



**MINUTES OF MEETING**

Financial Accounting Standards Advisory Council  
March 22, 2005

The Advisory Council met at the offices of the Financial Accounting Standards Board in Norwalk, Connecticut.

**Members Attending**

Richard J. Swift, Chairman  
Richard H. Booth  
Raymond J. Bromark

Edward E. Nusbaum  
Klaus D. Patzak  
Janet L. Pegg

Leslie Culbertson  
Colleen Cunningham  
Charles L. Hall

Kevin B. Reilly  
David B. Rickard  
L. Hal Rogero, Jr.

Gregory J. Jonas  
Joe Joseph  
Marc E. Lackritz

James R. Ryan  
Rita J. Spitz  
Mary S. Stone

Alan G. Levin  
Nellie Liang  
Russell V. Meyers

E. Anson Thrower  
Scott M. Waite  
Gregory G. Weaver

Mark W. Nelson

**Members Not Attending**

Alan W. Anderson  
Gary P. Fayard  
Robert E. Friedman

Joseph L. Sclafani  
David M. Walker  
Michael R. Young

Donald D. Humphreys  
Elizabeth F. Mooney

**Others Attending**

Financial Accounting Standards Board:

Robert H. Herz, Chairman  
George J. Batavick

Leslie F. Seidman  
Edward W. Trott

G. Michael Crooch  
Katherine Schipper

Donald M. Young

FASB Staff:

Suzanne Q. Bielstein, Director of Major Projects and Technical Activities  
Halsey G. Bullen, Senior Project Manager  
Holly H. Kispert, Postgraduate Technical Assistant  
M. Eric Smith, Industry Fellow  
Robert C. Wilkins, Senior Project Manager

Others:

William E. Balhoff, Audit Director, Postlethwaite & Netterville  
Robert F. Dacey, Chief Accountant, Governmental Accountability Office  
Jenifer Minke-Girard, Senior Associate Chief Accountant, Securities and  
Exchange Commission  
Daniel Noll, Director of Accounting Standards, AICPA  
Teresa S. Polley, Executive Director, FASAC  
Gregory Scates, Associate Chief Auditor, Public Company Accounting Oversight  
Board

### **Introduction and Approval of Minutes**

Mr. Swift called the meeting to order at 9:00 a.m. and welcomed the meeting participants.

Mr. Swift welcomed new FASB Board member Don Young and three new Council members: Gregory Jonas, Nellie Liang, and Andy Thrower.

Council members approved the minutes of the December 2, 2004, Council meeting.

### **Report of the FASB Chairman**

Mr. Herz reported on the following strategic and technical matters:

- The recent issuance of FASB Statements No. 123 (revised 2004), *Share-Based Payment*, No. 151, *Inventory Costs*, and No. 153, *Exchanges of Nonmonetary Assets*, and FSPs on the application of FASB Statement No. 109, *Accounting for Income Taxes*, to certain issues raised by the American Jobs Creation Act of 2004.
- Progress on the joint project with the IASB on reporting financial performance. In January 2005, the first meeting of the Joint International Group, a working group that comprises preparers, users, and auditors from all over the world, was held in London. At that meeting, the group discussed issues such as cash flow reporting, recycling, and the use of a single comprehensive statement of income. The staff will present a project plan to the FASB and IASB at their joint meeting in April 2005.

- The status of the Board's project on revenue recognition. Because of Board turnover and differing views among Board members, the Board asked the staff to review the tentative decisions to date and present the Board with recommendations on ways to move forward.
- The status of the Board's projects relating to FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*.
- The plans to issue two Exposure Drafts with the IASB on purchase method procedures and noncontrolling interests in June 2005.
- The plans to issue a proposal on moving the GAAP hierarchy from the auditing literature into the accounting literature. That proposal does not encompass any changes to the GAAP hierarchy.
- The progress on the codification project. Currently, the FASB is finishing a prototype section on investments and is hiring staff to work on the subject mapping process.
- The agenda for the joint meeting with the IASB in April 2005. The Boards plan to discuss the performance reporting project, the conceptual framework project, and the convergence projects.
- A new FASB project on improving disclosures for derivatives. As part of the project, the FASB will consider current U.S. accounting literature, the SEC's requirements for market-risk disclosures, and IASB disclosures.

On the codification project, a Council member asked about the timing, resources, and mechanisms in place to ensure that the final product is an improvement.

Mr. Herz stated that the time frame for completion is three to five years and that existing staff resources are not being consumed by this project. Rather, the FASB is hiring separate staff to work on this project. He noted that the codification will undergo many levels of review by staff members, outside experts, and the Board. In addition, before finalizing the codification, the Board plans to issue it for a verification period to help determine whether the codified guidance is consistent with existing GAAP and to ensure that it is user friendly.

### **Report of the SEC**

Ms. Minke-Girard reported on the following matters:

- The SEC staff's plans to issue interpretive guidance on Statement 123(R) and on materiality issues.

- The SEC staff's plans to issue its report to Congress, required under Sarbanes-Oxley, on off-balance-sheet arrangements. The report will cover a broad range of topics including leases, pensions, and derivatives.
- The issuance of SEC staff letters on leasing issues, cash flow issues, and oil and gas matters. Those letters are on the SEC's website.
- The issuance of final rules for the XBRL voluntary program. Companies can now voluntarily furnish XBRL data as an exhibit to certain EDGAR filings.
- The SEC's plans to hold a roundtable about Section 404 of the Sarbanes-Oxley Act in April 2005.

In response to a question about the SEC staff guidance on Statement 123(R), Ms. Minke-Girard stated that the guidance is expected to cover disclosures on changes in valuation methods and modifications to stock grants. She added that one reason for issuing the guidance is to clarify for registrants the SEC staff's expectations about registrants' use of valuation models and assumptions in valuing stock options.

In response to a question about current filings, Ms. Minke-Girard noted recent press reports that there are more delays in filings this year because of the Section 404 reports.

### **Report of the PCAOB**

Mr. Scates reported on the following matters:

- The PCAOB's proposed rules concerning independence, tax services, and contingent fees. The comment period ended on February 14, 2005, and the PCAOB received 804 comment letters.
- The meeting of the Standing Advisory Group on February 16, 2005. At that meeting, the PCAOB sought advice about risk assessment in financial statement audits as well as the auditor reporting model in connection with the audits of public companies. The group also discussed the interaction between auditors and clients when giving advice on accounting issues. The PCAOB believes that information sharing on a timely basis is a necessary component of the audit process.
- The PCAOB staff continues its work on engagement quality (concurring partner) reviews and communications with audit committees.
- The Small Business Forum established to assist auditors, audit committees, and companies in the small business environment gain a better understanding of the PCAOB and its auditing standards. Five educational meetings have taken place since its inception. The biggest issue discussed at those meetings is Section 404 and the inspection process. COSO has

formed a Small Business Guidance Advisory Group to help develop guidance for small businesses to use COSO's internal control integrated framework. A PCAOB observer is attending those meetings and is providing feedback on matters relevant to the audits of public companies.

- The inspection process for the year is completed. In February, the PCAOB released reports pertaining to nine small accounting firms. Inspection reports are available on the PCAOB's website.
- As of March 17, 2005, 1,477 firms were registered with the PCAOB; 921 of those firms are domestic and 556 are foreign.
- Staffing at the PCAOB is up to 291 employees of which 123 are in the inspections group.

A Council member asked for clarification on the distinction between appropriate information sharing and that which impedes independence.

Mr. Scates stated that the auditor may provide information to management when management seeks guidance. However, auditors cannot structure transactions and place themselves in the role of management.

A Council member asked whether summaries of the Small Business Forum meetings were available.

Mr. Scates stated that no summaries are currently available.

Mr. Trott suggested that the PCAOB make the FASB aware of any issues that arise during the inspection process that the Board should consider for its agenda.

Mr. Scates noted that the inspection reports consist of a public and a nonpublic portion. The SEC as well as the appropriate state boards of accountancy receive the full report and are therefore aware of any financial reporting matters that arise.

A Council member asked whether the PCAOB will rely on home-country inspections for foreign private issuers.

Mr. Scates stated that the PCAOB anticipates working with the appropriate foreign inspector during the 2005 inspection process. However, the PCAOB has not experienced that situation yet because domestic firms were the focus of inspections this past year.

### **Current Financial Reporting Issues**

Mr. Swift asked Council members for comments on their experience with Section 404 compliance this past year and their assessment of efforts needed moving forward.

Council members expressed the following views:

- The 404 process has heightened the awareness of internal controls and their importance in organizations, especially among nonfinancial employees, which is perceived as a benefit.
- The redundancy of some tests adds to the costs without a commensurate benefit. Going forward, it may be helpful to use a risk-based scope to streamline the process. The PCAOB should look at the efficiency of the process in addition to the effectiveness of the process.
- Some unintended consequences include IT projects and organizational changes being put on hold or limited to certain periods of the year.
- Section 404 compliance may create a false sense of security with regard to fraud.
- While an analysis of costs and benefits may be appropriate, it should not necessarily be done at the present time when the costs are at their highest and the benefits are yet to be realized.

Mr. Herz stated that another unintended consequence of the present environment is the reluctance by the Board's constituents to accept principles-based standards. Rather, some constituents seem to prefer bright-line rules so that judgments are not second-guessed later.

### **The FASB's Conceptual Framework**

Mr. Bullen stated that the conceptual framework project is a joint project between the FASB and IASB to converge, refine, and complete the existing frameworks. The Boards will begin deliberations at the joint meeting in April 2005 by first considering the objectives of financial reporting.

Mr. Bullen noted that both frameworks set forth similar objectives of financial reporting: to report information that is useful in making economic decisions, assessing cash flow prospects, and understanding enterprise resources, claims to those resources, and changes in them. Both frameworks focus on the information needs of a wide range of users, but the FASB's framework emphasizes usefulness in investment and credit decisions.

Mr. Bullen asked Council members to comment on the following issues: which external decisions and decision makers should be the primary focus; whether those who make investment, credit, and similar decisions about small, private businesses and not-for-profit organizations need different financial reporting information than those making decisions about large public companies; and whether a single kind of general-purpose external financial report continues to be the best way to provide financial information.

Council members expressed the following views:

- When the financial statements are prepared for a wide range of users, then the financial statements really are prepared for no one.
- The primary focus of financial reporting should be current shareholders.
- The primary focus of financial reporting should be owners and shareholders, with no distinction between current and potential shareholders.
- Debt holders also should be considered to be users of the financial statements. Financial reporting allows outside investors, both equity and debt holders, to evaluate the economic value of the firm.
- In considering who should be the primary focus of financial reporting, the dividing line should be between general-purpose users and users that have the ability to compel information from an entity.
- The information needs of users of the financial statements of privately held entities and not-for-profit organizations also need to be considered in the conceptual framework project.

Mr. Trott expressed concern about the comment that when financial statements are prepared for a wide range of users, they are prepared for no one. He stated that even if the focus is on current and potential shareholders only, those two groups have different information needs. Mr. Trott stated his belief that the audience of financial statements is the capital markets as a whole. He noted that because there are many different approaches to analyzing financial statements, a broad approach to providing financial information is needed.

A Council member expressed support for Mr. Trott's comments and suggested that the purpose of financial statements is to reflect the economics of an entity. The financial statements should provide the information, and individuals can use that information as they choose. With the current push toward alternative investments, the diversity of users is increasing. Therefore, the focus of financial reporting should be broad.

Mr. Herz noted that with technology, financial reporting should be flexible enough to respond to the needs of different groups of users.

A Council member noted that the public believes that the main purpose of financial reporting is to prevent another Enron. Therefore, there is a disconnect between the objectives of financial reporting and what the public thinks those objectives are. Other Council members agreed that with Sarbanes-Oxley, there is an increased emphasis on detection of fraud with very few tools to do so. Some attention to fraud prevention in FASB standards would be helpful.

Mr. Trott agreed that it is appropriate for the Board to consider fraud when creating accounting standards, but noted that it is difficult to approach standard

setting from an abuse-control standpoint. He stated that it is more appropriate for the PCAOB to provide guidance on fraud detection.

### **Fair Value Measurement**

Ms. Seidman stated that the objective of the fair value measurement project is to define fair value and establish a consistent framework for how to develop fair value measurements required under existing accounting pronouncements. The Board has redeliberated the Exposure Draft and made clarifying changes to the document in response to concerns raised in comment letters.

Ms. Seidman stated that the focus of the FASAC discussion is whether changes in an entity's creditworthiness should enter into the valuation of its own liabilities when specific accounting literature requires that liability to be remeasured at fair value. She noted that currently few Statements require that liabilities be remeasured at fair value, such as FASB Statements No. 133, *Accounting for Derivative Instruments and Hedging Activities*, and No. 107, *Disclosures about Fair Value of Financial Instruments*. However, some of the Board's active projects are contemplating measuring and remeasuring liabilities at fair value, including the fair value option project.

Ms. Seidman stated that the Board has agreed that, conceptually, changes in an entity's credit standing should be considered part of the fair value of the obligation because those changes would be observable in a hypothetical settlement or extinguishment of its outstanding liabilities. However, there are concerns with the practical application of that conceptual decision—specifically, the notion that gains that result from a deterioration of an entity's own creditworthiness would be recorded in earnings, especially in situations in which the entity is experiencing significant financial difficulty. Currently, the Board has agreed to deal with that concern on a standard-by-standard basis.

Ms. Seidman asked for Council members' comments on the issue. Council members expressed the following views:

- Credit standing is a valid element of fair value accounting. However, the counterintuitive results are a cause for concern. For example, as a company gets closer to bankruptcy, it would report bigger and bigger gains. Companies that are insolvent would not look insolvent.
- Those results are a better indicator of management's judgments and performance. As an entity's credit rating changes, there can be a real opportunity cost to current shareholders if management does not take advantage of it.
- Unless a company has the ability to realize the gain or loss from a change in credit rating, it does not seem appropriate to recognize it.

- An unintended consequence is that companies would be subject to criticism for having financed themselves above market, which would have the practical effect of causing CEOs to shorten maturities and have less secure sources of financing for their companies.
- The fundamental question is whether fair value accounting should be applied to debt. It may be easier for users to analyze the balance sheet if debt is recorded at its contractual value with additional disclosures about fair value.
- The root cause of concern may be a focus on one item of measurement, such as net income or earnings per share. This issue may provide an opportunity to expand the focus from net income to a broader view of an entity's performance.

Mr. Herz noted that this discussion emphasizes the connection with the performance reporting project. If there is improved disaggregation in the financial statements, it is possible that the narrow focus on one item of performance measurement may go away.

A Council member agreed that the issue should be addressed in the performance reporting project. With appropriate display and disclosure, the result may be less confusing and counterintuitive.

Mr. Trott stated that many Council members seem to believe that disclosures would be a good alternative to fair value measurement in the financial statements. He asked Council members whether they believe disclosures are treated the same as recognition in the basic financial statements.

A Council member stated that disclosures and recognition are not treated the same. To mark debt instruments to fair value causes concern conceptually and from a user standpoint. The face value of that debt—not the fair value—ultimately will be paid off, so the Board needs to determine what the most useful information is.

### **Fair Value Option**

Ms. Seidman stated that in its fair value option project, the Board is considering whether entities should be permitted a one-time irrevocable election, at the initial recognition of a contract, to report financial instruments at fair value with the changes in fair value included in earnings. This project was added to the agenda for three reasons:

- To address potential distortions that are occurring within a company's own financial statements when recognized financial assets and liabilities are being measured differently.
- To achieve an offsetting effect that is like hedge accounting for those instruments that are managed together in a portfolio.

- To achieve convergence with the IASB, who currently has a fair value option but is considering changes to that option.

Ms. Seidman stated that she would like comments on whether Council members are concerned that this option will introduce new reporting problems and whether there should be qualifying criteria for a company that would like to elect fair value for some or all of its financial instruments.

A Council member stated that a fair value option would provide an important new alternative and suggested that a working group be assembled to study the details.

Ms. Seidman stated that a small working group has been assembled, but that it only includes financial institutions. The Board will consider expanding the group.

Ms. Schipper noted that in this project, the Board will be considering a free-choice alternative and asked whether the resulting noncomparability would be a problem for users of financial statements.

A Council member stated that comparability is an issue but that the treatment alternative may result in better representation in the financial statements of the economic position of an entity.

### **AICPA Private Company Financial Reporting**

Mr. Balhoff described the efforts of the AICPA's Private Company Financial Reporting Task Force to study the issue of whether general-purpose financial statements of private, for-profit entities, prepared in accordance with GAAP, meet the needs of all constituents of that reporting. Mr. Balhoff summarized the Task Force's findings as follows:

- Attributes of GAAP reporting have high value according to all constituents (for example, common language, consistency, etc).
- Too many GAAP-specific requirements lack relevance or decision usefulness according to all constituents.
- A majority of each of the constituent groups who had an opinion believe it would be useful if underlying accounting in GAAP reporting was different, in certain instances, for public versus nonpublic companies. One exception was sureties in the broad outreach survey.

As a result of those findings, the Task Force reached the following conclusions:

- GAAP for private companies should be developed based on concepts and accounting that are appropriate for the distinctly different needs of constituents of that financial reporting.
- Although GAAP exceptions and other bases of accounting are being used and are sometimes appropriate, the Task Force does not believe that these exceptions and other bases of accounting are the best response to the findings identified in this study.
- Fundamental changes should be made in the current GAAP standard-setting process to ensure that the financial reporting needs of private-company constituents are met.

Mr. Balhoff stated that the Task Force recommends an outreach to the FASB and a collaborative effort that involves the key constituents of private-company financial reporting. He also noted that if there were two sets of GAAP, private companies would choose which GAAP to follow. He then opened the floor for comments.

Council members expressed the following views:

- There seems to be a disconnect between the results of the survey and the Task Force's recommendations. The findings seem to show that the general usefulness of GAAP is moderately high to high. Some organizations deal with their specific needs by using exceptions to GAAP, and many organizations that had not used exceptions to GAAP had never asked for them. It is difficult to reconcile those findings to a recommendation for an alternative GAAP.
- The conclusion that specific GAAP requirements are not relevant to private companies may be due to the nonapplicability of those requirements. For example, share-based payment GAAP requirements rated low for relevance in the survey. However, many private companies do not have share-based payment plans and therefore would not find GAAP requirements for share-based payments to be relevant.
- If public companies had answered some of the survey questions, such as those asking about relevance and decision usefulness of specific GAAP requirements, they probably would have answered the same way private companies did. The survey seems to be missing the reasons why private companies need special GAAP.
- The Task Force recommendations would introduce complexity, confusion, and noncomparability to financial reporting when a theme of today's discussion is simplicity, convergence, and codification.

- If a private company plans to become a public company, it would have to maintain its books in both sets of GAAP.
- The survey asked respondents to rate the relevance of 12 GAAP requirements. However, the degree of specificity of those 12 areas varies greatly, for example, the general concept of accrual accounting versus the specific area of variable interest entities. Therefore, diversity in relevance for those topics is almost certain.
- The authority of the FASB over private companies is not clear and is worth examining further.
- Users of private-company financial statements often have access to more information than users of public-company financial statements. That notion changes the cost-benefit analysis of certain GAAP requirements for private entities, and the FASB should continue to address those issues on a case-by-case basis. However, it does not require a separate GAAP.
- The Task Force should start with the FASB's conceptual framework to identify the users of private-company financial statements and determine whether their needs are different from those of users of public-company financial statements. Standards cannot be written until it is known what concepts are to be followed.
- The issue of two sets of GAAP may really be an issue of the size and complexity of a company rather than whether a company is public or private.
- The survey should have encompassed not-for-profit organizations.

In response to several of the comments, Mr. Balhoff noted that, currently, private companies that decide to go public must recast their financial statements under SEC rules, so that complexity already exists. He stated that users ultimately will drive an entity's decision about which GAAP to follow.

Mr. Herz stated that the Board has assigned a team including Board and staff members to work with the AICPA Task Force to further explore the issue. The goal is to develop a proposal that would be issued for public comment.

Mr. Batavick added that the IASB, other national standard setters, and the SEC also are studying the issue. The FASB will monitor those efforts and share information with those other groups.

### **Managing Changes to Financial Reporting**

Mr. Trott stated that the Board would like Council members' input on how the Board should evaluate agenda requests and make agenda decisions. He noted that the Board generally makes evolutionary, incremental changes rather

than revolutionary, or “big bang,” changes. He added that the Board determines the approach to be used on an issue-by-issue basis; not all projects will use the same approach.

Mr. Trott stated that one of the benefits of using an incremental approach is that the Board can respond more quickly to urgent issues. Incremental changes are pursued when timeliness is important. However, one of the costs of an incremental approach is that several models may exist simultaneously for similar items. He noted that one of the benefits of using a big-bang approach is that the Board can address issues broadly and treat all similar transactions in the same way using the same model. The cost is that big changes take more time to accomplish and there is a longer learning curve. Mr. Trott compared the two approaches using several examples: finite risk policies, pensions, and financial instruments.

Mr. Trott asked for Council members’ comments about the two approaches as well as the specific examples he outlined.

Council members expressed the following views:

- A big-bang approach is more advantageous because it allows the Board to move toward principles-based standards and address the fundamentals of accounting.
- If the Board moves toward big-bang changes, the Board will have to set priorities judiciously. Currently, the Board seems bogged down by incremental issues.
- From a practical standpoint, big-bang changes are more difficult to handle than incremental changes because of the significant learning process that is required. Big-bang changes also may be disruptive to users.
- The priority of projects and the approach used should be determined by the extent of the problem needing to be solved. How large is the problem and how urgent is it to fix?

Several Council members stated that the Board should focus on the “end game,” or the issue of what financial reporting ultimately should look like. The conceptual framework should be a priority and help to lead the Board to the appropriate answer in a given situation. A Council member added that if there is a strategic plan—an overarching framework of what the Board is trying to accomplish over a long period of time—the shorter term priorities would fall into place. Big-bang projects would be required only if the Board loses focus on the long-term goal.

Mr. Crooch stated that the concept of a strategic plan is good but that the Board has difficulty creating a strategic plan that the next Board will commit to and follow.

A Council member stated that the value of a strategic plan is to converge the Board's thoughts and goals. Even though the composition of the Board will change over time, there is value in having a coordinated set of goals.

A Council member compared the Board's agenda to a clock. The second hand represents the firefighting projects that result from an emergency in practice. The minute hand represents the major projects and deals with broader scope issues. Both types of projects move at a different pace, but they continue to move forward. The hour hand represents the conceptual framework; it moves more slowly but cannot stop. He noted that for each type of project, the Board should focus on the issue. What is the problem that needs to be solved?

### **Adjournment**

Mr. Swift stated that Mr. Rogero is retiring from FASAC. He thanked Mr. Rogero for his service and invited him to make parting comments.

Mr. Rogero expressed appreciation for the opportunity to serve on FASAC and stated that it was a very rewarding experience. He encouraged the Board to focus on the simpler answer rather than the complex answer for difficult accounting issues.

Mr. Swift thanked the Board and Council members for attending. He adjourned the meeting at 2:55 p.m.