



MINUTES OF MEETING

Financial Accounting Standards Advisory Council

March 26, 2002

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

Members Attending

Alan W. Anderson*
Fred D. Anderson
William E. Balhoff

Donald D. Humphreys
David M. Jones
Michael K. Kwatinetz

Robert T. Blakely
Raymond J. Bromark
Susan L. Decker

Alan G. Levin
Edward E. Nusbaum
James A. Parke

Joel S. Demski
Gary P. Fayard
Michael R. Foley

Janet L. Pegg
John F. Richards*
David B. Rickard

Geraldine U. Foster
Kenneth A. Goldman
John M. Guinan

L. Hal Rogero, Jr.
Joseph L. Sclafani
Mary S. Stone

Richard J. Swift, Chairman

* Present for part of the meeting only

Members Not Attending

Barry A. Brooks
Marc E. Lackritz
Philip B. Livingston
Gary M. Pfeiffer

Amy Ripepi
David M. Walker
Michael C. Wilhelm
Stephen G. Ryan

Others Attending

Financial Accounting Standards Board:

Edmund L. Jenkins, Chairman
G. Michael Crooch
John M. Foster
Gary S. Schieneman

Katherine Schipper
Edward W. Trott
John K. Wulff

FASB Staff:

Timothy S. Lucas, Director of Research and Technical Activities
Ronald J. Bossio, Senior Project Manager
L. Todd Johnson, Senior Project Manager
E. Raymond Simpson, Senior Project Manager
Robert C. Wilkins, Senior Project Manager
Carrie Bloomer, Project Manager
Kimberley R. Petrone, Project Manager
Robert L. Finch, Postgraduate Technical Assistant

Others:

Robert C. Butler, Former FASAC Chairman
Philip T. Calder, General Accounting Office
Jackson M. Day, Deputy Chief Accountant, Securities and Exchange
Commission
Teresa S. Polley, Executive Director, FASAC
Peter Wilmot, Vice Chairman, IASB Standards Advisory Council

Introduction and Approval of Minutes

Mr. Swift called the meeting to order at 9:00 a.m. and welcomed the Council, the Board, FASB staff, and guests. He introduced Peter Wilmot, Vice Chairman of the Standards Advisory Council of the International Accounting Standards Board (IASB), and Robert Butler, the former FASAC Chairman.

Council members approved the minutes of the December 4, 2002 Council meeting.

The Role of FASAC as an Advisor to the FASB

Mr. Swift reported on the closed administrative meeting that FASAC held the day before. The purpose of that annual meeting is to evaluate the role, mission, and effectiveness of the Council. He thanked Ed Jenkins for his participation in that meeting.

Mr. Swift stated that at the meeting, Council members agreed that he should write a comment letter on behalf of FASAC to the Financial Accounting Foundation (FAF) about its proposal to change the size of the Board and the number of votes necessary to adopt a standard. The letter would express that the general consensus of FASAC is against the FAF proposal to reduce the number of Board members from seven to five for the following reasons. First, reducing the size of the Board would severely limit the Board's ability to participate in outreach programs such as speeches, seminars, and conferences where the concept of independent, private-sector standard setting is promoted. The consensus of the Council is that a reduction in this activity is not advisable, especially in the present business and political environment. Second, the

internal process of project development at the FASB would be negatively impacted due to decreased timely interaction with members of the FASB staff. Having fewer Board members would place more emphasis on the FASB staff in the development of projects, rather than on the Board, where it belongs. Third, the public may perceive a reduction in the size of the Board as a reduced emphasis on standard setting, rather than an attempt to speed the process.

With respect to the voting requirements, Mr. Swift reported the general consensus of FASAC members that changing from a super majority to a simple majority would be a positive step that could expedite the standard-setting process and is a change for which a precedent exists.

On the issue of shorter comment periods, Mr. Swift reported that some FASAC members hold the view that such a change could negatively impact the ability of smaller entities to participate in the FASB's due process. Smaller firms would not always have the flexibility to devote resources to study and respond to FASB proposals under the shorter time frames suggested.

Mr. Swift reported that Council members strongly recommend that the FASB continue to prioritize projects based on the objective of mitigating risk to financial statement users. He added that the Board should adhere to its conceptual framework, which should be continuously reevaluated.

Codification and Simplification

Mr. Wulff stated that in January the Board agreed to take six actions in response to concerns expressed by constituents about the quantity, complexity, and the lack of retrievability of U.S. accounting literature. Those six actions are:

1. Evaluate the feasibility of issuing less detailed but more principle-based standards
2. Work with the Emerging Issues Task Force (EITF), American Institute of Certified Public Accountants (AICPA), the Securities and Exchange Commission (SEC), and any other rule maker to clearly delineate each organization's respective role and responsibility in the standard-setting process with the objective to streamline standard setting
3. Improve the quality of cost-benefit analyses done as part of the Board's due process
4. Explicitly address all related EITF, AICPA, and SEC literature in connection with issuing all new standards in an attempt to acknowledge that other pertinent literature might apply in a particular circumstance and, where possible, resolve any inconsistencies between new standards and existing literature
5. Include references to all applicable U.S. accounting literature in the FASB's *Current Text* and work with the AICPA and the SEC to develop an online database that would include all U.S. accounting literature in one source

6. Provide support as needed to the SEC in its efforts to modernize financial reporting and disclosure.

Mr. Wulff stated that the objectives of issuing broader, principle-based standards and of defining the roles and responsibilities of the various standard setters raise the possibility of significant change and improvement in future accounting rule making. He added that while those changes could be very positive, they would not come without some pain. He noted that the good news about principle-based standard setting is that the standard should be easier to understand and would offer the potential of better use of the skills of preparers and practitioners in the standard-setting process. He stated that the bad news about principle-based standards is that there likely would be fewer exceptions and safe harbors. Mr. Wulff noted that one of the key drivers of complexity in the current body of literature is pressure from various constituents to build exceptions and safe harbors into accounting standards.

Mr. Wulff stated that to move in the direction of broader, principle-based standards, it is critical to gain acceptance from preparers, auditors, and regulators. To that end, the FASB staff plans to draft an initial framework that delineates the issues that would typically be addressed in a broad, principle-based standard from the issues that would not. He said that this draft would serve as a discussion document for meetings with constituents and other rule makers.

Mr. Wulff stated that principle-based standard setting presupposes the existence of a clear, complete, and consistent conceptual framework. He noted that all of today's standards are principle-based. The problem is that some of those principles are incomplete, inconsistent, or ambiguous. To move in the direction of principle-based standards, the Board will need to commit resources to the completion of the conceptual framework and the resolution of those ambiguities and inconsistencies.

Mr. Humphreys stated that the focus on cost-benefit analysis is welcomed. He added that he hopes the FASB would communicate the results of those analyses early in a project's life so that constituents would be able to understand the costs and benefits associated with the project.

Mr. Wulff asked how the FASB could obtain input from preparers and others earlier in the process.

Mr. Humphreys stated that the FASB could survey constituents for information about the potential costs and benefits of a particular project.

Mr. Foster stated that typically the benefits apply to one group of constituents and the costs apply to another. He added that it is difficult to assign a meaningful number to the costs and benefits.

Mr. Guinan expressed his support for the Board's efforts. He stated that resolving the inconsistencies between new standards and existing literature might help address some concerns about the conceptual framework. He added that some FASB standards pre-date the conceptual framework and that it is appropriate to reevaluate the framework recognizing that the accounting environment has changed since the framework was initially created. He noted that this reevaluation would help to reduce some of the ambiguities in accounting literature and the costs in implementation.

Mr. Bromark asked about the extent to which the Board focuses on the qualitative characteristics of useful information to users and whether there is a process in place to ensure that the standards issued are faithful to those characteristics.

Mr. Wulff stated that the Board tries to understand what is driving the investor's decision-making process and what information is important to that process.

Mr. Schieneman stated that his goal is to increase the input of financial statement users to the extent possible. He added that he has asked the Association for Investment Management and Research (AIMR) to provide the FASB with its conceptual framework so that the FASB could study how the AIMR's framework fits in with the FASB's. He noted that user input is very important early in a project and that the Board is actively pursuing this.

Mr. Nusbaum expressed support for principle-based standards. He added that there is a unique opportunity in the current accounting environment such that changes could be made that were not possible before. He stated that moving in the direction of principle-based standards would allow flexibility in interpretation.

Mr. Al Anderson stated that a long-term culture shift would be necessary to change the mindset of the accounting community and the marketplace from a rule-based mindset to one based on principles.

Ms. Pegg stated that she supports principle-based standards but noted that analysts are concerned that principle-based standards will lead to a lack of consistency and comparability. She added that users should be guided through this transition and that added disclosures should be implemented so that users can get an idea of the reasons for any lack of comparability.

Mr. Wulff stated that the discussion illustrates the dilemma that the Board is facing. On the one hand it makes sense to move ahead quickly to visibly resolve these issues, but on the other hand behavioral changes to the way constituents view the whole standard-setting process are required. He added that it is hard to balance the two dynamics.

Dr. Stone stated that as the FASB moves forward in developing principle-based standards, part of the focus should be on how the Board will respond to requests for EITF and the AICPA's Accounting Standards Executive Committee (AcSEC) to provide interpretative guidance.

Mr. Balhoff stated that when FASAC first started discussing this topic, one of the things said was that well-intentioned, knowledgeable people would inadvertently be in noncompliance with the standards because they are so voluminous, complex, and difficult to retrieve. He emphasized that retrievability is an issue for smaller firms and businesses and should be considered so that accounting information can be disseminated more affordably.

Mr. Blakely asked whether there is an opportunity to collaborate with the IASB in achieving principle-based standards, since the IASB is working toward principle-based standards as well.

Mr. Wilmot stated that the IASB has always had a principle-based approach, but that principle-based accounting is extremely difficult to interpret and apply consistently. He added that some detailed rules are necessary to ensure consistent application. He stated that he believes that the IASB is moving more toward rules than principles.

Mr. Trott stated that standards are not either principle-based or rule-based. He noted that what is difficult is the ability to state clearly the objective of the standard and provide sufficient implementation guidance or detail so that there will be an acceptable level of consistent application. He noted that a balance of principles and rules is required. He stated that the Board has always attempted to find the right balance, which might vary depending upon the subject, the Board, and demands of constituents. He noted that FASB Statements No. 141, *Business Combinations*, and No. 142, *Goodwill and Other Intangible Assets*, are good examples of the attempt to have a principle-based standard with less detailed guidance. He stated that the demands for implementation guidance continue to be quite large. The Board and FASB staff are trying to change some thought patterns both within and outside the FASB to attain a better balance.

Mr. Day stated that everyone has a different idea of what "principle-based" means. He noted that implementation guidance could be principle-based or rule-based. He stated that principle-based standards should contain enough detail so that people would know how to implement them.

Ms. Decker stated that there is a large gray area between a principle-based approach and a rule-based approach. She noted that there has been some progress in recent standards. She suggested that there be a push toward an approach that focuses on the spirit of what is intended by the principle rather

than argue over the semantics of what principle-based means. She added that the accounting industry should be empowered to think and apply judgment to the principles.

Mr. Foster stated that if the FASB is going to move in the direction of principle-based standards, then there has to be a mindset change at every level—auditors, preparers, and the SEC. He noted that a principle-based standard on consolidation policy would be one that says if you control an entity, then you consolidate it. However, constituents have said that they prefer a rule that says that a 50 percent level of ownership requires consolidation.

Mr. Jenkins stated that in a principle-based approach, there are some guidelines that everyone would have to accept. Standards would be conceptually based. There would be no artificial provisions, like permitting the smoothing of the reported results. He stated that much of the complexity in standards comes from attempts to reduce volatility in reported income. He questioned whether everyone would be willing to accept that.

Mr. Fred Anderson suggested that resources be dedicated to the conceptual framework. He stated that the focus should be on the objective of the standard and what is trying to be accomplished. He stated that a move to principle-based standards requires an understanding of the implications for all constituencies and the support of those constituencies.

Mr. Goldman stated that each pronouncement should begin with its theory or objective. He stated that preparers need rules to help determine what is expected and to achieve a consistent interpretation. He added that a major step forward would be to have one definitive source of standards. There are too many sources of accounting rules today.

Mr. Guinan stated that he supports fewer rules and more principles. He added that an emphasis on principles would help auditors avoid situations in which a client says, "Tell me where it says I can't do this." A broad set of guidelines would be subject to interpretation, but that interpretation can be reactive to the substance of a transaction rather than its form. He stated that the opportunity for financial engineering would decrease with standards based more on broad principles.

Mr. Bromark stated that if the objective is to minimize the risk of misstated financial statements, then moving toward conceptually grounded standards shifts the focus from engineered transactions to accounting for the economic substance of transactions. He noted that the risk of inadvertent misstatement in today's environment is significant because of complexity and difficulty in application. He added that there would be more pride in the audit profession if it could bring some judgment and thought to the robust reporting of financial information, rather than only being a source of research.

Guarantor's Accounting and Disclosure Requirements for Guarantees

Mr. Trott stated that the issues addressed in this project originated from the work on special-purpose entities (SPEs), specifically the circumstances in which one party to a transaction provides a guarantee of debt or another element to another party. He added that in those situations, there was little or no accounting for those guarantees or disclosure of the risk that the entity had taken on. Mr. Trott noted that guarantees of all types also occur outside the SPE environment. Given the lack of information in the financial statements on guarantees, the Board decided to address the issue.

Mr. Trott stated that the proposed Interpretation would address the guidance in paragraph 12 of FASB Statement No. 5, *Accounting for Contingencies*, that states that there are certain exposures that should be disclosed even if the probability of loss is remote. He stated that the proposed Interpretation would clarify the types of guarantees that are included and the information that should be disclosed. He noted that the proposed Interpretation would not address the accounting for warranties and some insurance policies.

Mr. Trott stated that the proposed Interpretation would clarify that guarantees consist of two elements. One element of a guarantee is not contingent and that is the obligation to stand ready to act if a particular triggering event occurs. The second element of a guarantee is contingent and that is the possibility that a guarantor will have to act when a particular triggering event occurs. For example, in an insurance contract, the insuring entity receives a premium for its obligation to stand ready; the contingent portion of the obligation would require a payout in the event of the insured's loss. He added that the liability to stand ready would be recognized in the financial statements of the guarantor and the contingent portion of the guarantee would continue to be accounted for under Statement 5.

Mr. Jones asked whether this Interpretation would have impacted Enron's financial statements.

Mr. Trott stated that the Interpretation would have required certain disclosures about the nature of the company's guarantees, including triggering events and exposures.

Mr. Rickard asked about the mechanism to value the obligation to stand ready. He noted that the disclosures would be appropriate but that placing a value on the stand-ready portion of the obligation would be complex and expensive.

Mr. Trott stated that there are established debt guarantee markets that could aid in determining the fair value of the obligation to stand ready.

Mr. Rogero asked about the debit and credit that would be recorded for the obligation to stand ready.

Mr. Trott stated that the Interpretation will provide some specific guidance with respect to the recognition and measurement of the liability but would not address the debit in the transaction because guarantees arise in many different situations and therefore the accounting might differ depending on the situation. Referring to the insurance example used earlier, Mr. Trott stated that the premium on an insurance contract could be amortized into income over the life of the stand-ready period, or the premium could remain as a liability on the balance sheet until the stand-ready period ends. When a triggering event occurs, the guarantor would recognize a loss and remove the liability to stand ready. As another example, when a seller of a large-ticket product sells its product and also issues a guarantee that allows the buyer to obtain financing to purchase the product, a liability would be credited for the amount related to the guarantee. The debit would reduce the revenue for that sale.

Mr. Parke asked how to determine the cost of the guarantee for situations in which a robust marketplace does not exist.

Mr. Trott stated that an entity should determine what other entities charge for similar guarantees. Another alternative is to consider FASB Concepts Statement No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements*, and use a probability-based evaluation, which would be similar to the way an insurance company would determine a premium on a policy.

Mr. Sclafani stated that if the objective is to capture contingencies, then disclosure rather than recognition should be the answer. He added that he is not sure that recognition improves on disclosure.

Mr. Trott stated that GAAP requires that a liability be recognized when it is incurred. He indicated that a liability is incurred when a guarantee is written and that he is unable to justify not recording the liability. He stated that past thinking has viewed a debt guarantee as a loss contingency and assumed that the entire arrangement is contingent. However, he noted that the obligation to stand ready is not contingent.

Mr. Jenkins stated that the proposed Interpretation would highlight that guarantees are not provided for free. He added that the receipt of a premium simplifies the accounting but that embedded guarantees for which a premium is not received should not be ignored. He stated that the proposed Interpretation suggests that the recognition of guarantees should be consistent whether a premium is received or not.

Mr. Fayard stated that while the Board's efforts are conceptually based and theoretically pure, recognizing the stand-ready obligation does not

incrementally benefit financial reporting. He noted that disclosure would be sufficient.

Mr. Levin stated that with respect to the issue of costs versus benefits, disclosure provides the benefits to the users of financial statements at far less cost than accounting recognition.

Ms. Pegg stated that because analysts are concerned with the poor disclosure of guarantees, she believes disclosure would be sufficient.

Mr. Al Anderson suggested splitting the project to address disclosure and recognition separately so that guidance on disclosure can be released in a timely manner.

Mr. Blakely stated that GAAP already provides a mechanism to capture information on contingencies even though there is not quantification in all cases.

Ms. Schipper stated that she believes that FASAC is suggesting that the Board should consider cost-benefit issues in determining whether to require recognition of a material asset or liability.

Consolidations

Mr. Trott stated that the objective of the proposed Interpretation is to determine when one entity should consolidate another entity in circumstances in which the ownership of voting rights in another entity is not relevant. Typically within SPEs, voting rights are not relevant because there is little or no decision making required.

Mr. Trott summarized the provisions of the proposed Interpretation, noting that it would require identification of the primary beneficiary of the SPE and that the primary beneficiary of the SPE would consolidate the SPE, unless the SPE has sufficient independent economic substance to be given separate accounting recognition. Mr. Trott then described the type of investment that would be required for an SPE to be an independent entity. Among other things, there must be a minimum level of equity investment that is 10 percent of the total capital of the SPE.

Mr. Trott stated that the Board has not completed its deliberations on the proposed Interpretation and is addressing multiple seller/lessee arrangements as well as other types of conduits.

Mr. Nusbaum stated that he supports the Board's efforts to address the issues on a timely basis. He recommended that the Board consider removing private companies from the scope of the proposed Interpretation.

Mr. Balhoff stated that most private companies do not know they have SPEs and that many private companies form SPEs for tax purposes. He encouraged the Board to communicate with the AICPA's Technical Issues Committee to receive input on the impact on private companies.

Mr. Foley stated that the issuance of the proposed guidance would be helpful to the credit rating agencies. He asked about how the Board decided on using 10 percent as the minimum equity investment required.

Mr. Trott stated that the 10 percent minimum is an arbitrary amount developed out of concern that a principle-based approach to determining an adequate investment level would not be operational.

Mr. Rickard stated that he supports the project and encourages the Board to issue the guidance as soon as possible. He suggested that the Board also consider increased disclosure. As an investor, he would like to know whether a company makes extensive use of SPEs. He noted that the 10 percent minimum is rule-based guidance, but that some guidance is needed.

Mr. Bromark stated that the determination of the appropriate level of equity ownership should be left to the judgment of the auditor and preparer rather than being determined by bright-line guidance. He added that similar judgment is applied in practice in other areas.

Mr. Guinan stated that he also favors using presumptions rather than the 10 percent minimum but noted that the 10 percent minimum would be helpful until the broad standard on consolidations is completed. He questioned whether 10 percent is the appropriate level of ownership.

Mr. Parke asked whether the control model in FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, would create conflicts with the risks-and-rewards model proposed for SPEs.

Mr. Trott stated that some anomalies might result and that the Board would study the intersection of Statement 140 with the proposed Interpretation.

Mr. Blakely encouraged the Board to move quickly. He stated that there is an implementation issue for noninvestment-grade issuers whose debt covenants will be violated by this proposed Interpretation. He suggested that the Board consider this in finalizing the Interpretation.

Ms. Decker stated that additional guidance on determining the primary beneficiary would be helpful.

Mr. Foley stated that the proposed Interpretation would be a significant step forward in addressing SPEs and would capture a vast majority of the problem. He noted that it would be unfortunate if the bright-line rule of 10 percent resulted in some SPEs avoiding consolidation.

Report of the FASB Chairman

Mr. Jenkins stated that the Board is undertaking broad-based strategic planning efforts. The Board and several FASB staff members participated in two days of offsite meetings to discuss strategic planning. Mr. Jenkins reported that the group made significant progress on the issue of where financial reporting should be in 10 years and the strategies that would lead the FASB toward that goal. He stated that one of the most important objectives identified is to work on the FASB's conceptual framework, which is consistent with Council's recommendation.

Mr. Jenkins stated that he testified before the Subcommittee on Commerce, Trade, and Consumer Protection of the Committee on Energy and Commerce. Council members have received a copy of that testimony. Mr. Jenkins added that the FASB continues to work closely with members of Congress and their staffs as they consider and develop proposed legislation as a result of the Enron situation.

Mr. Jenkins stated that the Board appreciates Council's input on the FAF Trustees' proposal to reduce the size of the Board. He reminded Council members about the comment letter deadline of April 17.

Mr. Jenkins stated that a reorganization of the management structure of the FASB staff is under way. He noted that the organizational structure will change from a vertical structure to a horizontal one. The Director of Research and Technical Activities position will be divided into three separate positions. He stated that the change in structure would allow more of an opportunity for certain areas to have priority, particularly planning and staff development. Mr. Jenkins noted that two of the three positions have been filled and that the FASB is looking for candidates for the third position. He stated that Tim Lucas, the current Director of Research and Technical Activities, would leave the FASB on April 30, 2002. He thanked Mr. Lucas for his outstanding leadership during his 14-year association with the FASB.

Remarks from the Vice Chairman of the IASB Standards Advisory Council

Mr. Wilmot stated that the IASB Standards Advisory Council (SAC) is modeled after FASAC. The SAC has 44 members: 14 auditors, 8 users/analysts, 12 preparers, 3 academics, 5 standard setters, and 2 regulators.

Mr. Wilmot stated that there are varying perceptions of the role of the SAC. He added that the SAC has determined that it is an advisory body and therefore does not vote on accounting issues. He stated that the SAC tries to limit technical input to matters of principle and the IASB is free to accept or reject that advice. He noted that there has been some concern among the IASB that the SAC would become a second standard-setting body but those concerns have been resolved.

With regard to policy and procedures, there is a view among the SAC members that the SAC views on the agenda and the prioritization of projects should be persuasive. Mr. Wilmot stated that the SAC currently does not have an annual survey to gather input from the SAC members on projects and priorities but that the SAC intends to use a survey in the future. He added that the agenda committee of the SAC is modeled after FASAC where input on the agenda is provided during a conference call.

Mr. Wilmot stated that the SAC and the IASB have some key challenges going forward. He added that convergence continues to be an initiative but noted that convergence to some means convergence to U.S. GAAP. While some hold that view, he stated that the objective is to converge to the highest quality standards. Mr. Wilmot noted that another issue facing the IASB and the SAC is the adoption of fair value. He stated that many SAC members, especially those from developing countries, view a move from historical cost to fair value with some trepidation. He noted that to move toward that initiative, much work needs to be done to explain that fair value accounting is a better alternative.

Mr. Wilmot stated that another issue to be considered is the accounting by small- and medium-sized enterprises and by enterprises in developing countries. He noted that international accounting standards are used mostly in developed countries, rather than developing countries.

Mr. Wilmot stated that the Enron situation has caused the SAC to consider the way standards are set, whether standards are operational, and whether the standards are being applied correctly. He stated that the enforcement of IASB standards continues to be an issue and noted that it is essential for the standards to be properly implemented and monitored.

Mr. Leisenring added that several former FASAC members are now members of the SAC.

Mr. Humphreys stated that many in developed countries, not only those from developing countries, view a move from historical cost to fair value with trepidation.

Report on International Activities

Mr. Crooch stated that the FASB continues to monitor and participate in activities to foster convergence. The FASB is working jointly with the IASB on the second phase of business combinations. The FASB is leading the project on purchase method procedures, and the IASB is leading the project on fresh-start accounting. He noted that progress on those joint projects has slowed due to the IASB's continuing deliberations on the first phase of its project on business combinations.

Mr. Crooch stated that the FASB continues to develop policies for following IASB projects, specifically those for which the FASB is not directly participating. One of the issues to be addressed is monitoring the activities of the IASB's International Financial Reporting Interpretations Committee (IFRIC) to determine whether its guidance agrees with EITF guidance. Mr. Crooch noted the importance of monitoring and achieving convergence on the decisions reached by those two bodies.

Report of the SEC

Mr. Day stated that the SEC is supportive of the President's plan related to financial reporting, disclosure, and the accounting industry (a description is available on the White House website, www.whitehouse.gov). He noted that the plan discusses initiatives for more timely accounting information, more accountability of corporate officers, a stronger independent auditing system, and a more responsive standard-setting process.

Mr. Day stated that the SEC recently issued three new Financial Reporting Releases. FR 59 addresses pro forma information and, among other things, reminds registrants that the antifraud provisions of the securities laws apply to pro forma information. FR 60 addresses critical accounting policies and encourages registrants to include in their MD&A explanations of their "critical accounting policies," the judgments and uncertainties affecting the application of those policies, and the likelihood that materially different amounts would be reported under different conditions or using different assumptions. FR 61 addresses MD&A disclosures and encourages registrants to provide more information about liquidity and capital resources including off-balance-sheet arrangements, contingencies, SPEs, related parties, and fair value estimates in energy trading.

Mr. Day encouraged Council to read SEC Chief Accountant Robert K. Herdman's February 14, 2002 testimony on standard setting and SEC Chairman Harvey L. Pitt's March 21, 2002 testimony on accounting and investor protection issues.

Mr. Day stated that Mr. Herdman's testimony discusses whether standard setting is working properly and what needs to be done to improve it. The testimony acknowledges that standard setting in the United States is the best in the world but that it can and should be improved. The testimony expresses Mr. Herdman's view that when done properly, the private sector is the best place for standard setting. Areas that need to be improved in the standard-setting process include the timeliness of the process and the management of resources. Mr. Herdman's testimony notes that the SEC should have input on the FASB's agenda decisions and that when the SEC recommends accounting issues to be addressed, those recommendations should be addressed with top priority by the appropriate standard setter, whether the FASB, the EITF, or AcSEC.

Mr. Day stated that Chairman Pitt's testimony discusses working proposals for all the issues that the Commission is facing with regard to recent market events. Those issues include disclosures that go beyond the financial statements, improving oversight of the accounting profession, and improving the standard-setting process. The testimony also discusses the funding of the FASB and suggests that it should be involuntary to dispel the optic that funding influences the FASB's actions.

Mr. Humphreys asked for a confirmation on whether Mr. Herdman's comment at a Financial Executives International meeting suggests that there is currently a need for an accounting standard on revenue recognition.

Mr. Day stated that there is a need for a broad-based standard on revenue recognition. He added that guidance is also needed in other areas, including SPEs and aspects of the liabilities and equity project.

Mr. Foster asked whether the Commission would begin to establish an accounting oversight body prior to the enactment of legislation.

Mr. Day stated that Chairman Pitt's testimony expresses the belief that the SEC can establish the body without legislation.

Financial Performance Reporting

Mr. Schieneman stated that the Board added a project on reporting financial performance to its agenda in October. The objective of the project is to improve the usefulness of information that is displayed in the financial statements. The project focuses on the form, content, classification, and aggregation of the information in the financial statements. He noted that the Board rejected a broader scope that would have defined selected metrics and required that certain metrics be included in the financial statement disclosures.

Mr. Schieneman stated that as a first step, Board and FASB staff members have interviewed users of financial statements. The focus of the

interviews was to determine how financial information is currently being used and to gather suggestions for improvements. He added that the interviews revealed that there is a general satisfaction with the way financial information is currently displayed in financial statements and that there is not a great demand for sweeping changes. He stated that the interviews revealed that operating free cash flow and operating profits are the most commonly used data to measure performance; however, the definitions of those terms varied. He noted that net income is not ignored and in certain sectors it is used as the performance measure. He stated, however, that users generally make adjustments to net income and that their intent is to determine normalized or sustainable profits. He added that there is minimal demand for comprehensive income.

Mr. Schieneman stated that cash flow is an important metric but there is not a consistent definition of cash flow. He stated that most users believe that the information provided using the direct method under FASB Statement No. 95, *Statement of Cash Flows*, would be more informative. Users also requested that capital expenditures be separated into maintenance and expansion expenditures. He added that the users also suggested more disclosures on debt and risk exposures, detailed revenue and cost disclosures, more disaggregation, and greater comparability between quarterly and annual reporting (for example, quarterly disclosure of the amount recognized in the period for net pension costs).

Mr. Schieneman stated that a task force meeting was held in February to discuss the user interviews. Task force members generally have no appetite for rules in this area and would prefer the Board to focus on broad concepts for financial statement display.

Mr. Bossio clarified that the direct method of reporting cash flows from operating activities is desired by users in addition to, not a substitute for, the reconciliation to net income provided by the indirect method of reporting cash flows.

Mr. Kwatinetz stated that there is a discrepancy between what analysts report as earnings and what GAAP reports as earnings. He suggested that the FASB take charge of narrowing the gap between pro forma earnings and GAAP earnings.

Mr. Schieneman stated that this project would not define pro forma earnings and noted that the FASB has no authority over what companies report in press releases.

Mr. Wulff asked whether it would be helpful to develop various subtotals within the income statement or to define EBITDA.

Mr. Kwatinetz stated that it would be helpful to define the items that would provide predictive value to the users of financial statements.

Ms. Decker suggested that the Board develop a definition of EBITDA and free cash flow and leave the normalization of one-time items to users.

Mr. Humphreys encouraged the Board to harmonize its work on operating earnings with the work that Standard & Poor's is doing in that area. He added that the direct method of reporting cash flows would require added expense and significant system modifications to accommodate this request.

Mr. Schieneman stated that the Board has not yet considered whether to require the direct method.

Mr. Humphreys asked whether actuarial reviews would be required on a quarterly basis for pension expense to bring more comparability to quarterly and annual reporting.

Mr. Schieneman stated that more frequent actuarial reviews would not be required because the focus is on pension expense rather than the pension liability.

Mr. Rogero stated that the pension numbers would be virtually the same each quarter, so he questioned the value of that information. With regard to capital expenditures, he noted that in addition to expansion and maintenance expenditures, there are other categories of expenditures, such as those that are environmentally mandated and those that are made for cost effectiveness. He stated that would be difficult to separate expenditures into the appropriate category.

Mr. Rickard stated that his company does not currently use maintenance and expansion as terminology to describe capital expenditures. He suggested that the Board would have to provide implementation guidance to foster consistency in making such judgmental separations.

On the issue of costs of the direct method, Mr. Foster noted that in his experience at Compaq Computer Corporation, a cash flow statement prepared under the direct method required more effort the first time it was done, but after that it did not require significant additional work. He stated that Compaq operated in 12 different currencies and had subsidiaries all over the world.

Mr. Nusbaum agreed that the direct method is not costly to implement. He stated that the Board is moving the project in the right direction by requesting input from users.

Mr. Levin stated that the costs to develop a direct method cash flow statement depend on the size of the company and the number of currencies in which it operates. He added that a direct cash flow method would require significant system modifications for his company, and the costs of a direct method cash flow statement should not be underestimated.

Mr. Leisenring asked whether the costs associated with the direct method relate to operating activities or to financing and investing activities.

Mr. Levin stated that the more centralized the treasury function of a company, the lower the costs associated with developing direct method information for cash flows from investing and financing activities. He added that the operational side is more complex.

Ms. Pegg stated that the direct method cash flow statement helps the user focus on the quality of a company's earnings. She noted that the direct method helps the user understand the inflows and outflows of a company better than a net number does. She stated that more users are attempting to convert indirect cash flow statements to the direct method.

Mr. Goldman stated that he uses the direct method weekly to manage his company's cash flow. He suggested that the Board study the statement of cash flows to see if more relevant information would be provided if the statement were based on cash, cash equivalents, and short-term investments, rather than only cash and cash equivalents. He stated that he would favor enhancing the current statement and looking at the ability to add the direct method.

Mr. Foley stated that users would benefit from the direct method and that the rating agencies focus on cash flow because cash flow repays debt obligations.

Mr. Fred Anderson stated that he supports a requirement for the direct method because there are internal benefits for managing and forecasting cash and it gives users the ability to make pro forma adjustments on their own.

Mr. Schieneman stated that another complaint about the cash flow statement is the "other" classification. He added that users are concerned about what is included in that category. He noted that the direct method might alleviate the concerns with the other category.

Issues Related to the Recognition of Revenues and Liabilities

Mr. Johnson stated that in January 2002, the Board issued a proposal discussing a proposed FASB project to address the recognition of revenues and liabilities in financial statements. The comment deadline for the proposal is March 29, 2002. To date, the FASB staff has received three comment letters.

Mr. Johnson stated that the FASB staff will prepare an analysis of the letters. After considering the analysis, the Board will decide (1) whether to add the project to the agenda and, if added, (2) what the scope of the project should be.

Mr. Johnson stated that no general standard on revenue recognition exists. The guidance that does exist focuses on specific industries or transactions and was developed on an ad hoc basis, so inconsistencies exist. Mr. Johnson stated that broad conceptual guidance exists in the FASB's Concepts Statements but that guidance is difficult to operationalize and is not entirely internally consistent. The SEC attempted to fill the gap between the broad guidance and specific industry guidance with Staff Accounting Bulletin No. 101, *Revenue Recognition in Financial Statements*. However, SAB 101 applies only to public companies. Moreover, because SAB 101 is based on the FASB's revenue recognition concepts, it is subject to the shortcomings of those concepts. Mr. Johnson stated that the Board therefore has been urged to develop a general standard on revenue recognition.

Mr. Johnson stated that questions on liability recognition are also increasing. He noted that the Board itself has encountered difficult liability issues in several projects. Some of those difficulties stem from inadequacies in the Board's Concepts Statements. In particular, the liabilities definition needs to be clarified, and the guidance for recognizing liabilities needs to be improved.

Mr. Johnson stated that issues involving revenue and liability recognition are not unique to the United States. The United Kingdom's Accounting Standards Board (ASB) has undertaken a project on revenue recognition. The ASB issued a discussion paper, *Revenue Recognition*, in July 2001 and received about 50 comment letters on the proposal. The ASB is in the process of analyzing those letters. He noted that the ASB plans to develop a single accounting standard that establishes general principles of revenue recognition that are applicable to all entities. In addition, the IASB has indicated that it likely will consider adding to its agenda a project on revenue and liability recognition.

Mr. Guinan stated that the Board should undertake a revenue recognition project. He expressed concern that the project, as proposed, is too broad and will take too long to be completed. He suggested that the Board consider separating revenue and liability recognition into two projects.

Mr. Jenkins asked how the Board could separate the two areas given that they are interrelated.

Mr. Guinan stated that the credit on the balance sheet could be labeled unearned revenue and subsequently readdressed to determine the appropriate label.

Mr. Foster stated that it is dangerous to move forward in addressing revenue recognition without also addressing the definition of a liability.

Dr. Stone asked whether it would be possible to have a project on revenues and a project on liabilities at the same time.

Mr. Jenkins stated that the FASB is working to obtain resources to work on this project. He added that one of the accounting firms will provide an additional practice fellow to work on revenue recognition issues full-time. A part-time consultant also will be provided.

Mr. Wulff stated that he believes the Board would like to logically separate this project into manageable parts if it is possible. He added that ideas from FASAC members on how to separate the project are welcome.

Mr. Day stated that segmenting the project to issue timely guidance on revenue recognition is critical. He added that initially addressing revenue recognition might help to later address liability recognition.

Dr. Demski stated that the fundamental key to accrual accounting is recognition, given that accountants are in the business of providing information through accruals. Revenues and liabilities are secondary to the fundamental issue. He stated that this project should be viewed in terms of recognition and not in terms of revenues and liabilities. The project should focus on what gives GAAP its comparative advantage.

Mr. Fred Anderson asked whether the project was a candidate for a joint project with the IASB.

Mr. Johnson stated that the IASB presently does not have the resources to undertake a joint project given its current agenda.

Mr. Jenkins added that the FASB and IASB are in the early days of learning how to work together on projects. He noted that there are limited resources at each national standard setter and the IASB. He stated that the IASB is already working on other joint projects with the FASB and the ASB.

Mr. Guinan stated that the Board should prioritize this project above some of its other agenda items.

Adjournment

Mr. Swift thanked Council members for their participation. He adjourned the meeting at 2:40 p.m.