



MINUTES OF MEETING

Financial Accounting Standards Advisory Council
September 23, 2004

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

Members Attending

Richard J. Swift, Chairman
W. Steve Albrecht
Alan W. Anderson

Russell V. Meyers
Elizabeth F. Mooney
Mark W. Nelson

Richard H. Booth
Raymond J. Bromark
Leslie Culbertson

Edward E. Nusbaum
Janet L. Pegg
Kevin B. Reilly

Colleen Cunningham
Robert E. Friedman
Charles L. Hall

David B. Rickard
L. Hal Rogero
Rita J. Spitz

Donald D. Humphreys
Joe Joseph
Marc E. Lackritz

Mary S. Stone
Scott M. Waite
Michael R. Young

Alan G. Levin

Members Not Attending

Kelly Bulloch
Gary P. Fayard
David M. Jones

James R. Ryan
Joseph L. Sclafani
David M. Walker

Klaus D. Patzak
John F. Richards

Gregory G. Weaver

Others Attending

Financial Accounting Standards Board:

Robert H. Herz, Chairman
George J. Batavick
Gary S. Schieneman

Katherine Schipper
Leslie F. Seidman
Edward W. Trott

FASB Staff:

Suzanne Q. Bielstein, Director of Major Projects and Technical Activities

David M. Hansen, Postgraduate Technical Assistant

L. Todd Johnson, Senior Technical Advisor

Linda A. MacDonald, Project Manager

Peter C. Proestakes, Project Manager

Lawrence W. Smith, Director of Technical Application and
Implementation Activities

Donald B. Thomas, Project Manager

Others:

Douglas R. Carmichael, Chief Auditor–PCAOB

Thomas Hoey, Consultant

Jenifer Minke-Girard, Senior Associate Chief Accountant–SEC

Teresa S. Polley, Executive Director–FASAC

Introduction and Approval of Minutes

Mr. Swift called the meeting to order at 9:00 a.m. and welcomed the meeting participants. He updated Council members on the nominating process for new FASAC members. He stated that many excellent nominations have been received and that the FAF Board of Trustees would make the appointments on November 23.

Council members approved the minutes of the June 22, 2004 Council meeting with one correction on page eight. In the fifth line of the “Liabilities and Equity” section, the word “liabilities” was changed to “equity.”

Report of the FASB Chairman

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

- The comment letters received on the share-based payment Exposure Draft, the four public roundtable meetings held in Palo Alto and Norwalk, the redeliberations that began in August, and legislation in the U.S. House of Representatives.
- Correspondence from Congressman John D. Dingell of the House Committee on Energy and Commerce on oil reserve issues. The FASB responded by explaining the history of the accounting and disclosures relating to oil reserves.
- EITF Issue No. 03-1, “The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments.” The FASB has issued two proposed FASB Staff Positions on the Issue, one that would defer the effective date for certain parts of EITF 03-1 and the second proposing how to resolve implementation questions about temporary impairment.

- The redeliberations of the four Exposure Drafts relating to short-term international convergence. The FASB expects to issue final Statements in the fourth quarter of 2004 or the first quarter of 2005.
- The joint Board meeting with the IASB on October 19 and 20. The Boards will discuss, among other things, the revenue recognition joint project and the plan for enhancing their conceptual frameworks.
- The decision that the initial public document issued on the revenue recognition project will be a Preliminary Views rather than an Exposure Draft. The FASB is working toward issuing that document in the second half of 2005.
- The decision that the performance reporting project will be a joint project with the IASB. The Boards have formed an international joint advisory group that is planning to hold its initial meeting by the end of 2004. The FASB staff is developing a plan to address certain issues, including whether there should be a single statement of comprehensive income, the issue of recycling, whether to use the direct method for the statement of cash flows, and defining the primary financial statements. It is likely that the first public document will be a Preliminary Views.
- The decision to spend additional time drafting a common Exposure Draft for the joint project on purchase method business combinations, which should be released late in 2004 or early in 2005. The Boards are using the additional time to conduct field visits on the proposals.
- The two roundtable discussions on the fair value measurement Exposure Draft. The Board received 85 comment letters. The purpose of the document is to improve the guidance on measuring fair value, not to create additional requirements for fair value measurements in the financial statements.
- The progress of the project to interpret Statement 143 on asset retirement obligations. Some believe Statement 143 should be amended. The Board will meet with interested constituents before deciding on whether to finalize the Interpretation.

A Council member asked about convergence issues related to the European Commission's consideration of whether to require companies to adopt all or only part of IAS 39, *Financial Instruments: Recognition and Measurement*.

Mr. Herz stated that the European Commission plans to accept most of IAS 39, but there are certain aspects that they proposed deferring and asking the IASB to reconsider, namely, the accounting treatment of hedging. The IASB considers IAS 39 part of IFRS, notwithstanding what the European Commission

might do. The SEC considers that a company that claims to be filing in compliance with IFRS is in compliance with all of it, not only selective parts.

A Council member asked whether the changes made to the EITF processes have been an improvement and if any more changes are expected in the future.

Mr. Herz stated that increased Board involvement in the EITF agenda, meeting discussions, and consensus ratification generally has achieved the Board's goal of improvement. He noted that the Board's work on a codification of U.S. GAAP will have broad implications for the way the Board sets standards and may affect the EITF.

A Council member asked about the status of the project to amend FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*.

Mr. Herz stated that the Board is working on several issues relating to Statement 140 and expects to issue a revised Exposure Draft early in 2005.

Report of the SEC

Ms. Minke-Girard reported on the following matters:

- The status of staffing in the Office of the Chief Accountant, including progress toward filling positions for a valuation specialist, a deputy chief accountant focusing on international matters, and an XBRL specialist.
- The report to Congress, required under the Sarbanes-Oxley Act, on the study of off-balance-sheet activities is expected to be submitted in the fall of 2004.
- The SEC staff is developing guidance on materiality to help eliminate inconsistencies in evaluating materiality. The form of the guidance has not yet been decided. Depending on the form of the guidance, it may be issued for comment.
- The importance of registrants' compliance with Section 404 of the Sarbanes-Oxley Act; the SEC staff is trying to avoid adding new requirements during this time.
- The SEC's Office of Small Business Policy recently held the annual Government-Business Forum on Small Business Capital Formation.

A Council member asked whether there have been any recent developments with respect to disclosure of critical accounting policies.

Ms. Minke-Girard stated that she is not aware of current plans within the SEC to finalize rule making in this area. The Division of Corporation Finance continues to encourage companies to improve disclosures in this area.

A Council member expressed concerns about IAS 39 and asked whether the Office of the Chief Accountant is communicating with the European Commission about the disparate treatment and whether there are mechanisms in place to address potential differences in accounting.

Ms. Minke-Girard stated that the Office of the Chief Accountant is monitoring the process. Form 20-F filers will continue to be required to include a reconciliation to U.S. GAAP if there are differences in accounting.

Report of the PCAOB

Mr. Carmichael reported on the following matters:

- The progress on staffing at the PCAOB, with a continued need for staff in the areas of inspections and audit standard setting.
- The recently released inspection reports on the Big 4 accounting firms and the continuing inspections for the 2004 report.
- The SEC's approval of the standard on auditing documentation.
- The PCAOB's approval of conforming amendments to auditing standard number two.
- The existence of standard-setting projects dealing with communications and relationships with audit committees, engagement quality review (second partner review), independence, and tax services.

Current Financial Reporting Issues

Mr. Swift asked Council members for comments with respect to compliance with Section 404 of Sarbanes-Oxley and other current issues.

Council members expressed the following responses and concerns:

- Preparers generally believe they are on target to meet Section 404 requirements.
- Smaller companies are having more difficulty with Section 404 compliance due to resource constraints and auditor flight.
- Having operational management comply with all internal controls on a "no exceptions" basis is expected to be a challenge, especially in growth industries.

- Companies are unsure of the proper level of documentation; expectations of users, regulators, and legislators are unknown.
- Due to the current demands of Section 404, companies do not have the resources to implement new accounting standards, nor do they have the resources to devote to analyzing Exposure Drafts with comment periods that span the year-end reporting period.
- Companies are delaying implementation of major projects, such as changes to computer systems, until after the fourth quarter because of the need to retest internal controls.
- In deciding on the effective date for the Statement on equity-based compensation, the Board should consider the time required for companies to restructure their compensation packages.

2004 FASAC Survey on the Priorities of the FASB

Ms. Polley presented an overview of the results of the annual survey of the views of FASAC members on the following matters:

- The FASB's priorities
- Future financial reporting issues
- International convergence
- Differential accounting standards for certain entities
- The priority of a codification of U.S. GAAP.

Ms. Polley stated that the projects on revenue recognition, financial performance reporting by business enterprises, and fair value/fair value measurement ranked as the top three priorities for FASAC members. Future financial reporting issues are expected to arise primarily from risks and uncertainties in global capital markets as well as continued issues on revenue recognition.

On the issue of international convergence, more FASAC members would not automatically assign a higher priority to projects that provide the opportunity for convergence. Many Council member respondents believe that the Board's focus primarily should be on standard setting to meet U.S. needs.

On the issue of differential accounting standards for certain entities, the vast majority of respondents believe that the Board should not issue differential standards but expressed support for addressing the issue on a case-by-case basis. Most favored differences in disclosure requirements only, not differences in recognition and measurement criteria.

On the issue of the priority of a codification of U.S. GAAP, most strongly favor the Board's undertaking such an effort. However, some noted that a codification project should not take resources away from the Board's more urgent priorities.

Ms. Polley noted that the Board would consider FASAC's input when it discusses its technical plan for the next six months at an upcoming Board meeting. The full results of the survey will be sent to FASAC members within several weeks.

Ms. Bielstein stated that the Board will discuss the technical plan for October through March in the last week of September. She noted that she expects some staff capacity to be available for new projects when final Statements are issued in the equity-based compensation and short-term convergence projects. Projects the Board is considering include the conceptual framework, phase II of equity-based compensation, consolidation policy, and financial instruments. She stated that the Board is seeking to hire staff with a strong conceptual background to help with the conceptual framework project.

A Council member asked whether the new financing under Sarbanes-Oxley has affected staffing and helped to reduce resource constraints. That member also asked about the budget approval process.

Mr. Herz stated that the staff level has increased from the mid-50s to mid-60s for the professional staff. He stated that the budget is reviewed by the Finance Committee of the FAF Board of Trustees, approved by the full Board of Trustees, and sent to the SEC for review. He noted that the FAF staff works closely with the SEC staff in answering questions about the budget.

The FASB's Conceptual Framework: Relevance and Reliability

Mr. Johnson addressed criticisms some have made about the tradeoffs between relevance and reliability that the Board has made in setting accounting standards involving fair value measures. He explained that FASB Concepts Statement No. 2, *Qualitative Characteristics of Accounting Information*, explicitly rejects the view that reliability should be the dominant characteristic of financial statements. He added that in assessing those tradeoffs, the Board and some of its constituents may have different objectives in mind.

Mr. Johnson stated that some may have misinterpreted the definition of reliability in Concepts Statement 2, and that some seem to equate reliability with precision. He noted that the principal components of reliability are representational faithfulness and verifiability and that the purpose of verification is to provide assurance that accounting measures are representationally faithful. To be representationally faithful, accounting measures or descriptions must reflect economic phenomena and not simply accounting notions. He stated that reliability of certain accounting measures may be lower than is commonly

assumed, particularly if those measures cannot be directly verified but rather only indirectly verified.

Mr. Johnson reiterated the FASB and IASB's plan to move forward on a joint project to converge their conceptual frameworks into a common framework. In this project the Boards likely will try to improve the conceptual guidance on making the tradeoffs between relevance and reliability.

Many Council members expressed support for the reconsideration of the conceptual framework. Others expressed concerns that the project may be a Trojan horse toward full fair value accounting. There was concern about the ability to audit fair value measures that must be estimated. Many of the Council members expressed concern about exposure to litigation.

Council members noted:

- There may be value in presenting both cost and supplemental fair value information in the financial statements.
- Preparers and auditors likely will resist a move toward more relevance and less reliability until the issue of protection from legal liability is solved.
- Companies are more likely to be sued for lack of reliability compared with lack of relevance.
- The Board should reexamine the idea of conservatism when looking at the criteria for tradeoffs between relevance and reliability.
- The Board should understand the end state. What will the financial statements look like? The Board should engage all constituents in making that determination.

Mr. Trott said that neither this project nor the fair value measurement project is intended to move toward more fair value accounting. He noted that the Board wants its constituents to understand the tradeoff between relevance and reliability from the Board's perspective. He stated that one of accounting's biggest problems is the mixed attribute model. The Board has a stated objective of moving financial instruments to fair value, but nothing beyond that. There will continue to be debate about how to make tradeoffs between relevance and reliability.

Mr. Schieneman stated that there is a problem with trying to fit everything into conventional financial statements. He noted that the Board should consider presenting information in different ways based on the information that users need.

A Council member stated that the primary purpose for issuing financial statements is for a company to lower its cost of capital. He stated that

accounting volatility is different from economic volatility and that, eventually, the market can distinguish between the two. However, he noted that it is becoming increasingly difficult to separate accounting volatility from economic volatility.

Fair Value Measurement

Ms. Seidman stated that the objective of the fair value measurement proposal is to establish a consistent framework for how to develop fair value measurements that are currently required under existing accounting pronouncements. She stated that the proposal also would advance the Board's objective to simplify and codify the accounting literature.

Ms. Seidman stated that the FASB has received over 80 comment letters on the Exposure Draft and that respondents have made a significant effort to provide constructive, thoughtful comments on the proposal. She gave a summary of comments that the FASB received in the comment letters and at two public roundtable discussions. Some of the key comments included the following:

- Some believe that the Board should address the relevance versus reliability issue at the concepts level before issuing a final Statement.
- There was general support for the definition of fair value, with several helpful suggestions for clarity from valuation specialists and others.
- Some expressed concerns about the application of the fair value measurement principle to liabilities, in particular, with respect to the requirement that an entity consider the effect of its own credit standing in estimating fair value. Generally, they were concerned about recognizing gains or losses resulting from changes in credit standing, particularly in cases where the gains or losses are not realizable.
- Some valuation professionals asked for clarification about whether an entity's intent should factor into the selection of the valuation premise for nonfinancial assets.
- Some supported the hierarchy as a means of organizing disclosures, but disagreed with its use as a rigid approach to measurement.
- Some raised concerns that there are many reasons why strict adherence to the hierarchy can lead to valuations that do not reflect fair value (or an exchange price).
- Some also raised concerns about cost-benefit issues, indicating that "shortcuts" are used in practice to deal with high-volume transactions like municipal bonds and even used equipment.
- Some suggested that the Board develop a framework for all fair value disclosures, including a reconsideration and integration of existing disclosures.

Ms. Seidman stated that the FASB staff is developing a plan for redeliberations. The Board's goal is to issue a final Statement in the first quarter of 2005.

Several Council members echoed concerns expressed in the comment letters and at the roundtables. Several Council members expressed support for the project.

Mr. Trott stated that there were many requests for the guidance to be less prescriptive.

A Council member stated that the request for less prescriptive guidance is based on the need for flexibility to deal with the unique circumstances that will occur in the process of attempting to estimate fair value.

Uncertain Tax Positions

Mr. Trott stated that the project was added to the Board's agenda primarily in response to SEC concerns about diversity in practice for uncertain tax positions under FASB Statement No. 109, *Accounting for Income Taxes*. He stated that the Board discussed this issue in July 2004 and considered issuing an FASB Staff Position, but decided instead to issue an Interpretation of Statement 109. He summarized the Board's tentative decisions in the project. Other issues still to be considered include how the guidance applies to leveraged leases, certain measurement issues, and effective date.

Several Council members expressed the view that using the threshold for probability from FASB Statement No. 5, *Accounting for Contingencies*, is inappropriate, considering that auditors tend to interpret the probability threshold as 80 percent to 90 percent. Such a high standard would be unworkable in a practical sense. For example, an all-or-nothing situation would result in 100 percent recognition and therefore does not fairly recognize real-world patterns.

A Council member stated that in other projects there is a move from using probable as a recognition criterion to considering probability in measurement, which seems to be opposite of the direction the Board is moving in this project.

Mr. Trott noted that Statement 109 does not use fair value as a basis for measurement. The Board must address the issue within the constraints of Statement 109.

One Council member suggested that the Board address income taxes more broadly to allow for the right solution to the problem, rather than working around the wrong solution.

Several Council members from the user constituency noted that they do not find the income tax disclosures in the footnotes to be particularly helpful. They tend to focus on cash taxes rather than deferred taxes.

Short-Term International Convergence: Income Taxes

Mr. Trott stated that as part of its convergence efforts, the Board is working with the IASB on eliminating differences between Statement 109 and IAS 12, *Income Taxes*. One of the remaining issues is the exception in Statement 109 to the recognition of deferred taxes on the unremitted earnings of foreign subsidiaries. The IASB has tentatively decided to eliminate that exception.

Mr. Trott stated that the FASB has been meeting with tax experts to understand the complexity of calculating the tax effect of the unremitted earnings.

Several Council members expressed concern about trying to make that calculation. They noted that eliminating the exception relating to foreign subsidiaries would have a significant impact on systems and planning aspects of multinational enterprises and may not reflect the economic reality of transactions.

A Council member stated that most users are comfortable with the current reporting if the earnings are permanently reinvested in the foreign subsidiary.

Liability Extinguishment

Mr. Trott stated that one of the threshold issues in the project is to determine when it is appropriate to derecognize a performance obligation when one has a contract to perform. The Board has asked the staff to research whether it is possible to determine when a performance obligation has been satisfied according to the law. Mr. Trott noted that there have been difficulties in determining what law one would look to and what jurisdiction to consider. He asked Council members how they address issues of jurisdiction and applicable law in their current business activities and contracts.

Council members had the following comments:

- Almost all contracts are clear. Occasionally, companies will consult legal counsel when there are questions on whether the contract has been satisfied.
- Most disputes are handled directly with customers; very few end up in court. Legal criteria should not be used for accounting recognition unless it is likely there will be legal proceedings.
- In selling services rather than products, the determination of jurisdiction and what laws will apply is considered before entering into a contract.

Ms. Seidman noted that because the Board had not yet deliberated any issues in the liability extinguishment project, the discussion is very timely. She stated that she hears FASAC members saying that they generally do not look at revenue recognition and performance obligation issues from a legal standpoint. She stated that this discussion is based on a preliminary decision in the revenue recognition project to use the asset-liability approach. The main question is when a liability should be derecognized. She stated that existing GAAP that addresses extinguishment of liabilities appears to base that derecognition on a legal notion. Ms. Seidman stated that in her opinion, one possible outcome after the Board addresses the issues in the liability extinguishment project is that derecognition based on a legal notion should apply to financial liabilities. The Board may decide that nonfinancial liabilities require a different approach.

Codification and Retrieval Project

Mr. Smith described the Board's efforts to date on the codification project. He stated that the FAF Trustees approved the project earlier in September. He noted that the codification would be a topically structured document in both electronic and paper format. It would be a single authoritative compilation of accounting standards that would include everything that is in GAAP today, including AICPA literature. He stated that the goal is to rewrite the guidance into an organized structure so people could find answers more easily. The process is not intended to change GAAP other than to resolve conflicts in existing GAAP.

Mr. Hoey stated that the codification will encompass a single, fully functional, online, real-time database. The system will be designed to make access much simpler than what is available today. He said all information about a topic will be in one place. The system also will allow for tagging GAAP that is in the process of being changed.

Mr. Hoey stated that completion of this project will require a large project team. The team will need people to evaluate existing guidance, synthesize existing guidance within topical sections, and edit and review completed sections.

Mr. Herz stated that the biggest issue is getting a particular topic into a cohesive structure. He said the FASB will be looking for experts in particular topics to help synthesize and integrate the content.

Several Council members expressed strong support for this project. Council members also expressed the following comments:

- GAAP from audit literature, primarily as it relates to other comprehensive bases of accounting (OCBOA), should be brought into the codification effort.
- The database should have archival properties so that practitioners and others can determine what the appropriate accounting was in the past.

- The structure should be tested for usability by those who will use it.

A Council member asked how conflicts in accounting literature would be addressed.

Mr. Smith stated that the FASB would address any differences and that there would be appropriate due process for any changes.

Adjournment

Mr. Swift thanked the Board and Council members for attending the meeting and adjourned the meeting at 3:00 p.m.