- The FASB's priorities
- Future financial reporting issues
- Simplification
- The right level of implementation guidance
- Differential accounting standards for certain entities.

We will distribute the complete results of the 2005 survey within the next few weeks. (The results also will be posted to the FASB website, [www.fasb.org](http://www.fasb.org).)

### **Discussion at the September 2005 FASAC Meeting**

At the September 22 FASAC meeting, we will present an overview of the preliminary results of the FASAC survey. FASAC member reaction and additional input will help the Board assess its current agenda and activities.

### **Preliminary Results of the 2005 FASAC Survey**

#### **Section A—The FASB's Priorities**

This section asked several questions about the Board's current priorities. The first question asked respondents to name the five most important issues the Board should address. The following are the issues that appeared most often in FASAC members' responses. The number in parentheses reflects the number of respondents (both FASAC members and Board members) that mentioned that issue.

- Revenue Recognition (18 FASAC; 4 Board)
- Conceptual Framework (14 FASAC; 4 Board)

- Pension Accounting and Related Issues (14 FASAC; 4 Board)
- Financial Performance Reporting (12 FASAC; 6 Board)
- Leases and Other Contractual Obligations (12 FASAC; 1 Board)
- Fair Value/Fair Value Measurement (9 FASAC; 3 Board)
- Disclosure Framework (8 FASAC; 1 Board)
- Consolidations (7 FASAC; 2 Board)
- Purchase Method Procedures (6 FASAC)
- Financial Instruments/Derivatives (5 FASAC)
- Codification and Simplification (4 FASAC; 3 Board)
- Liabilities and Equity (3 FASAC; 3 Board)

Section A also asked respondents to prioritize the five specific standard-setting recommendations made by the SEC staff in its report on off-balance-sheet arrangements. FASAC member and Board members responses follow:

<b>Topic</b>	<b>FASAC Rank</b>	<b>Board Rank</b>
Lease Accounting	2	3
Accounting for Defined-Benefit Arrangements	1	1
Consolidation Policy	3	2
Fair Value of Financial Instruments	4	4
Disclosure Framework	5	5

The last question in Section A asked whether any projects should be removed from the agenda. Six FASAC members and three Board members specifically answered “No.” Ten FASAC members and two Board members did not directly answer the question (which perhaps can be interpreted as “no”). For those who responded in the affirmative, the following is a list of projects that they believe should be removed or deferred:

- International Convergence/Short-Term Convergence (3 FASAC; 1 Board)
- Purchase Method Procedures (3 FASAC)
- Noncontrolling Interests (2 FASAC)
- Reporting Financial Performance (2 FASAC)

Other projects mentioned (garnering one FASAC “vote” each) include cash-balance pensions (also mentioned by two Board members); revenue recognition (also mentioned by one Board member); liabilities and equity; fair value option; liability

extinguishment; derivatives disclosures; and private company financial reporting. One FASAC member expressed disappointment with the EITF agenda-setting process and believes the Board should not spend time, even if limited to the ratification of EITF issues, on such “narrowly defined technical inquiries with little broad applicability.” Two Board members support suspending work on the project on not-for-profit combinations until the related business combinations project is further along. One Board member supports suspending work on the QSPE project and addressing derecognition more broadly.

### **Section B—Future Financial Reporting Issues**

Section B of the survey asked two questions about potential financial reporting issues. The first question asked about the specific areas in which respondents foresee potential accounting and financial reporting issues. The following are the issues that appeared most often in FASAC members’ responses. The number in parentheses reflects the number of respondents (both FASAC members and Board members) that mentioned that issue.

- Fair Value Issues (8 FASAC; 3 Board)
- Executory Contracts/Lease Accounting/Off-Balance-Sheet Items (5 FASAC; 1 Board)
- Stock Compensation Arrangements (4 FASAC)
- Reporting Financial Performance/Financial Reporting Model (3 FASAC; 1 Board)
- Revenue Recognition (3 FASAC)
- Accounting for Employee Benefits/Pension Accounting (2 FASAC; 1 Board)
- Codification/Simplification/Principles-Based Standards (2 FASAC)

Some of the other items mentioned include derivatives and hedging, subsequent events, international convergence, the unit of account, intangible assets, contingencies, and cash flow reporting.

On the question of whether there are specific business, industry, or economic trends that might give rise to financial reporting issues, some of the issues mentioned by FASAC members include the following:

- Increasing commodity prices, especially energy and the impact on related hedging instruments.
- The widespread use of alternative financing vehicles for real estate and related valuation issues. As managements engage in more financial transactions which appear opaque and cannot be easily summarized in a single quantitative measure at a point in time, investors would benefit from discussion about

managements' objectives and risk management techniques. Traditional recognition and measurement standards may not accurately convey the risk of nontraditional, exotic mortgages and perhaps better disclosure could provide investors with more relevant information.

- Rising retirement costs—as the population ages, there may be shortfalls in pension plans that are not receiving adequate attention.
- Certain industries (telecommunications, broadcasting, entertainment) impacted by changes in technology may put pressure on asset values and related impairments.

### **Section C—Simplification**

Section C asked for suggestions on ways for the Board to address the simplification of the accounting literature and the standard-setting process. The following are some comments received:

- Identify the objective of each standard and the underlying economics of the specific transactions that the standard is designed to address.
- Aggressively field test new standards before issuing them in final form.
- Always keep convergence in mind. The FASB and IASB must have the same simplification goal.
- Give additional weight to the cost-benefit considerations raised by constituents regarding new accounting and disclosure requirements. This also applies to transition rules (for example, in assessing a retrospective versus cumulative adjustment approach).
- Simplify the language used in standards by following the SEC's plain English principles.
- Use more examples to illustrate concepts. Examples are often worth a thousand words.
- Eliminate the mixed attribute model. Consistency is needed to make financial statements more meaningful.
- Slow the pace of issuing new standards and allow longer implementation periods.
- Periodically test all existing financial reporting requirements for current cost-benefit, with a view to eliminating any requirements for which the benefits no longer clearly outweigh the costs.

- Create targeted resource groups that the Board could access to research and analyze issues.
- An unresolved problem in the path toward simplification is continuity of the leadership of the process given the five-year term of service for FASB Board members. The FAF should seek to minimize the turnover of individuals on the FASB Board who are so influential and intimately involved in developing principles-based accounting standards.

Section C noted that the Board continues to receive numerous requests for scope exceptions, treatment alternatives, and detailed implementation guidance simultaneously with a demand for standards that are more principles-based. What can the Board do to encourage acceptance of principles-based standards? The following are some comments received:

- The Board must first complete the conceptual framework and then begin issuing principles-based standards based on the framework.
- Decouple implementation guidance from the general principles in standard setting. Consider making implementation guidance nonauthoritative. Guidance should be more in the form of examples of implementation and less in the lengthy and hard to comprehend written narratives.
- Without a change in the legal and regulatory environments, it may be impossible to reduce the number of requests for implementation guidance.
- One impediment that needs to be addressed is the reality of the role of litigation as a consequence of pursuing these initiatives. Since the SEC is a proponent of the change, perhaps it could show leadership in clarifying its views of potential outcomes of management acting in good faith to adopt principles-based standards.

#### **Section D—The Right Level of Implementation Guidance**

Section D asked four questions about implementation guidance. First, are the methods used to convey implementation guidance adequate? Generally, FASAC respondents believe methods are adequate, but many had further suggestions for the Board.

- The methods are adequate but the message must be outstanding (simple, clear, etc.)
- The methods are adequate but may be overused.
- Ensure that all guidance receives adequate due process.

- FSPs are inadequate in that there is a lower level of awareness of FSP projects and thus less opportunity for the Board's constituents to provide comments until the guidance is issued.
- Make all EITF issue summaries and abstracts available, free of charge, on the website.
- We are concerned about various groups being formed to discuss implementation without such discussion being made public, like the Stock Options Implementation Group.

The second question asked whether the Board provides the right amount of implementation guidance. Most respondents believe the Board issues enough guidance. Comments included the following:

- Different preparers and auditors may need different levels of guidance; that is, smaller firms may need more guidance than larger firms.
- Ensure that the guidance clearly communicates how the guidance achieves the standard's accounting objective. The guidance should explain the critical aspects of the standard in a way that is understandable to a broad range of potential readers who have varying levels of insights into the standard and the transactions to which it applies.
- The amount of implementation guidance is excessive. The Board should reject calls to interpret issues it believes (1) the standards already address—those issues are about compliance, not standards; (2) are too narrowly focused to justify the cost associated with broad general standards; and (3) would require exceptions to principles.
- If standards were clearer, simpler, and more principles-based, we would not need so much guidance. As it is, there will never be enough guidance if the standard itself is conceptually flawed or operationally defective.
- The appropriate amount of implementation guidance depends on the education, experience, and resources of a given preparer or auditor. In many cases, the FASB provides an appropriate amount of implementation guidance but preparers and auditors do not have the background or time to understand the guidance.
- The current level of implementation guidance is adequate, although at times it is too regulatory focused instead of providing helpful, understandable guidance. Such guidance should be made nonauthoritative and nonbinding so that preparers and practitioners can have the necessary professional latitude in applying sound accounting principles to transactions.

The third question asked whether all authoritative implementation guidance should emanate from the FASB. Nearly all FASAC respondents believe that it should. Some suggested that industry task forces, accounting firms, user groups, the SEC, or the AICPA could or should have a role in developing guidance.

The final question in this section asked about the criteria the Board should use in deciding the implementation questions to address in an environment that also asks for principles-based standards.

- Address questions that stem from complex transactions or conflicting accounting literature.
- Issue guidance when there is potential for a broad range of interpretations of substantially similar fact patterns.
- Do not address diversity that arises from the application of reasonable judgments.
- The issues should be common to more than one industry and have a material effect on financial statements.
- Does the Board believe the principle outlined in the standard permits a reasonable practitioner to draw a conclusion on the implementation question? Does the Board believe such conclusion would be broadly consistent among practitioners? If so, the Board would not need to address the question.

#### **Section E—Differential Accounting Standards for Certain Entities**

Nearly all FASAC respondents do not believe a separate set of standards should be developed for private companies. Most would agree, however, that the Board should address the issue on a case-by-case basis and provide modifications to disclosures or to the effective dates of standards.

- Do the needs of users of private company financial information differ from the needs of users of public company information? Do those needs drive a different definition of assets and liabilities and the measurement attributes of assets and liabilities? If the accounting concepts that are relevant for private companies are the same concepts that are relevant for public companies, and the accounting standards are developed based on those concepts, then what is the basis of differential accounting?
- Users of private and public company financial reporting have substantially similar information needs. Standards governing recognition, measurement, display, and classification should apply to both public and private companies.

- Users of financial statements want to understand the financial health and growth of the enterprise. The form of ownership of the enterprise should not influence how these financials are presented.
- Many standards are written to specifically address issues of public companies without enough consideration given to how those standards will impact small and mid-sized private companies. Increasing efforts to make private companies aware of standards being considered and encouraging their comment would help the FASB identify the issues of private companies when standards are being drafted and debated.
- The FASB needs to be cognizant of private company needs as it issues new guidance. To a large degree, the FASB has put a target on itself by virtue of the complex standards that it has issued over the last 10 years or so. No one, be it small private company or large public company, can keep up.

On the question of whether fundamental changes should be made to the current standard-setting process to ensure that the needs of private company constituents are met, most respondents said no. However, many suggested that the Board expand its outreach to private companies to further engage them in the standard-setting process.

#### **Questions for Council Members**

1. What comments or insights do Council members have on the results of the survey?
2. Has your review of the results caused any changes to the views you expressed in your survey response?
3. What advice do Council members have for the Board as it prioritizes its work for the coming year?

## PENSION ACCOUNTING ISSUES

Financial Accounting Standards Advisory Council  
September 22, 2005

### BACKGROUND

In July, the Board directed the staff to research and analyze issues associated with FASB Statement No. 87, *Employers' Accounting for Pensions*<sup>1</sup> and present that information to the Board for an agenda decision. Considering a pension project at that time was based on the criticisms of Statement 87 by financial statement users (primarily investment analysts), input received in the past from the Financial Accounting Standards Advisory Council (FASAC) and User Advisory Council (UAC), and the SEC's 2005 Off-Balance Sheet Report. Users are not the only group concerned about the current pension accounting model. When it issued Statement 87 the Board itself acknowledged certain pragmatic compromises that departed from the fundamental principles determined by the Board "intend[ing] future changes [in practice] to occur in the gradual, evolutionary way."<sup>2</sup> Some of those compromises are precisely the aspects of pension accounting that many financial statement users have recently criticized. Finally, the IASB and FASB agreed in 2004 that the accounting for defined benefit pension plans should be a major project conducted jointly when resources permit.

Some users of financial statements have often criticized the accounting for defined benefit pension plans over the past several years. In addition, Council members who specifically mentioned pensions in the 2004 FASAC survey pointed to the issues of smoothing mechanisms, the complexity of the current accounting, and the lack of transparency as issues for the Board to address. In the 2003 FASAC Survey, Council members identified the accounting for pensions as one of the top five areas

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<sup>1</sup> Although this memorandum primarily addresses defined benefit pension plans, the accounting for retiree healthcare pursuant to FASB Statement No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions*, is similar and many of the issues apply to those benefits, as well.

<sup>2</sup> Paragraph 107 of Statement 87.

the Board should focus on and encouraged the Board to address measurement and recognition of plan assets and liabilities.

At the meeting on March 8, 2005, certain UAC members stated that (a) pension accounting has major systemic issues and is materially distorting financial statements, (b) several intermediate fixes would be very useful while simultaneously working on a more comprehensive project, and (c) Statement 87 was carefully thought out, well-defined, and appropriate for pension accounting at the time, but things have changed. Some UAC members said there is at least a need for incremental change and the Board should consider addressing pension and other postretirement benefits accounting together because they have very similar underlying economics.

In June 2005, the SEC issued its *Report and Recommendations Pursuant to Section 401(c) of the Sarbanes-Oxley Act of 2002 On Arrangements with Off-Balance Sheet Implications, Special Purpose Entities, and Transparency of Filings by Issuers* (referred to as the Off-Balance Sheet Report). The Off-Balance Sheet Report recommends that a project on pension accounting, conducted jointly with the IASB, should be undertaken when resources permit.

The SEC cites the following reasons for its recommendation:

1. The balance sheet is not transparent as to the true funded status of pension plans and benefit obligations, and the under-funded status associated with defined benefit pension plans is significant.
2. Pension plan assets and liabilities should be consolidated in the financial statements of the plan sponsor because the plan sponsor controls and bears the risks and rewards associated with those assets and obligations.
3. The accounting for defined benefit plans is not consistent with the accounting for other assets and liabilities.

Some financial statement users, while agreeing that pension accounting needs improvement, believe that the decreasing use of defined benefit pension plans indicates a lesser need for the Board to commit resources to such a project. Others believe that defined benefit pension plans are significant, both in terms of

sponsorship and in the significance of benefit obligations. According to Watson Wyatt, the rate of sponsorship of defined benefit pension plans among reporting entities in the Fortune 1,000 has remained at over 60 percent over the past four years. The percentage of the Fortune 1,000 remains over 50 percent when companies with frozen or terminated plans are excluded. The exhibit below summarizes the amounts of plan assets and benefit obligations for companies in the S&P 500.

**Funded Status of Defined Benefit Postretirement Benefit Plans for Companies in the S&P 500**

(\$ in billions):

	Pension <sup>3</sup>		Other Postretirement Benefits	
	2004	2003	2004 <sup>4</sup>	2003 <sup>5</sup>
Fair Value of Plan Assets	\$1,266	\$1,140	\$ 84	\$ 69
Projected Benefit Obligation (PBO)	1,431	1,310	419	400
Funded Status	\$ (165)	\$ (170)	\$(335)	\$(331)

At the FASAC meeting on September 22, 2005, the Board seeks input from Council members on whether, and to what extent, they believe the accounting for pensions and other postretirement benefits (and possibly other employee compensation arrangements) should be addressed. The purpose is not to suggest or develop any possible solutions to any particular issue. The factors that Council members may consider include: (a) the fundamental principles of pension accounting, (b) the

<sup>3</sup> Bear Stearns – *Accounting Issues, Pension Tension: A Risk-Based Approach to Pension Analysis* (June 2005)

<sup>4</sup> Goldman Sachs – *Portfolio Strategy/Accounting United States: Retirement liabilities mid-year update: Reforms and interest rates are still the focus, but health care is gaining attention* (Month Year?)

<sup>5</sup> Bear Stearns – *Accounting Issues, Pension Tension, Relapse or Recovery?* (September 2004)

pragmatic compromises contained in Statement 87, and (c) the magnitude of and the tradeoffs between a limited-scope, short-term project to make incremental improvements and a comprehensive, long-term project to completely reconsider the accounting for postretirement benefits and perhaps, broader employee compensation issues.

## **ISSUES AND CONCERNS**

The issues described below are categorized either as measurement issues, recognition issues, or presentation and display issues. Certain issues and concerns represent the opinions of certain constituents. Additional issues have been identified by the FASB staff.

### **Measurement Issues**

Footnote disclosures include information about plan assets, obligations, and costs, based on the measurement attributes determined to be representationally faithful by the Board when it issued Statement 87. Thinking about the amounts presented in the footnotes enables one to consider the measurement attribute apart from how the item is recognized.

### ***Plan Assets***

When it deliberated Statement 87, the Board noted that an employer's future contributions to the plan either would be increased or decreased by the performance of the plan assets so that the employer is deemed to bear the risks and reap the rewards associated with those assets. The Board also observed situations in which significant amounts of assets were withdrawn by employers, providing compelling evidence that an over-funded plan represented an asset of the employer. Subsequent to issuance of Statement 87, some have questioned whether an employer has an asset for an overfunded plan if there are regulatory restrictions on the employer's ability to withdraw such excess.

Plan assets are disclosed in the footnotes at their aggregate fair value. The Board concluded at that time that the "most relevant and reliable information available about [a] liability or asset is based on the fair value of plan assets...."

Although fair values may not be readily available for some investments (for example, private equity) the fair value measurement attribute for plan assets has not been controversial and has not been criticized by financial statement users or others. What have been criticized are the smoothing devices that allow economic events and transactions to be deferred rather than recognized in the accounting period in which they take place.

***Benefit Obligation***

The scope of Statement 87 defines pension benefit obligations to include benefits provided for in written arrangements and arrangements that are in substance plans. Paragraph 7 states:

This Statement applies to any arrangement that is similar in substance to a pension plan regardless of the form or means of financing. This Statement applies to a written plan and to a plan whose existence may be implied from a well-defined, although perhaps unwritten, practice of paying postretirement benefits.

Future amendments that must be negotiated, such as those that result from collective bargaining agreements, are not assumed to be a part of the substantive plan (that is, they should not be anticipated). Under FASB Statement No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions*, the substantive plan establishes the expected future outflows that determine the benefit obligation, and amendments to the written plan are anticipated as part of determining the substantive terms of the plan. Some believe present pension accounting should move closer to the substantive plan model established in Statement 106. Others may believe that measurement of postretirement benefit obligations should move in the opposite direction toward only promises that are legally enforceable. The present accounting model for a sponsor participating in a multi-employer plan versus a single-employer plan are very different. Some believe that is an issue that should be readdressed.

There are two alternative measures of the benefit obligation disclosed in the footnotes. The accumulated benefit obligation (ABO) and projected benefit obligation (PBO). The difference between the two is that the PBO includes the effects of

estimated future increases in compensation when the benefit formula defines the benefit in terms of pay. In developing Statement 87, the Board decided that the benefit obligation should reflect estimated future compensation if the benefit formula incorporates compensation. Some believe that future increases in compensation should not be anticipated; they explain that a plan sponsor has the option to terminate or freeze a plan and, therefore, not incur the cost of benefits that would arise due to future increases in compensation. Others believe that benefit obligations defined in terms of pay are similar to postretirement healthcare obligations that reflect future medical inflation in determining those obligations and that considering future increases in compensation is consistent with the going concern concept and that obligations should be based on expectations that the plan will continue as it presently is. The effects of any subsequent changes to the plan terms would represent events that trigger recognition when they occur.

Expected cash outflows associated with pensions are long-term in nature and must be discounted to derive the present value as of the measurement date. The discount rate is intended to reflect the rate at which the obligation could be effectively settled either by looking at the prices of annuity contracts or high-quality fixed income investments. Some do not believe discounting at the high-quality fixed income rate yields a representationally faithful measure of the benefit obligation. The alternatives suggested range from risk-free rates to rates that reflect the credit quality of the plan sponsor.

Finally, some plans (for example, plans with lump-sum settlement features) define the employee's benefit in terms of a cash balance. Such plans increase the balance annually with additional notional employer contributions and interest based on variable- or fixed-interest rates. The lump-sum amount at any given date may be more or less than the amount determined for the PBO according to Statement 87 (that is, by projecting the timing of future cash outflows and discounting at rates other than those used to grow the cash balances). Some believe that the obligation for plans with lump-sum settlement features should be based on the amount an employee would be entitled to receive as of the measurement date, not the amount that is based on discounted future cash outflows that assume a separation of

employment in the future. One view tends to favor a payable-on-demand liability, the other an expected outcomes approach. The issue for cash balance plans is similar to measuring the obligation for demand deposits for a financial institution.

Paragraph 98 of Statement 87 states that the “most relevant and reliable information available about [a] liability...is based on...a measure of the present value of the obligation using current, explicit assumptions.” The definition of what constitutes a “plan,” the treatment of future events such as increases in compensation, the appropriate discount rate, and how cash balance or other payable-on-demand plan obligations should be measured are fundamental issues that might need to be readdressed in a broad reconsideration of the present accounting model.

### ***Measurement Date***

Statement 87 indicates that the measurement date of plan assets and obligations may be the date of the financial statements or, if used consistently from year to year, as of a date not more than three months prior to that date. As a result, the amounts disclosed in the footnotes, and which also form the basis for recognition in the financial statements, may not reflect conditions as of the balance sheet date.

Although earlier measurement dates may have been necessary in the 1980s, the systems and processes necessary to determine the value of plan assets and benefit obligations have evolved since Statement 87 was issued, possibly rendering the need for a measurement date other than the balance sheet date unnecessary. Some believe the use of earlier measurement dates raises implementation issues, adds to the complexity of the present model, and leads to less transparent financial reporting.

### **Recognition Issues**

#### ***Exchange of Benefits for Employee Services***

Fundamentally, the Board concluded that an employer’s liability for the benefit earned by an employee should be recognized over that employee's approximate service period. The end of the attribution period for postretirement benefits other than pensions (Statement 106) is when the employee attains full eligibility for the postretirement benefits. Unlike other postretirement benefits, employees typically continue to earn additional pension benefits until they retire but in certain

circumstances the notion of full eligibility could apply to a pension arrangement. A comprehensive reconsideration of postretirement benefits could readdress the period over which the exchange of benefits for employee service should be recognized.

### ***Investment Returns***

Respondents to the Exposure Draft issued prior to Statement 87 argued that the inherent volatility in annually reporting actual investment gains and losses on plan assets was meaningless because of the long-term nature of the pension commitment, and the holding period for investments—until eventually used to satisfy pension benefits—is sufficiently long that there is opportunity for some gains or losses to reverse.

The Board responded in paragraph 174 in the basis for conclusions:

The Board does not believe that reporting volatility per se is undesirable. If a financial measure purports to represent a phenomenon that is volatile, the measure must show that volatility or it will not be representationally faithful.

However, the Board conceded that immediate recognition could produce a presently unacceptable level of volatility in reported earnings. As an alternative, Statement 87 allows, in measuring annual pension costs, the investment return on plan assets to be determined based on an expected long-term rate of return and the use of a market-related value of plan assets.<sup>6</sup> Further, investment experience different from that assumed can be recognized on a delayed basis (see discussion below under actuarial gains and losses).

Some critics of Statement 87 note that using expected long-term rates of return can lead to incorrect and misleading information about pension costs. They note that because of delayed recognition, net pension costs may include investment earnings even while a company is incurring actual investment losses. There even can be an increase in year-over-year expected returns when year-over-year actual returns are decreasing, and vice versa. Expected returns fail to represent the underlying economic gains or losses for the period. As a result, reported results do not reflect

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<sup>6</sup> Market-related value of plan assets is either the fair value of the plan assets or a calculated value that recognizes changes in fair value in a “systematic and rational manner” over a period of five years or less.

economic reality and the financial effects of investment decisions are not reflected in the financial statements on a timely basis. Some users believe there is no reason for a change in Statement 87 at this time, instead believing that delayed recognition reflects the long-term nature of pension obligations. They also may believe that the notes to the financial statements provide sufficient information for assessing actual investment returns and the impact of delayed recognition.

Under Statement 87, the expected annual return on plan assets is calculated using a value of plan assets determined using either (a) fair market value or (b) a calculated value that recognizes market gains and losses over not more than five years. Many companies choose to use a calculated value in determining the expected return.

Some users urge the Board to reconsider that aspect of Statement 87 because they believe that permitting use of a calculated value creates additional distortions between recognized returns on assets and actual returns. For example, in the year following a general market decline, the rate of return will be applied to an asset value that is higher than the actual asset value available to invest.

Use of an expected rate of investment return and a calculated value of plan assets represent departures from the Board's fundamental belief that changes in fair value was the most appropriate measurement attribute for investment gains and losses.

This is made clear in paragraph 177 in the basis for conclusions, which states:

The Board believes that both the extent of volatility reduction and the mechanism adopted to effect it are essentially practical issues without conceptual basis. The Board does not believe that the market-related value of assets used in this Statement as a device to reduce the volatility of net periodic pension cost is as relevant as the fair value required for other purposes.

### ***Actuarial Gains and Losses***

Actuarial gains and losses arise from changes in estimates and experiences that are different than what was assumed. The Board permitted delayed recognition of actuarial gains and losses in order to reduce volatility. However, the Board still viewed Statement 87 as an improvement because it provided for earlier recognition of significant liabilities and also introduced a requirement to recognize a minimum

liability<sup>7</sup> which limited the extent to which the delayed recognition of plan amendments and losses could result in not recording certain liabilities in an employer's statement of financial position at all.

Amortization of an unrecognized net gain or loss is not required unless, as of the beginning of the year, that unrecognized net gain or loss exceeds 10 percent of the greater of the projected benefit obligation or the market-related value of plan assets ("the corridor"). The Board decided on the "corridor" approach as a minimum amortization approach partially because it allows the possibility for gains and losses to offset each other without affecting net periodic pension cost.

Paragraph 188 states:

Like the period of amortization of unrecognized gains and losses, a decision about the point at which it becomes necessary to begin amortizing (the width of the corridor) is not conceptually based. The Board believes it is appropriate to relate that requirement to the market-related value of plan assets and the amount of the projected benefit obligation because the gains and losses subject to amortization are changes in those two amounts.

Some users of financial statements criticize the accounting for pensions because actuarial gains and losses resulting from changes in assumptions, and experience that is different than that which was assumed (including actual versus estimated investment returns), are not recognized when economic events and transactions take place. Some propose that changes in pension obligations and plan assets be reported without delayed recognition. One possibility might be to immediately recognize any difference between pension cost as presently measured and the change in the net funded status of the plan in other comprehensive income. Others propose less dramatic changes, such as reducing the corridor, thereby accelerating amortization of gains and losses, or by eliminating the corridor, thereby requiring that amortization commence immediately for all gains or losses.

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<sup>7</sup> Statement 87 requires immediate recognition of a liability (the additional minimum liability) when the accumulated benefit obligation (the obligation measured without estimating future increases in compensation for plans that base the benefit on compensation) exceeds the fair value of plan assets.

### ***Plan Amendments***

Amendments to a pension plan may provide additional benefits to employees for past service (prior service costs). In Statement 87, the Board concluded that, fundamentally, such amendments are made with the expectation that the employer will realize economic benefits in future periods. The Board also concluded that requiring the full amount of prior service cost attributable to a plan amendment to be expensed in the year the amendment is made would be too great a change from past practice. Therefore, Statement 87 allows the cost of those additional benefits to be amortized over the future service periods of active employees. IAS 19, *Employee Benefits*, requires prior service costs to be amortized over the period of vesting. There also may be instances when a plan amendment increases the benefits for retirees. Such amendments clearly cannot be recognized over those individuals' remaining service periods. Some hold the view that since those individuals are retired, additional benefits to them do not give rise to a future economic benefit; therefore, the entire cost of the amendment should be included as an expense in the current period. Although the Board agreed with that view to a certain extent, it concluded in paragraph 171 that there were some future benefits of increasing the benefits for retirees because in some cases, such as in collective bargaining agreements, some may view those benefits as being exchanged for services of active employees, and it is "simpler and more practical to recognize the cost of all plan amendments similarly, that is, on a delayed basis."

### **Presentation and Display Issues**

#### ***Net Pension Cost***

Fundamentally, net pension cost has as many as six possible elements: service cost, interest cost, the expected return on the plan assets if the plan is funded, amortization of unrecognized prior service cost if the plan has had amendments, any gain or loss from changes in assumptions, and amortization of the unrecognized net asset or obligation that existed as of the date of adoption of Statement 87. Although the Board believed that separate reporting for the individual components might be conceptually superior, it decided to retain the model in APB 8 of combining the

separate elements and accounting for that amount as a net number, and instead, improved the disclosure requirements related to the individual components. Some financial statement users argue that the requirement to report net pension cost distorts operating earnings by including financing and investing gains and losses in cost of sales and general and administrative expenses. Proponents of that view argue that interest and investment returns are non-operating and should be presented as financing/investing gains and losses. Others might agree with the reasons cited in Statement 87 for reporting net pension cost. They see no reason to change the existing requirements because disclosure of the individual components of net pension cost is required and the information needed to assess operating earnings excluding interest and investment returns is readily available. Income statement display is being addressed by the Board in its project on financial performance reporting. Decisions reached in that project will likely be relevant to the fundamental question of net versus gross presentation of the individual components of net periodic pension cost and could be influenced by any change to the delayed recognition features in the present model. Some may believe that changing the presentation of the individual components of net pension cost is not feasible until after the financial performance reporting project is completed.

***Plan Assets and Benefit Obligations***

The Board fundamentally decided that a plan sponsor with an over-funded pension obligation has an asset and that a plan sponsor with an under-funded pension obligation has a liability that should be reflected in the sponsor's statement of financial position. The Board did not conclude whether benefit obligations and plan assets held in a separate legal entity (a trust account) should be consolidated into the balance sheet of the reporting entity. A project to fundamentally readdress the accounting for postretirement benefits could consider the question of consolidation and, therefore, net or gross reporting.

Readdressing consolidation of plan assets and benefit obligations would be influenced by decisions reached in other FASB projects, including the conceptual framework and consolidations projects. Some may believe that the Board presently has the framework in place needed to deliberate the consolidation question for

pensions and other postretirement benefits. Others may believe that the Board should wait for the completion of projects that will determine the fundamental principles that are needed to answer the consolidations question for postretirement benefits.

### **NATURE OF A POTENTIAL PROJECT**

This memorandum describes many of the issues related to the present accounting for pensions and other postretirement benefits. It does not attempt to provide a complete analysis of those issues or to describe every issue that has been raised about the present accounting model. Council members' opinions regarding the appropriateness of the present accounting model, including the nature and extent of any deficiencies, will influence the scope of any project to readdress postretirement benefits accounting issues, including the following alternatives:

1. If Council members believe that the fundamental principles of the present accounting model are appropriate, but that the compromises should be readdressed, they may believe that a narrow-scope project should be added to the Board's agenda. Such a project would focus on a narrow set of issues, for example, recognizing the net funded or unfunded status in the balance sheet, possibly through other comprehensive income.
2. If Council members believe that the fundamental principles of the present accounting model do not lead to reported amounts that are representationally faithful, they may believe that a comprehensive reconsideration of the accounting for postretirement benefits should be added to the Board's agenda. Such a project would broadly reconsider issues associated with measurement as well as recognition. Some may believe that progress in a comprehensive project would be hindered because decisions to be made in other projects, such as the conceptual framework, financial performance reporting, and consolidations, projects are necessary to resolve fundamental measurement and recognition issues.
3. If Council members believe that the Board should comprehensively readdress the accounting for postretirement benefits, but that limited improvements are

needed in the short run, they may believe that a project should be added to the Board's agenda that would make incremental improvements, while also beginning to more fundamentally readdress postretirement benefits accounting issues. For example, the initial phase could focus on recognizing the net funded or unfunded status in the balance sheet, possibly through other comprehensive income.

4. If Council members believe that addressing the issues associated with accounting for postretirement benefits is a relatively lower priority, they may advise the Board not to add a project to its agenda at this time. Council members may believe a project on postretirement benefits is a relatively lower priority for the reasons listed below, or for other reasons.
  - a. Sponsorship of defined benefit plans is declining
  - b. Progress must be made on the conceptual framework, consolidations, and financial performance reporting projects in order to provide the framework needed to address fundamental measurement and recognition issues
  - c. Board resources should be allocated to other projects, such as valuing financial instruments at fair value, consolidations, and lease accounting.

The staff intends to ask the Board in the fourth quarter to decide whether to add a project on postretirement benefits to its agenda, and if so, what the nature, scope, and timing of that project it believes is needed to improve financial reporting for postretirement benefit plans. The Board's decisions will be discussed with the IASB in order to develop a joint approach that would enable both boards to achieve international convergence.

#### **QUESTIONS FOR COUNCIL MEMBERS**

1. How would Council members prioritize the issues identified in this memorandum: For example, how important is the need to readdress:

- a. The scope of Statement 87 (written plans, legal obligations, or substantive arrangements)
  - b. Fair value as the relevant measure for plans assets
  - c. The relevant measure of the benefit obligation (for example, PBO, ABO, benefit obligation discounted using the plan sponsor's credit quality, and so on)
  - d. Measurement of benefit obligations for plans with lump-sum settlement features (project and discount, walk away amount, and so on)
  - e. The attribution methods used to reflect the principle of expensing benefit costs over the period of employee service
  - f. The measurement date (for example, require all plan measurements to be as of the date of the annual financial statements).
  - g. Recognition of investment returns
  - h. Recognition of actuarial gains and losses
  - i. Recognition of costs associated with plan amendments (active employees and retirees).
  - j. Presentation of the elements of net benefits cost
2. Would you advise the Board to undertake one of the following alternatives or another course of action, and why?
- a. Undertake a narrow-scope project (for example, to require recognition of the net funded or unfunded status, possibly through other comprehensive income)
  - b. Undertake a comprehensive reconsideration of the accounting for postretirement benefits (or possibly including all compensation and benefits)

- c. Undertake a comprehensive reconsideration of the accounting for postretirement benefits with incremental improvements instituted in phases
- d. Do not undertake a project on postretirement benefits at this time.

**JOINT CONCEPTUAL FRAMEWORK PROJECT**

**Financial Accounting Standards Advisory Council  
September 2005**

**BACKGROUND**

The FASB and IASB are actively deliberating issues in the first phase of their joint conceptual framework project relating to the objectives of financial reporting and the qualitative characteristics of financial reporting information. The Board currently plans to formally seek comment on the decisions reached in this phase in the first quarter of 2006.

The FASB decided to consult with its Financial Accounting Standards Advisory Council for advice on broad, strategic issues in the project. Council meetings for the past year or so have each included discussion of conceptual issues and this meeting is no exception. This September 2005 meeting discussion will focus on two topics that the Boards discussed in June and July: understandability and materiality. (Appendix I to this paper contains a list of tentative decisions reached to date).

## **UNDERSTANDABILITY**

An objective of this project is to improve the existing discussion in the FASB and IASB frameworks about the qualitative characteristics of financial information. In recent months the Board made decisions about how to improve and converge the discussion of the qualitative characteristic referred to as *understandability*. Understandability in this context refers to the understandability of reported financial information. It does not refer to the understandability of the accounting standards themselves.

### **How Understandability is Defined in the Existing Frameworks**

Both the FASB and IASB frameworks regard understandability as a qualitative characteristic of financial information. The IASB framework states, “An essential quality of the information provided in financial statements is that it is readily understandable by users.” That framework does not explain what understandability means. The FASB framework goes a step further by describing understandability as a link between the qualities of users and qualities of accounting information, and defining understandability as “the quality of information that enables users to perceive its significance.”

Both frameworks explain that relevant information should not be excluded because it is too complex or difficult for certain users to understand. To exclude relevant information due to its complexity would result in financial information that is not a faithful representation.

### **Capabilities of Users**

The Board discussions of understandability included consideration of the capabilities of those who are expected to understand the information provided by financial reporting.

The existing IASB and FASB frameworks describe the capabilities of users in a similar manner. The IASB framework assumes users “have a reasonable knowledge of business and economic activities and accounting and a willingness to

study the information with reasonable diligence.” FASB Concepts Statement 1, *Objectives of Financial Reporting by Business Enterprises*, says that and also says:

Financial information is a tool and, like most tools, cannot be of much direct help to those who are unable or unwilling to use it or who misuse it. Its use can be learned, however, and financial reporting should provide information that can be used by all—non-professionals as well as professionals—who are willing to learn to use it properly. [paragraph 36]

The Boards agreed that those concepts about the characteristics of users of financial reporting be retained in the converged conceptual framework. That decision means that financial reporting is not aimed at all users, but the subset of users that have a reasonable knowledge of business, economic activities and accounting who are willing to study the information with care. Appendix II illustrates the users to which reported financial information is aimed.

### **The Converged and Improved Definition**

Board members discussed how to draft the definition in plain English, using terms that are commonly understood and defined and avoiding implying more meaning than is commonly attributed to those terms.

The Boards observed that some individuals who express concern about understandability are focusing on the comprehensibility of a particular *standard*. While standards of course should be comprehensible, especially by preparers and auditors, in the frameworks understandability is a quality of financial reporting information, not financial reporting standards. The Boards agreed that the definition of understandability should clearly make this distinction.

Based on the Boards' discussions, the following draft definition has been prepared:

*Understandability* is the quality of information that enables users who have a reasonable knowledge of business, economic activities and accounting, and who study the information with reasonable diligence, to comprehend the meaning of the information. Understandability is enhanced when information is aggregated, classified, characterized,

and presented in a clear and concise manner. Relevant information should not be excluded because it is too complex or difficult for some users to understand.

## **MATERIALITY**

The existing IASB and FASB frameworks also include discussion of materiality. In recent months, the Boards discussed how those discussions might be improved and converged,

### **Is Materiality a Qualitative Characteristic or Just a Filter?**

Materiality is described in the IASB framework as an aspect of relevance. The framework states:

Information is material if its omission or misstatement could influence the economic decisions of users taken on the basis of the financial statements.  
[paragraph 30]

The framework goes on to note that materiality provides a threshold or cut-off point rather than being a primary qualitative characteristic that information must have if it is to be useful.

FASB Concepts Statement 2 describes materiality as:

The magnitude of an omission or misstatement of accounting information that, in the light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would have been changed or influenced by the omission or misstatement. [Glossary of Terms]

Concepts Statement 2 treats materiality as a separate constraint, rather than as an aspect of relevance:

Materiality is not a primary characteristic of the same kind [as relevance and reliability]. In fact, the pervasive nature of materiality makes it difficult to consider the concept except as it relates to the other qualitative characteristics, especially relevance and reliability. [paragraph 124]

Concepts Statement 2 explains how a materiality threshold relates to reliability. Using an example of an applicant for employment who is negotiating with an employment agency, it explains that:

Salary information accurate only to the nearest thousand dollars might not be acceptable to an applicant for an \$8,000 a year job, but will almost certainly be acceptable if the job pays \$100,000 a year. An error of a percentage point in the employee's rate of pension contribution would rarely make information about fringe benefits unacceptable. An error of a year in the retirement date of someone who would block the applicant's advancement might be quite material. An error of a year in the applicant's mandatory retirement date will probably be immaterial to a person 20 years old, but quite material to a 63-year-old person. [paragraph 127]

Each framework's discussion of materiality acknowledges that materiality is not a primary qualitative characteristic. In addition, the analysis in the previous paragraph seems to provide compelling evidence that materiality relates not only to relevance, but also to reliability; or in our new terminology, faithful representation. For these reasons, the Board decided that materiality relates to faithful representation, in addition to relevance.

During the June meetings, consideration was also given to whether materiality is a separate qualitative characteristic or something else. Both the IASB framework and Concepts Statement 2 acknowledge that materiality does not seem to be of the same nature as relevance and representational faithfulness. The view in Concepts Statement 2 that materiality is a screen also is consistent with the suggestion in the IASB framework that materiality is a threshold. Accordingly, the Board decided that the converged framework should consider materiality as a screen or filter to determine whether information is sufficiently significant to influence the decisions of users in the context of the entity, rather than as a qualitative characteristic itself.

The staff developed the following draft definition of materiality to reflect existing framework definitions of materiality and the improvements agreed to by the Boards:

Information is material if its omission or misstatement could influence the economic decisions of users taken on the basis of the financial statements. Materiality depends on the nature and amount of the item judged in the particular circumstances of its omission or misstatement. Given the pervasive nature of materiality, it is difficult to consider the concept except as it relates to the qualitative characteristics of relevance and faithful representation. Thus, materiality is a screen or filter used to determine whether information is sufficiently significant to influence the decisions of users in the context of the

entity, rather than as a qualitative characteristic of decision useful financial information.

### **QUESTIONS FOR DISCUSSION BY COUNCIL**

1. The Boards' objective is to sharpen the framework discussion of understandability to clarify that it does relate to whether users can comprehend the reported financial information but does not refer to comprehensibility of the standard itself. Does the proposed definition achieve those objectives?
  
2. Both existing frameworks say that financial reporting is aimed at users who have a reasonable knowledge of business and economic activities and accounting and a willingness to study the information with reasonable diligence (the center ring in the diagram in Appendix II).
  - a. Is that the right group for the converged framework to aim at? If not, which user group should it aim at?
  
  - b. Do council members agree that relevant information should not be excluded because it is too complex or difficult for certain users (such as some to which financial reporting is not aimed) to understand.
  
3. Do Council members agree that materiality is a filter or a screen to determine whether information is sufficiently significant to influence the decisions of users? Do Council members have suggestions for how the proposed definition of materiality might be improved?

## Appendix I

### **TENTATIVE DECISIONS REACHED BY THE FASB AND IASB**

The Boards deliberated issues relating to the objectives of financial reporting at the Boards' joint meeting in April. They reached the following tentative conclusions:

- Financial reports should be prepared from the entity's perspective and should aim to provide information to a wide range of users, rather than focusing on the information needs of existing common shareholders only. The framework should identify the primary users as present and potential investors and creditors (and their advisers). Later in the project, the Boards will consider whether financial reporting also should provide information to meet the information needs of particular types of users, such as different types of equity participants.
- The objective is to provide information about the entity that is useful to the external users who lack the power to prescribe the information they require and must therefore rely on the information provided by an entity's management. The entity's management also will be interested in that information. However, because management has the power to obtain the information it requires, any additional information needs of management are beyond the scope of the framework. Similarly, certain external users, for example, a credit rating agency or a bank lender, generally have the power to prescribe the information they require and their additional information needs may therefore be beyond the scope of the framework.
- As discussed in the two Boards' existing frameworks, the financial statements should provide information to help users to assess an entity's liquidity and solvency. However, that objective should be consistent with the overall objective of providing decision-useful information to a wide range of users. Therefore, the information provided in the financial statements should not be focused on meeting the information needs of particular types of users that primarily use the financial statements to help them assess an entity's liquidity and solvency.
- As with the existing frameworks, the Boards' converged framework should be concerned with *general purpose* financial reports, which focus on the common information needs of users. That does not preclude the Boards from concluding, in a standards-level project, that additional information should be provided to meet the information needs of particular types of users.

At their May 2005 meetings, the Boards discussed issues relating to some of the qualitative characteristics of accounting information and reached the following conclusions, which are generally consistent with the present frameworks except as noted:

- *Relevance* is an essential qualitative characteristic. To be relevant, information must be capable of making a difference in the economic decisions of users by helping them evaluate the effect of past and present events on future net cash inflows (predictive value) or confirm or correct previous evaluations (confirmatory value), even if it is not now being used. Being “capable of making a difference,” rather than now being used, is a change from the present IASB framework; “confirmatory” rather than “feedback” value is a change from the present FASB framework. Also, the information must be available when the users need it (timeliness).
- Accounting information has *predictive value* if users use it, or could use it, to make predictions. Accounting information is not intended, in itself, to be a prediction or to be synonymous with statistical predictability or persistence.
- *Faithful representation* of real-world economic phenomena is an essential qualitative characteristic, which includes capturing the substance of those economic phenomena. Faithful representation also includes the quality of *completeness*. The common conceptual framework will need to discuss thoroughly what faithful representation means and what it does not mean.
- Financial information needs to be *neutral*—free from bias intended to influence a decision or outcome. To that end, the common conceptual framework should not include conservatism or prudence among the desirable qualitative characteristics of accounting information. However, the framework should note the continuing need to be careful in the face of uncertainty.
- Financial information needs to be *verifiable* to provide assurance to users that the information faithfully represents what it purports to represent and that the information is free from material error, complete, and neutral. Descriptions and measures that can be directly verified through consensus among observers are preferable to descriptions or measures that can only be indirectly verified.
- Representations are faithful—there is correspondence or agreement between the accounting measures or descriptions in financial reports and the economic phenomena they purport to represent—when the measures and descriptions are verifiable, and the measuring or describing is done in a neutral manner. Therefore, faithful representation requires completeness, not subordinating substance to form, verifiability, and neutrality. Consequently, the common framework should drop the widely misinterpreted term reliability from the qualitative characteristics, replacing it with faithful representation. That replacement is a change from the current IASB and FASB frameworks.
- Although empirical research may provide evidence useful in standard-setting decisions, for example, in assessing trade-offs between desirable qualities, the conceptual framework project should not seek to develop empirical measures of faithful representation or its component qualities.

At their June 2005 meetings, the Boards discussed issues relating to qualitative characteristics of accounting information, including the existing characteristics of comparability and understandability, and potential new characteristics. The Boards reached the following conclusions:

- *Comparability* is an important characteristic of decision-useful financial information and should be included in the converged conceptual framework. Comparability—which enables users to identify similarities in and differences between economic phenomena—should be distinguished from consistency—the consistent use of accounting methods. Concerns about comparability or consistency should not preclude reporting information that is of greater relevance, or that more faithfully represents the economic phenomena it purports to represent. If such concerns arise, disclosures can help to compensate for lessened comparability or consistency.
- *Understandability* also is an essential characteristic of decision-useful financial information and should be included in the converged conceptual framework. Information is made more understandable by aggregating, classifying, characterizing, and presenting it clearly and concisely. Whether reported information is sufficiently understandable depends on who is using it. The information in general-purpose external financial reports should be understandable to financial statement users who have a reasonable knowledge of business and economic activities and accounting and a willingness to study the information with reasonable diligence. Relevant information should not be excluded because it is too complex or difficult for some users to understand.
- *Materiality* relates not only to relevance, but also to faithful representation. Materiality should be included in the converged framework as a screen or filter to determine whether information is sufficiently significant to influence the decisions of users in the context of the entity, rather than as a qualitative characteristic of decision-useful financial information.
- *Transparency*, often cited recently as a desirable characteristic of financial information, seems to be too difficult to define. In current usage, it appears to encompass some of the qualitative characteristics already included in the framework. Because it would be redundant, transparency should not be added to the converged framework as a separate qualitative characteristic of decision-useful financial information.
- Other possible characteristics considered, including credibility, high quality and internal consistency, do not describe attributes of decision-useful financial information that are distinct from other qualitative characteristics. Thus, they

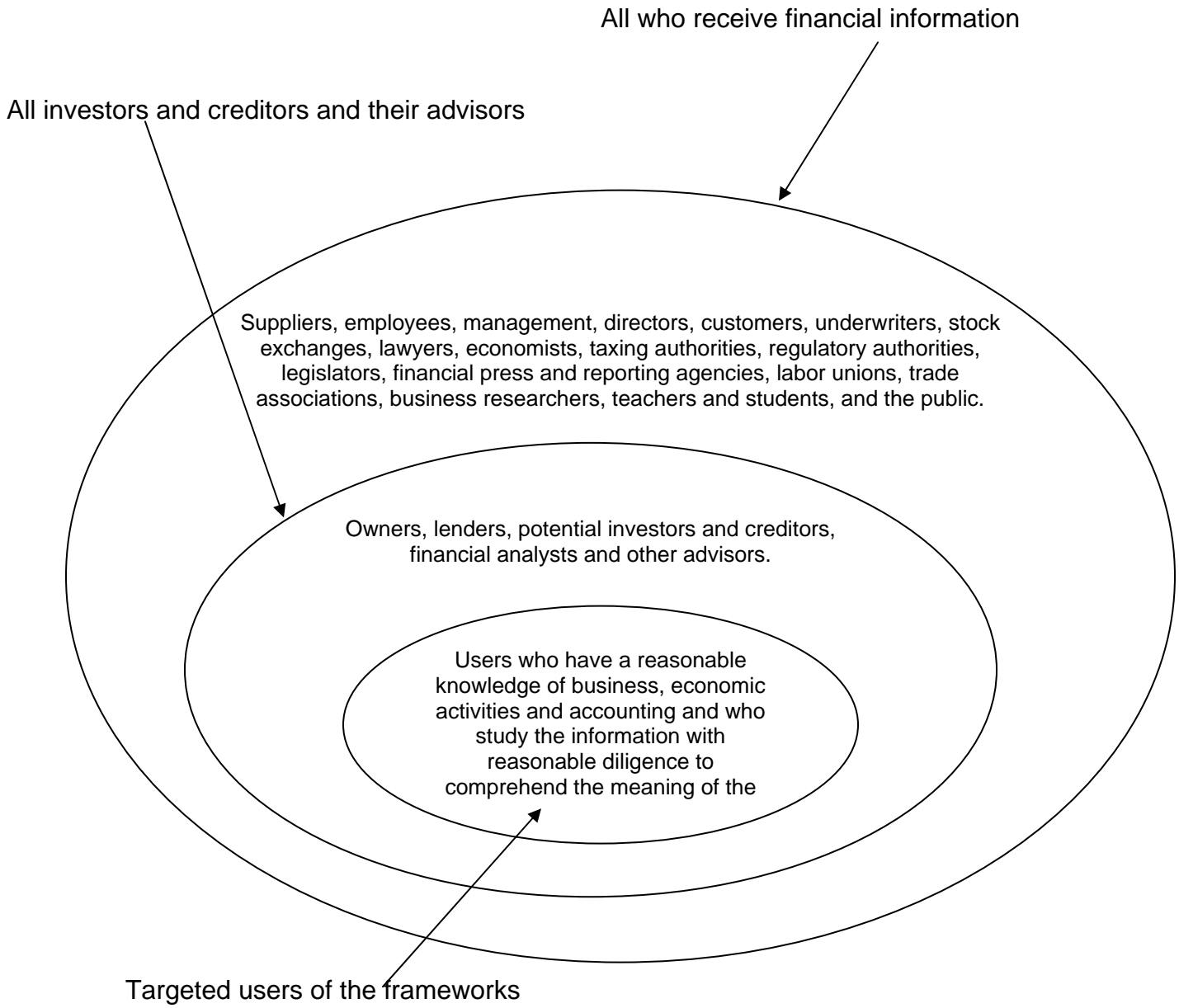
should not be added as separate qualitative characteristics in the converged framework.

- The converged framework should include information about the types of costs that should be considered in deciding what financial information to provide, as well as criteria to help standard setters decide how to take particular types of costs into account.
- The converged framework should include presumptions not only about the capabilities of financial statement users but also about the capabilities of financial statement preparers and auditors.

At their July 2005 meetings, the Boards discussed issues relating to (a) the definitions of stewardship and accountability and their relationships to objectives of financial reporting, (b) relationships between qualitative characteristics of financial reporting information and how they are used in building decision-useful financial reports, and (c) the definitions of understandability and materiality. The Boards reached the following conclusions:

- *Stewardship* or *accountability* should not be a separate objective of financial reporting by business entities in the converged framework. The converged framework should clearly describe its meaning of stewardship, which encompasses management's responsibility not only for the custody and safekeeping of assets entrusted to it but also for their efficient and profitable use. As a consequence, the converged framework should clarify that financial information useful for making investment, credit, and similar resource allocation decisions—the primary objective—would include financial information useful for assessing management's stewardship.
- The different qualitative characteristics, which include relevance, faithful representation, comparability, understandability, and their sub-qualities, sometimes suggest different answers to standard setting and financial reporting issues. Previously, discussion of such differences has focused on hierarchy (that is, which characteristics prevail over others because they are ranked higher) or bargaining (that is, how much of one quality the Boards are willing to "trade-off" to get more of another quality). It would be better to view consideration of the qualitative characteristics of financial reporting information as steps in a *process* that results in decision-useful financial reporting.

Appendix II



## **Fair Value Measurements: Differences between a Transaction Price and a Model-based Estimate**

Financial Accounting Standards Advisory Council  
September 2005

### **Background**

EITF Issue 02-3, "Issues Involved in Accounting for Derivative Contracts Held for Trading Purposes and Contracts Involved in Energy Trading and Risk Management Activities," applies to certain derivative instruments that are measured at fair value under FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*. In particular, it focuses on transactions that involve any long-dated, over-the-counter (OTC) derivative instrument in an illiquid market (Issue 02-3 transactions).

An issue addressed in Issue 02-3 is how to estimate the fair value of the derivative instrument at the inception of the contract (initial recognition). The issue focuses on whether the estimate should be based on (a) the transaction price or (b) the entity's estimate of the price (or rate) for the derivative instrument, which often would be derived from a model. A difference can exist, for example, when the price charged to a customer is different from the estimated price that the derivatives dealer could obtain in a transaction with another dealer.

Briefly, the FASB staff guidance in Issue 02-3 (footnote 3) specifies that the initial fair value estimate should be based on the transaction price *unless* the estimated model value is derived principally from observable market inputs. That guidance was intended to prevent the upfront recognition of gains and losses (so-called "dealer profit") on derivative contracts for which the fair value estimate involved numerous entity-specific inputs. Concerns existed about the reliability of the estimate in those cases. Issue 02-3 did not address when to recognize any difference between the transaction price and the entity's model value. As a result, practice is diverse with regard to both the method and timing of recognition of any differences. For example, some entities do not recognize the difference in earnings until the inputs to the model are principally observable market data (generally at or near the end of the contract). Other entities amortize the difference into earnings over the term of the derivative instrument.

Respondents to the Board's June 2004 Exposure Draft, *Fair Value Measurements* (FVM ED), raised issues with regard to how the FASB staff guidance in Issue 02-3 interacts with the proposed fair value hierarchy. They also asked the FASB to address the subsequent recognition of any amounts deferred at the inception of the contract.

In June 2005, the Board directed the staff to develop an FASB Staff Position (FSP) to address those issues in the context of its tentative decisions reached in redeliberations of the FVM ED. The FSP would nullify the FASB staff guidance included in Issue 02-3. It would not affect the consensuses reached by the EITF in Issue 02-3.

## **Tentative Decisions Reached by the Board**

### **Fair Value**

Fair value is an estimate of the price that would be received for an asset or paid for a liability in a current transaction between marketplace participants in the reference market for the asset or liability.

### **Initial Fair Value Estimate**

In an actual transaction involving the reporting entity, the price paid for an asset or received for a liability (transaction price) is presumed to represent the fair value of the asset or liability at initial recognition, absent persuasive evidence to the contrary. For an Issue 02-3 transaction, the Board decided that:

- a. The transaction price presumption is not rebutted at initial recognition if the market in which the transaction occurs (for example, a retail market) is the reference market for the derivative instrument. In that case, the fair value of the derivative instrument should be based on the price in that market (the transaction price). That would often be the case if the reporting entity is the purchaser of the derivative (the customer).
- b. The transaction price presumption is rebutted at initial recognition if the market in which the transaction occurs is *not* the reference market for the derivative instrument. That is, the fair value of the derivative instrument instead would be based on the price in the reference market for the derivative instrument (potentially, a model value). That would often be the case if the reporting entity is a dealer in derivatives that has access to a more advantageous market for the derivative instrument (for example, a dealer market).

### **Dealer Profit (Loss)**

The Board agreed that if the transaction price presumption is rebutted at initial recognition, the derivative arrangement is a multiple-element transaction. In addition to the derivative instrument (the unperformed element), the transaction includes a compensation element to the entity for structuring and/or arranging the transaction (the performed element), measured as the difference between the transaction price and the model value.

The Board agreed that conceptually, the compensation element or “dealer profit” (loss), should be recognized in earnings at initial recognition. However, the Board acknowledged that when the model value used to estimate the fair value of the derivative instrument is derived principally from entity inputs within Level 5 of the fair value hierarchy, some (or all) of the dealer profit (loss) might represent

measurement error, raising concerns about the reliability of the estimate. In view of those concerns, the Board agreed that dealer profit (loss) should not be recognized in earnings until a minimum reliability threshold is met for the model value (or when the contract expires due to maturity or exercise).

The Board decided that the minimum reliability threshold would be met when the model value falls within Level 4 (that is, when the model value is derived principally from market inputs, whether those inputs are directly observable or otherwise derived and corroborated by other market data through correlation or other means). Therefore:

- a. If the minimum reliability threshold is met for the model value at initial recognition, dealer profit (loss) should be recognized in earnings.
- b. If the minimum reliability threshold is not met for the model value at initial recognition, dealer profit (loss) should be deferred, for example, as a deferred credit (debit) separate from the derivative, until the minimum reliability threshold is met for the model value (at which time, the difference would be recognized in earnings). Dealer profit (loss) that is deferred should not be amortized into earnings over the term of the derivative instrument.

### **Subsequent Fair Value Estimates**

The Board decided that in subsequent periods, changes in fair value should be recognized using the estimates indicated by the entity's model. The Board considered but rejected an alternative approach that would have used the same standard of reliability for recognition of changes in the fair value estimate over the term of the derivative instrument (for example, by updating the estimate only for observable changes in inputs to the model). However, the Board concluded that approach would have created inconsistencies between Statement 133 and other existing (and proposed) accounting pronouncements, adding to the complexity in generally accepted accounting principles. The Board decided that in subsequent periods, the emphasis should be on consistency in applying the model used to estimate fair value over the term of the derivative instrument.

### **Disclosures**

The Board decided that at initial recognition, an entity should disclose information that enables users of its financial statements to evaluate the financial effects of Issue 02-3 transactions during the current reporting period, focusing on the reliability of the estimates and the related earnings effects, if any. In addition to the enhanced disclosures that would be required by the FVM ED, an entity would be required to disclose the amount of deferred dealer profit (loss), if any, changes in the balance of the deferred amount during the current reporting period, and where any deferred amount is reported in the statement of financial position.

### **Effective Date and Transition**

The Board decided that the Issue 02-3 FSP should have the same effective date as the Fair Value Measurement Statement, for fiscal years ending after December 15, 2006. Because the Fair Value Measurement Statement provides the context and

guidance necessary to apply the Issue 02-3 FSP, earlier application is encouraged if the Fair Value Measurements Statement is applied concurrently.

The Board decided that the provisions of the Issue 02-3 FSP should be initially applied retrospectively (similar to a change in accounting principle). The cumulative effect of the change in accounting principle should be applied to the carrying amounts of assets and liabilities as of the beginning of the fiscal year in which the Issue 02-3 FSP is applied. An offsetting adjustment, if any, should be made to the opening balance of retained earnings for that period. The disclosures for a change in accounting principle in FASB Statement 154, *Accounting Changes and Error Corrections*, would be required.

The Board decided that an Exposure Draft of the Issue 02-3 FSP will be posted to the FASB website for a 30-day comment period.

### **Discussion at the September Council Meeting**

At the September Council meeting, the Board seeks input from Council members on the following issues related to the application of the fair value hierarchy and the transaction price presumption:

1. Do Council members agree with the Board's decisions about when a transaction price should be rebutted (generally, when the reporting entity has access to a more advantageous market than the market in which the transaction occurred)?
2. Do Council members agree with the Board's use of the fair value hierarchy to effectively determine when "dealer profit" should be recognized at the inception of a derivative contract (that is, in cases where the transaction price is rebutted and the estimate of fair value is Level 4 or higher in the fair value hierarchy)?
3. Do Council members have concerns about initially establishing a deferred amount relating to contracts whose transaction price differs from a fair value estimate that is derived from an estimate that is predominantly based on inputs that are not from observable market sources (Level 5)?

This paper focuses on a narrow issue relating to derivatives. However, the approach described could have broader applicability in future standards for arrangements that would be recognized and measured at fair value. For example, if the Board issues a standard that would allow companies to carry some or all of their financial instruments at fair value, similar issues would arise when an entity has access to both retail and dealer markets. Another circumstance where the transaction price and the entity's estimate of fair value could differ is a performance obligation in the revenue recognition project (this statement is hypothetical; the Board has not made any decisions on subsequent measurement of performance

obligations). Do Council members have concerns about potentially applying this approach in a wider ran