

FASB User Advisory Council
MINUTES OF THE MEETING
March 8, 2005

The FASB User Advisory Council met at the New York Helmsley Hotel in New York City.

Members Present

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| Jeremy Bean | Michelle Kaufman |
| Ann Duignan | Janet Pegg |
| Robert Ehudin | Steve Percoco |
| Allison Emmerich | Adam Quinton |
| Robert Freidman | Rick Sherlund |
| Chuck Hill | Damon Silvers |
| Gregory Jonas | Scott Sprinzen |
| Joe Joseph | James Wei |

Members Absent

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| Jane Adams | Bill Mann |
| Gary Black | Elizabeth Mooney |
| Stuart Coco | Barry Nelson |
| Diane D'Erasmus | John Richards |
| Betsy Graseck | Austin Rogers |
| Richard Greenwood | Linda Selbach |
| Neville Grusd | Robert Sharps |
| Trevor Harris | Rita Spitz |
| Joseph Higgins | Robert Treanor |
| Adam Hurwich | |

Others Attending

Financial Accounting Standards Board:

Robert H. Herz, Chairman
George J. Batavick, Board Member
G. Michael Crooch, Board Member
Katherine Schipper, Board Member
Leslie F. Seidman, Board Member
Donald M. Young, Board Member
Suzanne Q. Bielstein, Director of Major Projects and Technical Activities
Lawrence W. Smith, Director of Technical Application and Implementation Activities
Michael A. Kramer, Postgraduate Technical Assistant

Others:

Douglas R. Carmichael, Chief Auditor, Public Company Accounting Oversight Board
 James J. Leisenring, Board Member, International Accounting Standards Board
 Teresa S. Polley, Executive Director, Financial Accounting Standards Advisory Council
 Gary Schieneman, Former FASB Board Member, Vera Global Partners
 Richard J. Swift, Chairman, Financial Accounting Standards Advisory Council
 Scott Taub, Deputy Chief Accountant, U.S. Securities and Exchange Commission

Introduction

Mr. Young, who chaired the meeting, called the meeting to order at 9:00 a.m. and welcomed members of the Council, members of the Board and the FASB staff, and observers. He thanked the Council members for attending and noted that the purpose of the meeting is for the Council to give the Board input on users' needs in the financial reporting process. He thanked Mr. Schieneman for his work to create the User Advisory Council during his tenure as an FASB Board member. He then introduced Mr. Herz to give an update on recent FASB activities.

Report of the FASB Chairman

Mr. Herz first reviewed the key objectives of the Board. Those objectives are to improve accounting standards for better financial information, to facilitate an overall simplification of the standards-setting process and the GAAP literature, and to further international convergence. When adding a project to the Board's agenda, each of those three objectives is heavily considered. Input from users is very beneficial and all feedback is much appreciated.

Mr. Herz then reported on the following technical activities:

- In December, the Board issued FASB Statement No. 123 (revised 2004), *Share-Based Payment*. The Board also issued three narrower-scope international convergence Statements, FASB Statements No. 151, *Inventory Costs*, No. 152, *Accounting for Real Estate Time-Sharing Transactions*, and No. 153, *Exchanges of Nonmonetary Assets*.
- The Board addressed several tax issues raised by the American Jobs Creation Act of 2004. The Board provided guidance on how to account for the benefits given by the Act, the qualified production activities credit. The Board also provided guidance for the one-time break on repatriating assets and accounting for its tax consequences.
- The Board added a joint project with the IASB on the conceptual framework. That project will address unresolved issues and create a common framework between both Boards. The first step is to publish technical communications documents about the project. The first document, which is more technical, will explain the key issues that will be considered in the project, including potential tradeoffs. The second document is less technical and is an executive-style brief.
- The Joint International Group on the financial performance reporting project met recently in London. This is a user-driven project to disaggregate and improve display of financial information.

- The business combinations project is close to issuing joint Exposure Drafts with the IASB on purchase method procedures and noncontrolling interests.

Mr. Herz commented on the significance of January 1, 2005, which was the implementation date for international standards in the European Union countries and others around the world. He noted that the changes required to convert from national standards to more capital-markets-based international standards are significant.

Mr. Herz described the Board's codification project, which is an effort to take existing U.S. GAAP literature and restructure it in a more organized fashion. It is a massive, but necessary, undertaking that will ultimately make it easier for preparers, auditors, and others to research accounting literature by specific topic.

Mr. Herz stated that an AICPA Task Force is studying the issue of whether general-purpose GAAP financial statements meet the financial reporting needs of constituents of that reporting. That Task Force surveyed users, who believe that existing GAAP financial statements have value and are cost-beneficial overall, but that may not be the case in all instances. There is a potentially disturbing trend of increasing departures from GAAP in auditor reports. The Board and the AICPA have agreed to explore the issue further. User input on this issue will be helpful.

Report from the SEC

Mr. Taub reported on current activities in the Office of the Chief Accountant. The OCA staff is preparing implementation guidance on Statement 123(R). The SEC staff hopes to address the interaction of Statement 123(R) with SEC rules such as ASR 268 and non-GAAP measures. Part of the reason for issuing the guidance is to clarify the SEC staff's expectations on how registrants should implement the standard. Mr. Taub noted that the SEC staff has received questions about estimating volatility, using implied and historical volatilities, and adjusting historical volatility. Other questions relate to valuation methods and disclosures if an entity changes methods.

Mr. Taub noted that the report on off-balance-sheet transactions is the largest remaining task from Sarbanes-Oxley. The report likely will be fairly broad and include recommendations for improvement that affect various parties throughout the financial reporting community.

Mr. Taub noted that the SEC staff also is working on guidance regarding materiality. The SEC staff is interested in improving consistency in this area.

The SEC will hold a roundtable meeting in April about Section 404 compliance. Some have said that the costs are too high and are higher than originally estimated. Much of the roundtable will focus on the drivers of those costs.

Liabilities and Equity

Ms. Schipper described some of the issues that the Board is addressing in the liabilities and equity project. She noted that the Board will reconsider the definitions of liabilities and equity in this project. The Board also will define multicomponent versus single component instruments and will reconsider the measurement and display of

instruments. Ms. Schipper noted that an overarching objective is to achieve convergence with the IASB.

Ms. Schipper described the Board's tentative decisions that define settlement characteristic, direct ownership relationship, and indirect ownership relationship. She summarized the Board's proposed changes to classifications. For example, an instrument that lacks a settlement characteristic is equity. An instrument that establishes a direct ownership relationship is equity, even for mandatorily redeemable common shares. An instrument that establishes an indirect ownership relationship is equity if its settlement establishes a direct ownership relationship.

One Council member noted that a share repurchase from put options would not currently hit the income statement but would under the new guidance.

Ms. Seidman stated that if the instrument is similar to a derivative, with a variable amount, it would be marked to market. When the amount is fixed, it would be treated more like a debt instrument with interest payments.

The discussion then focused on the issue of changes in an entity's own share price affecting the income statement. A Council member expressed concern about the prospect of running changes in stock price through the income statement. He noted that in some situations, it may be unavoidable, but there is the potential to mislead investors by creating a circular process that can be manipulated. He suggested that the Board discuss safeguards and explore the potential for abuses during its deliberations.

The discussion then turned to the extent to which liquidity demands should drive classification. A Council member stated that classification depends on who is using the information. Different users will find different information most appropriate. An equity holder might prefer a different classification of those instruments than a debt holder. A display that makes solvency obligations transparent would be beneficial.

Ms. Schipper noted that if more instruments are classified as liabilities and remeasured, more changes in the entity's own share price would affect the income statement. One solution is for changes in the fair value of instruments indexed to the entity's own shares to be sequestered and labeled in the financial statements so that the information is transparent.

Some thought that Ms. Schipper's suggestion might be a good starting point. Others continued to express concerns with marking liabilities to fair value.

A Council member noted the difficulty of developing one set of rules to address many different objectives. He suggested developing a framework that would allow flexibility in financial reporting with increased disclosures. He stated that the concept of a mezzanine section may have merit.

Another Council member stated that having one set of rules would work provided that analysts came to a consensus on how to treat specific types of instruments.

Managing Changes to Financial Reporting

Ms. Seidman described the mission of the FASB and noted that one of the Board's goals is to improve the overall usefulness of financial information. She stated

that the Board is expected to respond promptly to changes in the economic environment and determine deficiencies in financial reporting. International convergence also is increasingly important.

Ms. Seidman noted that the Board generally takes an incremental approach to financial reporting changes to respond to new developments and recently identified problems. For example, because of an urgent need for guidance, the Board decided to address consolidation issues for special-purpose entities rather than address consolidation policy more broadly. A “big bang” approach is appropriate when the Board deals comprehensively with an issue, such as the liabilities and equity project. Ms. Seidman noted that the Board determines the approach to use on an issue-by-issue basis and weighs the benefits of promulgating evolutionary versus revolutionary changes.

There are costs associated with both types of changes, but they differ. For incremental changes, the Board sometimes must compromise or make scope exceptions to provide guidance quickly. Incremental changes can result in serial or sequential decisions that create a complex, and sometimes inconsistent, set of rules. Those rules may be more cohesive if reviewed and modified simultaneously in a comprehensive, big bang project.

The big-bang approach allows the Board to address issues more comprehensively, which may result in all similar transactions being treated in the same way using the same model. The need for subsequent changes to the accounting literature may be reduced. The downside is that it takes much longer to address issues, and the breadth of the project can be unwieldy and unworkable.

Ms. Seidman presented two examples: finite risk policies and pensions. She described how the Board’s approach to each of those examples might differ using an incremental approach versus a big-bang approach. She asked for Council members’ input on how users weigh the trade-off between the need for timely improvements against the potential for complexity and a lack of comparability that may arise from incremental solutions. She also asked if users would be willing to wait for and absorb comprehensive changes, and if there are any other areas of accounting that would benefit from undergoing a comprehensive review.

Council members expressed the following views:

- Generally speaking, the Board should look at everything broadly. Financial reporting is always changing and analysts are subject to fads and current trends. Therefore, incremental changes may not be the best response.
- Constituents are better served by comprehensive guidance than by substantial inconsistencies that may arise from incremental solutions. The Board should weigh the costs and benefits of an incremental versus big-bang approach on a project-by-project basis.
- The conceptual framework is the best model for making comprehensive changes. In the 1980s, no one realized the impact that the conceptual framework would have on financial reporting. The framework is the true big bang, but it permeates over a great length of time. Working with smaller issues and incremental solutions is not

mutually exclusive to also working on comprehensive changes and on the big bang of the conceptual framework.

- With any issue, it is important to increase transparency so that users can adjust their calculations and understand assumptions. The analyst community should have a mechanism to raise issues when there is not enough disclosure. Even if the financial statements are not perfect, increased disclosure helps analysts ask the right questions and look harder at issues.
- Convergence issues raise a larger concern when managing changes in financial reporting. Convergence is easier to achieve if the IASB and FASB participate in big-bang joint projects, but that will slow down the standard-setting process. Investors do not want to wait for standard setters to reach agreement with each other before they deal with abusive situations in financial reporting. In addition, convergence may not always be the best approach. For example, American pension systems are very different from European plans and others governed by international standards.
- Pension accounting has major systemic issues and is materially distorting financial statements. An incremental approach and a big-bang approach may not necessarily be mutually exclusive. Several intermediate fixes would be very useful while simultaneously working on a more comprehensive project.
- Statement 87 was carefully thought out, well-defined, and appropriate for pension accounting at the time, but things have changed. Earlier this decade, when the market was down, many companies were uncomfortable with Statement 87. If the market goes up, the same companies will have fewer issues with pension accounting. There is at least a need for incremental change, but the Board should undertake big-bang changes if there have been major changes in the underlying business model and comprehensive change is needed to fix all of the problems. Both companies and investors would be happy to have a comprehensive fix to pension accounting. In addition, the Board should consider addressing pension and OPEB accounting together, because they have very similar underlying economics.
- The issue of finite risk policies is an isolated problem that has arisen within the essentially healthy paradigm of insurance accounting. Investors should not have to wait for an unnecessary reconsideration of the entire insurance model to deal with this narrow issue. The narrow problem of disguising financing as insurance should be eliminated with an incremental solution.
- Lease accounting could benefit from a comprehensive review as it currently is complex and not intuitive. The concept of operating leases is outdated and was a way to keep liabilities off the balance sheet.

Mr. Crooch stated that his inclination always has been toward an incremental approach because of the disruption that a big bang creates. Before a big-bang project is added to the agenda, the Board should weigh the benefits against the costs of disruption in the capital markets. The benefit needs to be at least equal to this disruption. A pervasive problem must exist before starting a big-bang project, and the major focus of the Board should be to provide users with the best information so they can do their job.

Revenue Recognition

Mr. Tovey stated that various constituents have different views on what is wrong with revenue recognition. He noted that in the FASAC survey for the last several years, FASAC members ranked revenue recognition as a top priority for the Board to address. He noted that recent research has concluded that revenue-related issues are the top reason for restatements.

Mr. Tovey stated that existing revenue recognition guidance is quirky and complex. There are holes, gaps, and conflicts in the accounting literature. He noted that some of the current authoritative literature on revenue recognition was written in 1933 and 1934 and did not contemplate the types of transactions that give rise to revenue recognition issues. Mr. Tovey referred to the earlier discussion on incremental change versus a big-bang approach and asked Council members what approach the Board should use in revenue recognition.

Council members expressed the following views:

- There would be little downside to doing a big-bang project. The Board should not be overly concerned about a disruption in the capital markets from a big-bang approach to revenue recognition. The Board does not work on projects in a vacuum. Information is available to understand what is happening at the Board. That information gets into the marketplace, and analysts will use that information.
- There is not a need for a big-bang project to deal with revenue recognition. Most users work within specific industries, so a patchwork of standards is not a problem provided there is uniformity within an industry.
- Many of the revenue recognition problems highlighted in the market relate to outright fraud, an issue that cannot be solved by accounting standards. The Board needs to distinguish between the need for new rules and the need for enforcement. The general area of revenue recognition is not fundamentally flawed.
- There are more immediate concerns for the Board to address than revenue recognition, such as the conceptual framework and pension accounting.
- A new model for revenue recognition may create more problems and would not necessarily result in something better than the current system. The Board should focus on the gaps in the accounting literature, such as service transactions.
- Accounting policy footnotes generally are robust enough for analysts to discern revenue recognition differences between companies within an industry. If the disclosures are not sufficient, it is easy to call the company to obtain the appropriate information.
- The Board should consider what package of information would be most useful for users to best predict future revenue. Analysts are looking for information about unit sales, better disaggregation of revenue streams, and disclosure of market share.

Adjournment

At 12:30 p.m., Mr. Young closed the meeting to public observation. The Council adjourned for lunch and a working session to discuss how the User Advisory Council can best provide input to the Board. Mr. Young adjourned the meeting at 1:30 p.m.