



MINUTES OF MEETING

User Advisory Council
May 1, 2007

The User Advisory Council met at the New York Marriott Eastside Hotel in New York, New York.

Members Attending

Jane Adams
Jeremy Bean
Neri Bukspan
Julie Burke
Ann Duignan
Robert Ehudin
Alison Emmerich
Robert E. Friedman
Neville Grusd

Charles Hill
Gregory J. Jonas
Sudhir Nanda
Georgene Palacky
Janet Pegg
Hal Schroeder
Rick Sherlund
Damon Silvers
James Wei

Members Not Attending

Robert Axel
James Goff
Trevor Harris
Joe Joseph
Elizabeth F. Mooney
F. Barry Nelson
Mark Newsome

Stephen Percoco
Lawrence Pohlman
Adam Quinton
Rita Spitz
Christianna Wood

Others Attending

Financial Accounting Standards Board:

Robert H. Herz, Chairman
George J. Batavick
G. Michael Crooch
Thomas J. Linsmeier

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

FASB Staff:

Suzanne Q. Bielstein, Director of Major Projects and Technical Activities
Jill Carrick, Assistant Project Manager
Christopher A. Cornett, Postgraduate Technical Assistant

Chandini C. Smith, Senior Technical Advisor
Larry W. Smith, Director of Technical Application and Implementation Activities
Kevin M. Stoklosa, Project Manager

Others:

James Gerber, Director of Research, AllianceBernstein L.P.
James J. Leisenring, Member, International Accounting Standards Board
Jenifer Minke-Girard, Senior Associate Chief Accountant, Securities and
Exchange Commission
Teresa S. Polley, Executive Director, FASB Advisory Groups, Financial
Accounting Standards Advisory Council
Greg Scates, Associate Chief Auditor, Public Company Accounting Oversight
Board

Introductory Remarks

1. Mr. Young welcomed the Council members and stated that the meeting would start with a general question-and-answer session.

SEC and Budget Issues

2. Council members asked questions about the following:
 - a. The recent media coverage on SEC involvement in the Board member appointment and budget approval process
 - b. How the budget process works in general and how the Financial Accounting Foundation (FAF) would function in the event that the budget is not approved on a timely basis.
3. Mr. Herz explained the funding of the FASB before and after the Sarbanes-Oxley Act of 2002 (SOX). Before SOX, the FASB was funded primarily through voluntary contributions from its constituents, including preparers and auditors, and the sale of publications. Since the passage of SOX, the voluntary contributions have been replaced by accounting support fees levied on all corporate registrants and mutual funds. Section 109 of SOX states that the SEC may review the level of accounting support fees included in the Board's budget. FAF management submitted the 2007 budget to the SEC staff in November 2006; the SEC approved the budget in March 2007. Late in 2006, the SEC staff expressed a desire to formalize its process for providing input on appointments and reappointments of both Board members and FAF Trustees, which was done through a letter agreement between the FAF and the SEC in March 2007. Members of the SEC staff took the position that the approval of the 2007 budget would be subject to formalizing this process. In addition, in its review of the 2007 budget, the SEC staff objected to the granting of an 8 percent salary increase to Board members that the FAF Trustees had approved based on independent market surveys, and requested the FAF to scale the increase back to 3 percent. Mr. Herz noted that the letter

- agreement explicitly reserves all final decisions on appointments and reappointments to the Foundation's Board of Trustees. Mr. Herz also noted that the FAF maintains a reserve fund, which is equal to one year of the organization's expenses.
4. A Council member stated that an inherent degree of engagement exists between the Board and the SEC, but the nature of the engagement should be carefully defined and controlled by a system of checks and balances. He expressed a preference for further transparency in the appointments process and stated that the controversy over the budget approval process had the feeling of a "shakedown." He expressed concern that similar pressure could be applied in other contexts.
 5. Ms. Minke-Girard noted that the Commission's role in the budget process is consistent with fulfilling its oversight responsibility over the FASB as a designated accounting standards setter. She stated her belief that the Commissioners believe the details of the most recent agreement between the FAF and the SEC are consistent with the policy statement agreed to in 2003. She also noted her belief that the recent events do not affect the SEC staff's day-to-day interaction with the FASB staff and she hopes that will continue.
 6. Mr. Trott stated that in his opinion the recent matter concerning the Board's budget went beyond a mere resolution of administrative responsibility. He noted that the Board continues to have a productive relationship with the SEC and expressed his hope that the positive nature of the relationship would continue. Mr. Trott stated that the FASB's funding is set by law, and that the Trustees do not have the option of accepting contributions from other sources. Additionally, he noted that the change to the appointments process was handled between the FAF Board of Trustees and the SEC and that many of the FASB Board members were unaware of the issue until late in the process.

Timing of Options Grants

7. A Council member described two recent decisions by the Delaware Chancery Court, which concluded that the timing of option grants to precede the release of positive news, or so-called spring loading, was determined to be a *per se* breach of fiduciary duty, unless fully disclosed to a corporation's shareholders. He noted that this decision affected the accounting treatment of those grants under both APB Opinion No. 25, *Accounting for Stock Issued to Employees*, and FASB Statement No. 123(R), *Share-Based Payment*.
8. Mr. Herz noted that he is aware that the resolution of the legal issues on the spring loading of option grants could well have implications on the accounting treatment of those grants.
9. Ms. Minke-Girard noted that the OCA staff is aware of the recent Delaware Chancery Court decisions. She stated that many options-

granting cases are matters being addressed by the Commission's Division of Enforcement and, therefore, she could not comment on specific cases. She also noted that she was not aware of any planned changes to the SEC staff's September 2006 letter on accounting for stock options in the historical financial statements of public companies.

Fair Value Option

10. A Council member described a recent initial public offering and the use of the fair value option and asked whether the policy of valuing equity method investments by considering unrealized gains on contemplated dispositions as a component of that value was appropriate.
11. Mr. Herz stated that the Board is aware of the issue in question and is attempting to collect specific facts to better understand the issues involved.
12. Ms. Minke-Girard noted that the SEC staff does not typically discuss registrant-specific issues in a public forum. She added that the SEC staff is aware of how some parties are applying the fair value option and is monitoring the application of the fair value option to equity method investments generally.
13. A Council member asked why the Board issued FASB Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*, despite the overwhelmingly negative reaction from the user community.
14. Mr. Trott stated that the input from the user community was not overwhelmingly negative and that the CFA Institute stated that Statement 159 would be a logical step to full fair value. Further, he noted that the standard requires significant disclosures about the use of the fair value option to address the concerns of users. He stated that the fair value option is intended to increase the relevance and transparency of the financial statements. Additionally, he noted that significant optionality exists in current accounting models, including FASB Statements No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, and No. 133, *Accounting for Derivative Instruments and Hedging Activities*.
15. Mr. Crooch stated that he is disappointed that some issuers have used the transition requirements of Statement 159 to avoid recognizing losses in a way that runs contrary to the spirit of the Statement. He noted that Statement 159 is intended to provide preparers with a method of accounting for hedging transactions that reflects the economic reality of those transactions but is less onerous than Statement 133.
16. A Council member noted that the CFA Institute qualified its support for the fair value option as temporary assuming a more rapid move to full fair value of financial instruments. Mr. Herz noted that the Board has undertaken a joint project with the IASB to address the accounting for all financial instruments and that a discussion document is expected to be issued by the end of the year. Additionally, Mr. Herz expressed hope that

the fair value option would be a worthwhile experiment to determine if the market participants will embrace full fair value for financial instruments.

17. A Council member expressed disappointment that two companies recently had “unadopted” Statement 159 upon realizing that the auditing profession and the SEC were questioning the treatment in transition. Mr. Herz stated that he interprets the unadoptions as a positive development, in that the market reacted swiftly to address transactions for which the accounting form did not mirror the economic substance. Ms. Seidman noted that the issues cited by these companies were driven by the transition guidance and thus were only expected to apply in the year of adoption. She also noted that the disclosures required by FASB Statement No. 157, *Fair Value Measurements*, would address concerns about transparency in the use of the fair value option.
18. A Council member stated that the disclosures required by Statement 157 are valuable and would address many initial concerns about the application of the fair value option. However, the number of options available to preparers is beginning to outpace the ability of professional investors and analysts to understand them. That Council member noted that he does not see a clear roadmap being advanced by either the Board or the IASB to facilitate the transition to full fair value for financial assets and liabilities. He expressed concern that financial statements are becoming less comparable, even between entities in the same industry, and that this lack of comparability is exacerbated by the use of fair value. He stated that a change to full fair value represents a fundamental shift in the purpose of the income statement, by replacing the matching principle with a notion of projected profits from future years discounted to the present at the time of recognition.
19. Mr. Herz stated that the financial statement presentation project may address many of those concerns.

International Convergence

20. A Council member asked about recent articles in the press about an accord between the European Union and the United States with a common goal of establishing a single set of accounting standards by 2009. He asked how this accord affects the SEC’s roadmap to international convergence and its plans to issue a concept release to address the possibility of U.S. companies filing under international financial reporting standards (IFRS).
21. Ms. Minke-Girard stated that the SEC staff continues to “work the roadmap” released in 2005. She referred to a recent SEC press release outlining the SEC’s next steps relating to IFRS. The press release announced the SEC’s plans for a proposing release that will request comments on proposed changes to the Commission’s rules affecting financial reports filed by foreign private issuers that are registered with the

Commission. The approach would be to give foreign private issuers a choice between IFRS and U.S. GAAP. The press release also referred to SEC plans to issue a Concept Release on the issues about the possibility of treating U.S. and foreign issuers similarly in this respect by also providing U.S. issuers the alternative to use IFRS.

Liabilities and Equity

22. Ms. Bielstein presented a series of slides detailing the current progress on the Board's project on liabilities and equity and its interaction with the financial statement presentation project. She explained the format of the financial statements under consideration in the financial statement presentation project and illustrated the concept with an example.
23. Ms. Carnrick stated that the liabilities and equity project is an attempt to be sensitive to user concerns that current accounting models do not accurately represent the economic reality of certain transactions and instruments. As an example, she cited convertible debt and noted that many users believe the current approach to accounting for these instruments understates an entity's cost of borrowing in many cases.
24. Ms. Carnrick described the benefits of separating owner and nonowner sources of financing, including (a) providing a picture of an entity's true financing cost and leverage, (b) segregating transactions with owners of the entity from other capital providers, and (c) permitting the calculation of key ratios.
25. Ms. Bielstein described two of the approaches that the Board is considering in the liabilities and equity project. The *ownership approach* can be described as the current shareholder approach because it focuses on classifying transactions that affect the returns to the current shareholders as liabilities (or assets in some cases). The *ownership-settlement approach* can be described as the "modified shareholder" approach because it includes share-settled instruments in the definition of equity. Ms. Bielstein then described another approach that does not distinguish between liabilities and equity but rather presents the disaggregated claims against the value of the entity on the face of the financial statements.
26. Ms. Smith asked Council members whether they believe it is useful to classify claims against the value of the entity, whether equity or debt, according to the categories developed in the financial statement presentation project (as operating, financing, or equity). Additionally, she asked Council members which approach to classifying liabilities and equity they favor and which approach best reflects the economic substance of the transactions.
27. Council members expressed the following views:
 - a. The liabilities and equity project illustrates the importance for the Board to clearly articulate its vision of what the financial statements

represent. The Board should ensure that the new form of the financial statements serves the needs of the different groups of users who depend on financial statements. The classification of instruments as liabilities or equity is subject to game playing precisely because the categories have meaning to users.

- b. A “feedback loop” may result from the ownership approach. This results from the earnings of a company being affected by changes in its share price, which is in turn affected by earnings.
- c. The ownership-settlement approach could lead to differing treatment for economically similar instruments, such as cash-settled and share-settled stock appreciation rights.
- d. The claims approach would have the benefit of eliminating the practice of structuring certain instruments solely to receive a particular treatment. Analysts would continue to look at the most subordinated interests as being akin to equity.
- e. The effectiveness of a claims approach could be enhanced by disclosure of the relative rights and priorities of different claims.
- f. Fully developing the claims approach would take time and would delay the liabilities and equity project.
- g. The classification of particular instruments may not matter to sophisticated investors, as long as they have sufficient disclosures to decide how to treat each class of instrument in their analysis.
- h. The entity view of the financial statements serves the needs of a wider array of users of financial statements.

Hedge Accounting

- 28. Mr. Stoklosa described some of the practice problems with Statement 133, the current hedge accounting standard. In many cases, the accounting under Statement 133 is not representative of the economic substance of the underlying transaction. The guidance itself is complex. Incorrect implementation of the guidance has resulted in a significant number of restatements. The disclosures currently required are inadequate to meet the needs of analysts and other users.
- 29. Mr. Stoklosa described several potential approaches to accounting for hedging activities and asked Council members for their views.
- 30. Council members expressed varying views. A majority expressed a preference for either a fair value approach or no hedge accounting over a bifurcation-by-risk approach. Some Council members expressed the view that requiring full fair value for financial instruments would resolve many of the hedge accounting issues. Some expressed the view that no hedge accounting should be permitted, particularly for cash flow hedges. Some Council members suggested that the Board expand the fair value option to

include certain nonfinancial items. Some Council members encouraged the Board to not add a project to address hedge accounting.

31. A Council member asked why the Board adopted such stringent effectiveness testing rules. Mr. Herz noted that the ability to dedesignate and redesignate inherent in Statement 133 created the potential for earnings management and that effectiveness testing was part of the Board's attempt to address this issue.

Derivatives Disclosures

32. Mr. Stoklosa then described the progress on the derivatives disclosures project. He summarized the proposed tabular disclosures and noted that the three primary objectives of the project are to provide the following information:

- a. An understanding of how and why an entity uses derivatives
- b. An understanding of how derivatives and related hedged items are accounted for
- c. Transparency into the overall effect of derivatives on an entity's financial position, results of operations, and cash flows.

33. Mr. Stoklosa summarized some of the comments received on the Exposure Draft, including that the disclosures by risk and accounting designation are too cumbersome; the disclosures do not provide an integrated view of risk management; the disclosures should not be required on an interim basis; and for some large companies, the disclosures would be too voluminous to be useful. He then asked Council members for their views.

34. Several Council members commented that the tabular disclosures would provide useful information. Some expressed the view that the disclosures should be required on both an interim basis and an annual basis. Others expressed the view that interim disclosures need not be as expansive as annual disclosures, particularly if the information did not change significantly.

Financial Accounting Standards Research Initiative

35. Mr. Linsmeier described the objectives of the Board's new research initiatives by which the Board will more effectively monitor, coordinate, and use in standard-setting efforts the research and data collection performed by academics, regulators, businesses, analysts, and proxy firms. One such effort is the Financial Accounting Standards Research Initiative (FASRI), an effort to work with academic researchers to conduct survey, experimental, and controlled-economy research that is relevant to FASB standard-setting efforts. This initiative will use FASB constituents as research subjects. Mr. Linsmeier asked Council members for comments on the initiatives and whether there are other types of research the Board should try to access.

36. Council members suggested the following:

- a. The Board should consider surveys and research performed by the CFA Institute, as the objectives of that research overlap with the objectives of the Board's research initiatives.
- b. The Board should consider accessing portfolio managers and other investment professionals with good long-term performance records to participate in its research initiatives.
- c. A research topic that the Board should consider is the market impact of past rule changes.
- d. The Board should consider publishing the results of its research initiatives online free of charge.
- e. The Board's participation imposes a degree of discipline to the research process, which could result in more firms being willing to participate. Over time, the Board will gain a reputation as a source of high-quality research.
- f. The Board's research efforts will bring more users into the standard-setting process and help to ground the Board's conclusions using empirical data.

Report on the Investors Technical Advisory Committee

37. Ms. Polley described the activities of the Investors Technical Advisory Committee (ITAC), an advisory group created by the FASB late in 2006 to increase participation in the standard-setting process by investors with strong technical accounting expertise. She noted that the ITAC will provide the Board and staff with technical accounting advice from the investor's perspective on current projects and that it will identify critical financial reporting deficiencies that require the Board's attention. The ITAC decided to meet as a group at least quarterly in closed sessions and to meet with the Board in open sessions at least annually. ITAC members have created working groups on specific projects. For example, the working group on derivatives disclosures drafted a comment letter on the recent Exposure Draft. The letter was reviewed and approved by all ITAC members and then submitted to the FASB.

38. A Council member who also participates on the ITAC noted that the role of the ITAC is to consider project issues in more detail than FASAC or the UAC, which considers issues at a higher level. She noted that the ITAC is independent of the FASB staff and reaches its own conclusions, which it would communicate directly to the Board.

ADJOURNMENT

39. Mr. Young closed the public portion of the meeting at approximately 1:00 p.m.