



**MINUTES OF MEETING**

Financial Accounting Standards Advisory Council  
June 21, 2005

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

**Members Attending**

Richard J. Swift, Chairman  
Raymond J. Bromark  
Stephen J. Cosgrove

Elizabeth F. Mooney  
Janet L. Pegg  
Kevin B. Reilly

Leslie Culbertson  
Colleen Cunningham  
Robert E. Friedman

David B. Rickard  
James R. Ryan  
Joseph L. Sclafani

Charles L. Hall  
Donald D. Humphreys  
Gregory J. Jonas

Mary S. Stone  
E. Anson Thrower  
Arleen R. Thomas

Marc E. Lackritz  
Nellie Liang  
Russell V. Meyers

Scott M. Waite  
Michael R. Young

**Members Not Attending**

Richard H. Booth  
Gary P. Fayard  
Joe Joseph

Klaus D. Patzak  
Rita J. Spitz  
David M. Walker

Alan G. Levin  
Mark W. Nelson  
Edward E. Nusbaum

Gregory G. Weaver

**Others Attending**

Financial Accounting Standards Board:  
Robert H. Herz, Chairman

George J. Batavick  
 G. Michael Crooch  
 Katherine Schipper

Leslie F. Seidman  
 Edward W. Trott  
 Donald M. Young

**FASB Staff:**

Suzanne Q. Bielstein, Director of Major Projects and Technical Activities  
 Halsey G. Bullen, Senior Project Manager  
 Elizabeth A. Figgie, Assistant Project Manager  
 Rebecca L. Goodman, Postgraduate Technical Assistant  
 Jennifer S. Moriarty, Practice Fellow  
 Stuart J. Moss, Practice Fellow  
 Lawrence W. Smith, Director of Technical Application & Implementation Activities  
 Jennifer L. Sullivan, Project Manager

**Others:**

Teresa S. Polley, Executive Director, FASAC  
 Gregory Scates, Associate Chief Auditor, Public Company Accounting Oversight Board  
 Scott A. Taub, Deputy Chief Accountant, Securities and Exchange Commission

**Introduction and Approval of Minutes**

Mr. Swift called the meeting to order at 9:00 a.m. and welcomed the meeting participants and new Council members Arleen Thomas and Stephen Cosgrove.

Council members approved the minutes of the March 22, 2005, Council meeting.

**Report of the FASB Chairman**

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

- The recent issuance of FASB Statement No. 154, *Accounting Changes and Error Corrections*, FASB Interpretation No. 47, *Accounting for Conditional Asset Retirement Obligations*, FASB Staff Position FAS 19-1, "Accounting for Suspended Well Costs," and the FASB Exposure Draft, *The Hierarchy of Generally Accepted Accounting Principles*.
- The expected issuance of three Exposure Drafts on projects related to FASB Statement No. 141, *Business Combinations*, including one each on purchase method procedures and noncontrolling interests in June 2005, and one on not-for-profit organizations late in 2005.
- The expected issuance of three Exposure Drafts in August 2005 on projects related to FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, including one on hybrid

instruments, one on servicing rights, and one on qualifying special-purpose entities and isolation of transferred assets.

- The expected issuance of an Exposure Draft of a proposed Interpretation on uncertain tax positions later this summer.
- The expected posting to the FASB website of a milestone draft on the liabilities and equity project, which considers simple instruments. Deliberations on the second milestone, which considers compound instruments, are set to begin in June 2005.
- The expected issuance of a final Statement on fair value measurement in the third quarter of 2005.
- The addition of two projects to the Board's agenda, one on disclosures for derivatives and one on defining insurance risk transfer for insurers and insureds.
- The main topics discussed at the semiannual joint meeting of the FASB and IASB in April, including the joint project on the conceptual framework, the joint project on performance reporting, and the Boards' overall convergence strategy.
- The Board's activities on private company financial reporting and small business issues. Messrs. Trott and Batavick reported on their involvement with the AICPA and the SEC on this issue.
  - Mr. Trott noted that he, Mr. Batavick, and FASB staff member Russ Golden would meet later this week with representatives from the AICPA to discuss further how to proceed on the private company financial reporting initiative. The group will discuss what is meant by "general-purpose financial statements," and whether private company standards should be standalone or based on current GAAP with differences identified for private companies.
  - Mr. Batavick noted that the SEC's Accounting Subcommittee of the Advisory Committee on Smaller Public Companies is considering several issues facing small business issuers, including whether accounting and disclosure requirements should differ for small business issuers. The Subcommittee has concluded that recognition should not change for small business issuers but that measurement, disclosure, and transition guidance are areas that could be considered for differences.
- The SEC's recent report on off-balance-sheet (OBS) transactions. The FASB staff will prepare an agenda package based on the recommendations included in the report. Some of the recommendations include accounting for pensions and other postemployment benefits, leases, consolidation, and reporting full fair value for all financial instruments.
- The internal strategic review of the EITF. Mr. Smith stated that as part of the review, a questionnaire was sent out and meetings were held with constituents. Mr. Smith noted that the EITF generally is supported as a

standard-setting body. Some of the recommendations resulting from the review include:

- Expose all consensuses for comment.
- Publish the EITF's operating procedures on the website.
- Develop better criteria for determining whether an issue should be addressed by the EITF or by an FASB Staff Position.
- Do not give the EITF the ability to amend the FASB literature. If the EITF believes an issue requires amending the accounting literature, then give that issue to the Board to address.

In response to a question, Mr. Herz stated that the Board sees no reason to reexpose the standard on fair value measurement in light of its changed position on block discounts. Mr. Herz noted that the Board's changed position was strongly supported by user constituents. Mr. Trott added that the decision to reexpose considers, among other things, whether reexposure would be likely to generate new information about the Board's decisions. He stated that he did not believe that reexposure of the Board's decision on block discounts would generate new information for the Board to consider.

### **Report of the PCAOB**

Mr. Scates reported on the following matters:

- The PCAOB participated in the SEC's roundtable held April 13, 2005, on implementing Section 404 of Sarbanes-Oxley. After the discussion, the PCAOB committed to issuing additional guidance on implementing Auditing Standard No. 2, "An Audit of Internal Control over Financial Reporting Performed in Conjunction with an Audit of Financial Statements."
- On May 16, 2005, the PCAOB issued a Policy Statement on AS No. 2, in which the PCAOB made the following points:

The auditor should integrate the audit of internal control with the audit of the financial statements. The auditor also should exercise judgment to tailor the audit plans to the risks facing individual clients. The auditor should use a top-down approach that begins with company-level controls. The auditor also should use the work of others as provided in the standard and should engage in direct and timely communication with the audit client.

- The PCAOB staff issued Staff Q&As addressing:
  - Top-down and risk-based approach
  - Scope and extent of testing
  - Using the work of others
  - Auditor's quarterly responsibilities.
- On May 24, 2005, the PCAOB announced its first enforcement action. The Board revoked the registration of a public accounting firm and barred the

firm's managing partner from association with a registered accounting firm after finding that information was concealed from the PCAOB and false information was submitted in connection with a PCAOB inspection. The Board also censured two former partners in the firm, finding that they participated in the misconduct but noting that they promptly alerted the PCAOB and cooperated in the Board's investigation.

- On May 25, 2005, the PCAOB staff issued a Staff Q&A related to attest engagements regarding extensible business reporting language (XBRL) data furnished under the SEC's XBRL voluntary financial reporting program in the EDGAR system.
- The second Standing Advisory Group meeting was held on June 8-9, 2005, and covered first-year implementation issues of AS No. 2. The Group expressed the view that no additional guidance on AS No. 2 was needed at this time.
- To date, 1,522 firms are registered with the PCAOB; 935 of those firms are domestic and 587 are foreign.
- Staffing at the PCAOB is up to 345 employees of which 167 are in the inspections group.

### **Report of the SEC**

Mr. Taub reported on the following matters:

- The SEC issued guidance on May 16, 2005, on Section 404 of Sarbanes-Oxley that is consistent with that issued by the PCAOB.
- The Section 404 reporting deadline for small business filers has been delayed.
- The SEC staff continues to seek input from preparers and auditors on internal control reporting requirements.
- The Committee of Sponsoring Organizations (COSO) will issue guidance on how the COSO framework can be applied to smaller companies. Mr. Taub noted that smaller companies have different ways to meet the control objectives in the framework, not that they have fewer objectives to meet.
- SEC Chief Accountant Donald Nicolaisen published an article on international convergence in the April 2005 volume of the *Northwestern Journal of International Law and Business*.
- The SEC staff believes that the reconciliation to U.S. GAAP currently required for non-U.S. registrants would no longer be required when IFRSs are a complete, high-quality set of standards consistently and rigorously applied and sufficiently understood by financial statements users.

- For the 2004 reporting period, there were approximately 30-40 20-F filers using IFRSs. For the 2005 reporting period, the SEC staff expects a much larger number, perhaps 300-400, using IFRS. The SEC staff will review all of those filings at some level.
- The SEC published 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*. Mr. Taub encouraged Council members to read the report.
- SEC Chairman William Donaldson will resign effective June 30. Congressman Christopher Cox has been nominated to become the next Chairman.

### **International Convergence**

Mr. Crooch stated that the FASB and IASB continue to hold joint meetings twice each year to discuss joint projects and strategic issues about convergence. He noted that short-term convergence projects originally were intended to quickly eliminate what appeared to be small, isolated differences in standards; however, the Boards have learned that the differences have not been small or easy to eliminate. As a result, the Boards have emphasized long-term joint projects as they offer the best opportunity for true convergence.

Mr. Herz added that joint projects provide a better chance of agreement because both Boards are working on the same issues at the same time.

Council members expressed the following views:

- The Boards have made significant progress in converging standards; however, there are differences in how the standards are being applied in practice.
- Crafting a better solution in a long-term project is preferable to choosing one or the other Board's existing standards in a short-term effort.
- A long-term approach to convergence will allow the system—that is, current practitioners and those involved in education—to keep up-to-date with the Boards' decisions.

### **Derivatives Disclosures**

Mr. Moss stated that the Board added the derivatives disclosures project to the agenda in March 2005 because of concerns raised by constituents that required disclosures lack transparency about the financial impact and risk profile of derivative portfolios of many reporting entities. He noted that the FASB staff established a User Group comprising top buy- and sell-side analysts, representatives of the International Swaps and Derivatives Association, and

general accounting analysts and authors. Mr. Moss noted that the User Group includes directors of financial policy at large financial institutions.

Mr. Moss requested the Council's feedback on the three scope alternatives outlined in the meeting materials and summarized as follows:

Alternative 1: Limit the scope to derivatives accounted for under FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*.

Alternative 2: Expand the scope to include all financial instruments and converge with the IASB by using IAS Exposure Draft 7, *Financial Instrument Disclosures* (ED 7).

Alternative 3: Expand the scope to include all financial instruments.

Council members expressed the following views:

- In determining the scope, the Board and staff should start with the question, "What is the problem that needs to be fixed?" One deficiency of current disclosures is evidenced by the surprise to investors when there is a market "meltdown." The primary focus of the project should be on disclosing the extent of an entity's use of derivatives and the inherent risks, including the likelihood and quantification of a worst-case scenario.
- The SEC report on off-balance-sheet transactions provides an analysis of some of the problem in its discussion of a disclosure framework. The Board could approach this project with a view of what might go into a disclosure framework, rather than developing a laundry list of disclosures.
- Users will be better able to determine how a given marketplace occurrence may affect an entity if (a) disclosures are categorized by function rather than by nature (for example, disclose available-for-sale securities with descriptive categories such as autos and mortgages to reflect a bank's risks on its balance sheet) and (b) derivatives are reported gross rather than net (such as swaps netted within a bank's net interest income line).
- The global nature of financial instruments indicates that convergence should be the most appropriate alternative.
- The Board should consider addressing the project in two phases—first, derivatives accounted for under Statement 133, and second, all other financial instruments—to expediently address current concerns but also comprehensively address the issues.

Mr. Taub noted that if the project scope is limited to derivatives accounted for under Statement 133, then different disclosures could result for similar economic transactions. As an example, he noted that an entity that borrows with variable-rate debt would have different disclosures than a company that borrows with fixed-rate debt and then enters into a swap.

In response to a Council member's concern that the disclosures should include the measurement uncertainty of the financial instrument itself,

Ms. Seidman stated that such disclosure would be required under the fair value measurement project.

## **Financial Performance Reporting**

Ms. Sullivan summarized the decisions made at the joint FASB-IASB meeting in April and noted that the Board's goal is to issue an Exposure Draft of those decisions in the fourth quarter of 2005. Ms. Sullivan then summarized the discussion at the June 14, 2005, Joint International Group (JIG) meeting that focused on the meaning of *net income* and approaches to aggregation or categorization of information in a statement of earnings and comprehensive income.

Council members expressed the following views on those matters:

- The current U.S. GAAP presentation model may not need to be changed. Financial statement users seem to use net income more than any other metric.
- Several preparers stated that they receive a large number of questions from analysts about earnings per share but have never received a question from an analyst about other comprehensive income (OCI).
- Users indicated that analysts may not ask questions about OCI because the information often is buried in the footnotes.
- Several members, including user representatives, supported a single statement of comprehensive income that includes a subtotal for net income.
- A framework should be developed to determine whether an item should be reported within the net income subtotal or the OCI total. Several members suggested that the determination be based on a core versus noncore classification. One member defined core as items that are the result of management action that can be expected to be sustained.

Mr. Trott stated that the user community should give the Board feedback on (a) whether issuers can better communicate through categorization and disaggregation, (b) whether such communication would lessen the need for a net income subtotal, (c) whether the Board should specify, or give issuers the flexibility to determine, the appropriate categorization and disaggregation.

## **The Conceptual Framework**

Mr. Bullen stated that the FASB and IASB began deliberations on the joint conceptual framework project by considering the objectives of financial reporting and the qualitative characteristics of accounting information. Two of the qualitative characteristics discussed by the Boards are neutrality (versus conservatism) and faithful representation. The Boards unanimously decided to retain neutrality as a characteristic desired in financial reporting. Conservatism

should be discussed in the framework, but the Boards decided that it should not be a separate qualitative characteristic.

Mr. Bullen asked Council members for their views on neutrality and conservatism.

Council members expressed the following views:

- Excessive conservatism is not helpful in financial reporting. However, in practice, problems arise when the accounting is too optimistic and the actual results fall short.
- The public has an expectation that financial statements will be conservative, particularly after recent corporate scandals and subsequent regulatory actions.
- Neutrality is the most appropriate objective because once a bias is introduced—either conservative or aggressive—no guidance can specify how much bias is too much.

On the next topic, Mr. Bullen stated that the Boards decided to retain the concept of faithful representation as a qualitative characteristic. They agreed that “substance over form” should not be a characteristic of faithful representation, but that some of the characteristics might include completeness, reliability, and verifiability. Mr. Bullen asked Council members whether the Boards should provide better definitions of faithful representation at the conceptual level.

Council members expressed the following views:

- Representational faithfulness should be the primary characteristic.
- Substance over form adds nothing to the definition of representational faithfulness.
- A change in the conceptual framework will not guarantee a change in practice. For example, while some preparers will try in good faith to provide representationally faithful financial statements, others will ask where the literature explicitly specifies that they must account for certain transactions in a certain way.

## **Revenue Recognition**

Ms. Schipper summarized the practical and conceptual reasons for the joint FASB-IASB revenue recognition project as outlined in the meeting materials. She stated that three levels of guidance are planned: revisions to certain conceptual guidance, general guidance on revenue recognition, and application guidance on specific types of activities such as rights to use and service transactions.

Ms. Schipper described two possible approaches to revenue recognition: a conceptual approach and a performance value approach. The conceptual approach entails treating the assets and liabilities in a revenue arrangement no differently than any other assets and liabilities and measuring them at fair value (initially and possibly subsequently). The performance value approach entails the same treatment of assets as in the conceptual method, but liabilities would be measured at performance value, or the price to a customer for each element of the contract on a standalone basis.

Ms. Schipper stated that the Board tentatively has defined *performance value* as an amount a customer would pay if buying an element (good or service) on a standalone basis. If the transaction amount is different from the sum of the performance values of those elements, the difference would be allocated, attributed, or deferred using a rule. Ms. Schipper stated that the Board tentatively has decided to pursue the performance value approach and that the Board will address the following issues next:

- Criteria to separate elements (how to identify assets and liabilities)
- Initial measurement of elements
- Subsequent accounting for performance and stand-by obligations
- Accounting for contract assets
- Revenue disclosures.

Ms. Schipper asked Council members for their views.

Several Council members encouraged the Board to consider whether the performance value approach creates a more or less fertile environment for perpetration of fraud in revenue recognition. Those members noted that the vast majority of restatements is caused by revenue recognition issues. They noted that revenue recognition is an area in accounting that should be more prescriptive and less subject to management judgments.

Ms. Seidman stated that one of the benefits of the performance value approach is that measurements would be based on vendor-specific, objective evidence from the customer's perspective. There would be less need for management judgment than under the conceptual approach.

Mr. Taub stated that while revenue recognition is an area susceptible to fraud, it is not possible to write rules that will prevent fraud.

Other Council members expressed support for the performance value approach. Some noted that entities may measure multiple-element arrangements differently, leading to lack of comparability.

Ms. Seidman noted that any revenue arrangement with multiple elements is difficult to measure regardless of the approach used.

**Adjournment**

Mr. Swift stated that Mr. Meyers was retiring from FASAC. He thanked him for his service to the Council.

Mr. Swift thanked the Board and Council members for attending the meeting and closed the meeting to public observation at 2:30 p.m. Council members held a closed educational session on XBRL. Mr. Swift adjourned that session at 4:35 p.m.