

FASB User Advisory Council
MINUTES OF THE MEETING
September 29, 2005

The FASB User Advisory Council met at The University Club in New York City.

Members Present

Jane Adams
Jeremy Bean
Gary Black
Ann Duignan
Robert Ehudin
Alison Emmerich
Robert Freidman
Neville Grusd
Trevor Harris
Charles Hill
Adam Hurwich

Gregory Jonas
Joe Joseph
Michelle Kaufman
Sudhir Nanda
F. Barry Nelson
Janet Pegg
Steve Percoco
Adam Quinton
Rick Sherlund
Rita Spitz
James Wei

Members Absent

Diane D'Erasmus
Betsy Graseck
Richard Greenwood
Joseph Higgins
Elizabeth Mooney

John Richards
Austin Rodgers
Damon Silvers
Robert Treanor

Others Attending

Financial Accounting Standards Board:

Robert H. Herz, Chairman
George J. Batavick, Board Member
Leslie F. Seidman, Board Member
Donald M. Young, Board Member

FASB Staff:

Suzanne Q. Bielstein, Director of Major Projects and Technical Activities
Richard C. Cronin, Postgraduate Technical Assistant
Jill M. Carnrick, Project Research Associate
Patricia A. Lapolla, Project Administrative Assistant
Stuart J. Moss, Practice Fellow
Peter C. Proestakes, Project Manager
Brooke E. Richards, Project Manager
Lawrence W. Smith, Director of Technical Application and Implementation Activities
Stephanie A. Tamulis, Project Manager

Others:

Rob Axel, Vice President Financial Management, Prudential Asset Liability and Risk Management
Neri Bukspan, Managing Director, Chief Accountant, Standard & Poor's Credit Market Services
Douglas R. Carmichael, Chief Auditor, Public Company Accounting Oversight Board
Allan Cohen, Executive Director – Financial Reporting and Accounting Policy, Time Warner Inc.
Mitchell Danaher, Assistant Comptroller, General Electric Co.
Donald Nicolaisen, Chief Accountant, Securities and Exchange Commission
Teresa S. Polley, Executive Director, Financial Accounting Standards Advisory Council

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 also noted that members of Financial Executives International and the Institute of Management Accountants will participate in a portion of the meeting, presenting an opportunity for users and preparers to discuss their respective needs in relation to the proposed standard on business combinations. He then introduced Mr. Herz to give an update on recent FASB activities.

Report of the FASB Chairman

Mr. Herz first reported that several documents are currently out for comment including an Exposure Draft on uncertain tax positions and Exposure Drafts on business combinations and noncontrolling interests.

Mr. Herz stated that several accounting issues have arisen in relation to Hurricane Katrina. The major issue is whether some or all of the effects of the hurricane should be treated as extraordinary items. The FASB did not rule officially on this issue; however, accounting professionals agree that extraordinary treatment would not be the most effective way of communicating the information. That application is consistent with the previous EITF issues that addressed the events of September 11, 2001.

Mr. Herz stated that the Board recently decided to issue guidance on disclosures for nontraditional loan products. The guidance will point to existing accounting literature and SEC rules.

International convergence continues to be an important objective at the FASB. The semiannual meeting with the International Accounting Standards Board (IASB) is scheduled for the end of October in Norwalk. The meeting will allow both Boards to discuss the progress on their joint projects including revenue recognition and reporting financial performance. In addition, both Boards will meet with representatives from the CFA Institute to discuss a comprehensive business reporting model under development by the Institute.

Preliminary discussions have taken place recently between the FASB, the SEC, and the PCAOB about a combined effort to reduce complexity and increase transparency in the financial reporting system.

Report from the SEC

Mr. Nicolaisen reported on current activities of the Office of the Chief Accountant. He noted that Christopher Cox is the new Chairman of the SEC and has placed a high priority on addressing accounting issues. One major area of interest to both the Chairman and the SEC staff relates to the issue of globalization of financial reporting. The objective is to continue improving the transparency and reducing complexity within the financial reporting system.

Chairman Cox also is very committed to technology, as indicated by the SEC's implementation of a voluntary program for the use of XBRL. Although XBRL is not the exclusive technology tool that will be considered by the SEC, it does represent a methodology to begin the process of moving away from the slow process of a paper-based reporting system. Mr. Nicolaisen asked the user community, as the primary beneficiary of improvements in reporting, to demand an approach that will provide information in a manner that is unvarnished and understandable to users.

An SEC Staff Accounting Bulletin will be issued in the near future that addresses the movement away from two current methods of measuring the materiality of errors that exist in financial statements: the roll-forward method and the iron-curtain method. Mr. Nicolaisen noted that balance sheets have become "less pure" over time and that the intent of this guidance is to improve clarity and restore confidence in the financial reporting system.

Mr. Nicolaisen stated that his term as the SEC's Chief Accountant will conclude at the end of October. The SEC staff is actively engaged in a search for his successor.

Financial Reporting Initiatives—Smaller Public Companies and Private Companies

Mr. Batavick reported that in late 2004 the SEC created the SEC Advisory Committee on Smaller Public Companies to assess the current regulatory environment as it pertains to smaller public companies. Smaller public companies have struggled in both the start-up phase of raising capital as well as continuing operations in the current regulatory environment. The committee has four subcommittees: corporate governance and disclosure, capital formation, internal control, and accounting standards. In addition, a Size Task Force was charged with developing a recommendation on the appropriate definition of a "smaller public company."

The accounting standards subcommittee was asked to evaluate the “Big GAAP, Little GAAP” issue to determine whether a separate body of GAAP should exist for smaller public companies. The subcommittee unanimously agreed that there should not be a separate set of GAAP for smaller public companies.

The Size Task Force has presented to the SEC a two-tier approach to define a smaller public company. A smaller public company would be defined as an entity with a market capitalization of \$700 million or less, and a further cut would be made for “micro-cap” companies, which have a market capitalization of \$100 million or less. The accounting standards subcommittee will recommend to the SEC that micro-cap companies be afforded the same extended effective dates for new accounting standards that are occasionally given to private companies. This additional time would allow those companies to leverage the experience and knowledge of the larger companies gained from their implementation of the new standards.

The AICPA surveyed users, preparers, and auditors about private companies. Survey responses indicated that there should be a separate set of GAAP for private companies. The FASB is working with the AICPA to explore measures for improving the reporting for private companies. The Board believes that there should be one set of GAAP but that differences may be appropriate in certain circumstances for private companies. To further evaluate this issue, the Board and AICPA representatives are trying to determine whether there are certain attributes of private companies that would cause user needs or cost-benefit considerations to be different from those of public companies.

Pension Accounting Issues

Mr. Proestakes described the existing accounting for pensions, noting that the Board issued FASB Statement No. 87, *Employers' Accounting for Pensions*, in 1985. At that time, the Board noted that the standard should apply to written plans as well as substantive obligations and that the cost of the expected benefits should be expensed over the estimated period of employee service. The Board believed that fair value was the most relevant measurement tool for plan assets and that the projected benefit obligation (PBO) was the most relevant measurement for the obligation. The PBO represents the actuarial present value of the future cash outflows, including a projection for increases in future compensation. The Board also determined that the net funded or unfunded position represented either an asset or a liability to the reporting entity.

Mr. Proestakes noted that Statement 87 is very explicit about the compromises that the Board made principally to reduce earnings volatility, accomplished through delayed recognition. Because of those deferral mechanisms, the Board also created an alternative measure of the obligation, the accumulated benefit obligation (ABO), which is used to establish a minimum liability to be recognized. Statement 87 also provided for the continuation of the past practice of recognizing the combined net amount of each individual component of cost relating to both operations and financing. Additionally, measurements were allowed to be made at a date other than the fiscal year-end. Despite those compromises, the Board agreed that Statement 87 resulted in significant improvements in comparability and disclosure.

Issues in FASB Statement No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions*, are similar to those for pension accounting with regard to delayed recognition. However, with postretirement benefits, there is only one measure of the obligation, the accumulated postretirement benefit obligation, and as such, there is no need for a minimum recognition. In addition, the costs of the healthcare benefits are expensed over the period of full eligibility, which is typically the period of vesting, rather than the period of service as with pensions.

FASB Statement No. 132, *Employers' Disclosures about Pensions and Other Postretirement Benefits*, improves the disclosures and creates symmetry between the disclosures for pensions and other postretirement benefit plans. Statement 132(R), issued in 2003, enhances disclosures to provide additional information about plan assets, allowing for a more complete assessment of risk and the expected rate of return.

Assuming the Board decides to add a project to its agenda, it must first define the intended scope, which could be any of the following: (a) be limited strictly to pension accounting, (b) address pensions and other postretirement benefits, or (c) include all deferred compensation arrangements. The Board also must decide whether to complete the existing project dealing with lump-sum settlement features as a discrete project or to incorporate it into another project.

The FASB staff has identified several potential areas for improvement. One possibility is to focus on balance sheet display of the true net funded or unfunded status, accomplished through recognition in earnings or other comprehensive income. Another possibility is to disaggregate the separate components that make up pension cost, showing those related to compensation as operating expenses and those related to financing in a separate financing category. Alternatively, an effort could be made to eliminate smoothing by addressing the compromises in Statement 87.

One Council member asked whether the IASB is addressing pension accounting. Mr. Proestakes stated that an IASB project was suspended in 2003. Both the FASB and IASB have identified a need to address the area of pension accounting, and the FASB is initiating the process of developing a joint project.

Mr. Proestakes asked Council members for their opinions on the necessity of a project to address pension accounting issues and the appropriate scope for such a project.

Council members expressed the following views:

- Statement 87 is particularly problematic to users when trying to build meaningful forecasts that incorporate minimum pension liabilities, intangible assets, and other comprehensive income. At the very least, distinguishing the split between operating and financing components would be beneficial to users.
- Certain analysts believe that gains or losses from pension plans have nothing to do with the generation of revenues. Therefore, the returns on plan assets materially distort the underlying economic earnings of the company.
- The Board should take a long-term view when determining the scope of the pension project. However, waiting another five years to reach a comprehensive standard

seems too long. Therefore, it seems advisable to make some quick fixes in the short term to address the concepts of display and smoothing.

- In eliminating smoothing, volatility is introduced into the financial statements. This creates a display issue, whereby the FASB will need to develop an approach that separates some of this volatility and classifies it differently so that the user does not confuse its effects with those of ongoing operations. For example, the service cost component might be included in the cost of sales, while the earnings on the assets and the interest on the PBO might be classified as either investing or financing activities.
- Although analysts have concerns that the proposed changes to pension accounting will introduce a great deal of volatility into the financial statements, it would be preferable to be forced to deal with the volatility and understand it rather than being lulled into the false sense of a smooth result.
- Several issues that need to be addressed can be dealt with in other FASB projects, such as the control issue and the consolidation issue. Therefore, the Board does not need to address those issues in a pension project.
- Issues relating to other postretirement benefits should be addressed concurrently with the pension issue.

Mr. Herz asked for Council member views on using either the ABO or the PBO. He stated that an argument could be made that the PBO fits better within a model of long-term smoothing, whereas the ABO might fit better in a model that is free of smoothing effects.

One Council member stated that the extent to which users consider contingent payments in their analyses will determine if the ABO or PBO is more appropriate. Another Council member noted that an ABO is more of an academic concept because it does not conform to a going-concern basis of a company's future liabilities.

Mr. Proestakes asked Council members if a meaningful improvement could be made by recognizing the plan assets and the PBO in the balance sheet or if this information is sufficiently disclosed in the footnotes. One Council member noted her preference to include the true funded status, without smoothing, somewhere in the balance sheet. Other Council members voiced their concern with focusing solely on fixing issues in the balance sheet, as there are other issues relating to the income statement and the statement of cash flows that often get overlooked. For example, it is not a trivial issue to consider where the different components of pension cost should be classified in the statement of cash flows.

Business Combinations

Ms. Tamulis described FASB Statements No. 141, *Business Combinations*, and No. 142, *Goodwill and Other Intangible Assets*, which primarily eliminated goodwill amortization, introduced the goodwill impairment test, and provided criteria for the recognition of intangible assets. The IASB and the FASB decided to conduct the second phase of the project jointly in an effort to develop one converged standard on business combinations. In June 2005, the FASB issued a joint proposed Statement on business combinations and a proposed Statement on accounting and reporting of noncontrolling

interests. Ms. Tamulis guided the group through three examples to demonstrate several of the proposed changes to the existing accounting rules for business combinations.

One Council member asked for clarification about the transition provisions that would exist under the proposed standard. Ms. Tamulis noted that the proposals are prospective and, as such, a company that had an acquisition prior to the effective date of the new standard would continue to follow the existing requirements within Statement 141.

Another Council member asked about the reasons for allowing an income-generating event to be recorded upon a step acquisition. Ms. Tamulis explained that to record the assets and liabilities at fair value on the acquisition date, the original purchase amount must be stepped up to allow everything to be measured on a fair value basis. The Board did not view this as a gain on purchase. Instead, the Board agreed that when an entity takes control, the nature of the investment changes and results in a remeasurement event.

Messrs. Danaher and Cohen then introduced several specific issues on which they requested feedback. The first issue relates to transaction costs. The direct costs of an acquisition, such as banking fees or attorney fees, are currently capitalized as a part of the acquisition. The Exposure Draft proposes that those costs be expensed as incurred. Mr. Cohen asked for Council members' views on the proposed change and how analysts view transaction costs in their analysis.

A majority of Council members preferred that transaction costs be expensed. However, several expressed the view that those costs should continue to be capitalized.

Council members also expressed the following views:

- Certain analysts do not include the acquisition-related costs in any forward-looking discounted cash flow calculation. Instead, some include the costs as invested capital; others consider them a nonrecurring expenditure.
- When forecasting, analysts are concerned with the organic underlying growth of the company and therefore almost always exclude acquisition-related costs from earnings in their projections. They will not normally exclude costs incurred after the acquisition that the company attempts to pass off as acquisition costs.
- Acquisition-related costs do not represent an asset. The costs should be expensed; however, the amount of acquisition-related costs should be disclosed so that analysts can factor them into invested capital and treat them separately and distinctly from ongoing earnings.
- An entity that researches a potential target and decides not to acquire it will expense the costs related to performing its due diligence. Therefore, a company that performs those same activities and decides to go forward with the acquisition should account for those costs in the same manner.
- The cost to the buyer is higher than the consideration received by the seller, so shareholders would want to see a number that truly reflects the cost of acquisition to the buyer. The buyer ultimately makes the decision about which bankers and lawyers

to retain, and the corresponding costs represent a portion of the total acquisition cost to that particular buyer.

Mr. Danaher then asked Council members for their views on restructuring costs. Under the proposed standard, restructuring costs would be charged to expense unless they meet the definition of a liability at the acquisition date. A majority of Council members preferred that restructuring costs be recognized as postcombination expenses.

Council members also expressed the following views:

- Analysts constantly make judgments based on information specific to a particular company. For serial acquirers, restructuring is part of their growth strategy, so those costs should be included in their normalized earnings and should be evaluated in the forecast. Analysts would like to be able to make the judgment of what to include in their forecasts.
- Theoretically, a restructuring charge should be excluded from recurring earnings if something had changed in the company causing it to be a different company going forward, whether it is a geographic move or getting out of some line of business that does not qualify as discontinued operations.
- Many investors are focused primarily on ongoing operations and have begun to exclude any noncash charges from their analysis. As a general principle, the FASB should move GAAP earnings closer to cash earnings. Expensing restructuring costs related to an acquisition accomplishes this.

On the next issue, Mr. Cohen noted that the current accounting guidance defers the recognition of contingent consideration. The Exposure Draft proposes that contingent consideration be recognized at fair value at the date of acquisition. Going forward, changes in the fair value of contingent consideration that is a liability would be recognized in income.

Mr. Cohen asked Council members for their views on the proposed treatment of contingent consideration and how they currently factor contingent consideration into their analysis when valuing a company. A majority of Council members noted a preference for the proposed treatment over current practice.

Council members also expressed the following views:

- The approach in the Exposure Draft provides more information to investors in terms of the nature of the contingent consideration and how it changes over time. A major concern with the existing guidance is that cumulative earnings over the next three years could be paid to the seller, yet there is no liability recognized. Thus, it appears that the return is much higher than it actually is because investors are unaware of the growing off-balance-sheet liability.
- Management might be motivated to overstate the fair value of contingent liabilities at initial measurement and correspondingly reduce that value over time. However, those concerns can be compensated for through appropriate disclosures.
- This topic poses a similar question to one that was raised in the discussion of stock option accounting. Would users rather see something on the books that is exactly

wrong, or would they prefer to see something that is approximately correct? Additionally, while there might be disagreements between the buyer and seller as to the value of the target, it would be hard to believe that the acquiring management does not have some estimate of what the future obligations would be.

Mr. Cohen then raised the issue of how to approach the measurement of fair value. An entity-specific approach would establish values based on what the acquirer thought it was acquiring and how it intends to use the acquired asset. A market-participants approach would consider value from a third party's perspective. Mr. Cohen asked Council members for their views on those approaches to measuring assets in a business combination.

A majority of Council members preferred an entity-specific approach. Several Council members stated that the entity-specific approach would better represent the enterprise economics in the financial statements. Gaining an understanding of what the company is valuing is more useful because strategies vary widely throughout the market.

Ms. Tamulis asked for Council members' views on the proposed treatment of step acquisitions. Views were mixed, with some members preferring the proposed accounting and others preferring the current accounting. One Council member stated that presenting the current fair value of all that an entity has acquired control over, as proposed in the Exposure Draft, seems to provide much more relevant information to users.

Derivatives Disclosure

Ms. Seidman stated that the FASB has received ongoing requests to enhance the disclosures that are currently required by FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*. The required disclosures focus mainly on a narrative discussion of why the entity is holding the derivatives and, in the area of hedge accounting, some quantitative disclosures are required to identify what did not go right in the hedging strategy. However, little information is required to be disclosed about effective hedges.

Ms. Seidman stated that the Board's goal in this project is to significantly improve the disclosures about the nature and extent of an entity's derivative activity. From a quantitative standpoint, one approach would be to require disclosure of the amounts that are recognized in the balance sheet, income statement, and statement of cash flows as well as the identification of the line items within each statement where those amounts are classified. She noted that the Board considered adding a broader project that would require disclosures about an entity's exposures to risk and how those risks are managed; however, the majority of the Board agreed that it was important to first make an incremental improvement in the area of derivatives disclosure.

Ms. Seidman told Council members that the Board welcomes input on the type of information that users would like to have disclosed in the financial statements as well as the most effective organization and presentation of this information. For example, she asked whether it would be useful to have a breakdown of the risks relating to derivative activity and disclosure of the activities that relate to hedging and those that do not.

Council members expressed the following views:

- Users would benefit from a disclosure of the impact of one or two standard deviations on a company's valuation of derivatives. It would also be useful to know if the company is exposed to systemic risk to better understand what would happen to the derivative portfolio if one of these events were to occur. Because several risk factors can concurrently affect derivatives, it would be necessary for a company to choose to base its discussion on the predominant risk. Another Council member disagreed, stating that allowing companies to pick and choose which risks to disclose could be potentially dangerous. Furthermore, when evaluating derivatives, it is necessary to know if the instruments are exposed to interest rate risk, credit risk, foreign currency risk, or all of the above.
- Looking at derivatives in isolation is not meaningful. It is necessary to take a holistic approach to understand why derivatives are being used, what they are tied to, and their overall role in the asset and liability management of the entity.
- The categorization of derivatives disclosures needs to be improved because it is difficult to understand the areas that are affecting the company's risk profile for a company that includes many types of businesses. It might be useful to require disclosures based on business activity because analysts value each type of business differently.
- Disclosure of the income statement impact of derivatives that are not designated as hedges is critical. In terms of hedges, the Fannie Mae situation has made clear the need for better disclosure about the particular model that a company is using to account for derivatives as hedges under Statement 133.
- Many companies record the changes in value of nonhedging derivatives through cost of sales. Therefore, it would be useful to understand how much of the cost of sales could be attributed to derivatives.
- Users often look to the MD&A section for information, such as value-at-risk information, before analyzing the footnote disclosures, so incorporating those types of disclosures in the project would be helpful.
- In the area of debt and interest rates, current disclosure includes a maturity table for the debt and information about the contractual rates. This information would be enhanced if the effect of hedging was clearly identified as well.

Liabilities and Equity

Mr. Young stated that the final item on the agenda is the Board's liabilities and equity project. A milestone draft has been posted to the FASB website and discusses single-component instruments and their treatment as either liabilities or equity. The issue that the Board is now deliberating is whether compound instruments, such as convertible debt, should be separated into components of debt and equity. Ms. Richards presented several examples to demonstrate the items that the Board is considering and asked for Council members' input on the various approaches.

Council members expressed the following views:

- The entire model would be simplified by adopting a narrower view of equity, which could remove the need for an excessive number of payoff profiles to determine whether an instrument is a liability or equity. It was noted that an implication of the narrow view and the fair value measurement attribute is that changes relating to the company's stock price would flow through earnings. Some Council members agreed that the fair value of those instruments would provide the most useful information to users.
- Another approach would address the balance sheet as a snapshot of liquidation and legal rights. Under that approach, the value of the convertible debt would be measured by attributing the appropriate interest expense, and the convertible debt would reside on the balance sheet at the liquidation value. Another Council member noted that many convertible instruments are issued today that automatically convert into equity upon bankruptcy, so an argument could be made to include those in equity from the beginning.

Adjournment

At 1:00 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 2:00 p.m.