

User Advisory Council
MINUTES OF MEETING
October 7, 2003

The User Advisory Council met at the University Club in New York, New York.

Members Attending

Jane Adams	Charles Hill
Jeremy Bean	Adam Hurwich
Gary Black	Michelle Kaufman
Stuart Coco	Bill Mann
Diane D'Erasmus	F. Barry Nelson
Ann Duignan	Janet Pegg
Alison Emmerich	Marguerite Piret
Robert Friedman	John Richards
Steven Gavios	Linda Selbach
Betsy Graseck	Robert Sharps
Richard Greenwood	Rita Spitz
Neville Grusd	Scott Sprinzen
Trevor Harris	Robert Treanor
Joseph Higgins	James Wei

Members Not Attending

Craig Broderick	Steve Percoco
John Casesa	Adam Quinton
Mark Casey	John Robertson
Raymond Katz	Austin Rodgers
Michael Kwatinetz	Edward Schreiber
Elizabeth Mooney	Damon A. Silvers

Others Attending

Financial Accounting Standards Board:	
Robert Herz, Chairman	Katherine Schipper
George Batavick	Leslie Seidman
G. Michael Crooch	Edward Trott
Gary Schieneman	

FASB Staff:	
Suzanne Bielstein	Director of Major Projects and Technical Activities
Peter Proestakes	Project Manager
Daniel Slayton	FASB Fellow
Jennifer Sullivan	Project Manager
Michael Tovey	FASB Fellow

John Richter EITF Technical Assistant, Financial Accounting Standards Board
Shelby Kazazeen Postgraduate Technical Assistant

Others:

Jennifer Minke-Girard Associate Chief Accountant, Securities & Exchange Commission
John Murphy Vice President, Merrill Lynch
Richard Swift Chairman, Financial Accounting Standards Advisory Council
Teresa Polley Executive Director, Financial Accounting Standards Advisory Council

Introduction

Mr. Schieneman called the meeting to order at 9:00 a.m. and welcomed the Council, the Board, FASB staff, and observers. He thanked Council members for attending this second meeting of the User Advisory Council and emphasized the importance of users' input to the FASB. He noted that, since the previous Council meeting, the FASB has actively incorporated feedback received from Council members into its consideration of various projects, and he encouraged Council members to continue providing this valuable input. Finally, Mr. Schieneman gave a brief overview of the projects that would be discussed in the meeting.

Disclosures about Pensions

Mr. Schieneman stated the FASB's project on pension disclosures was added in response to concerns voiced by the User Advisory Council at its previous meeting, as well as comments received from various other sources. During that meeting, Council members advised the Board that disclosures about companies' pension and postretirement benefit plan assets, obligations, and cash flows could be improved. He described the requirements of the recently-issued Exposure Draft, *Employers' Disclosures about Pensions and Other Postretirement Benefits*, and noted that the document addresses disclosures but does not include guidance related to pension accounting and recognition. He noted that the Exposure Draft calls for increased disclosures to describe plan assets, interim benefit cost, obligations and, most notably, cash flows, which are an area of particular concern to Council members. In addition, the Exposure Draft proposes eliminating the reconciliations of plan assets and obligations, as prescribed by FASB Statement No. 132, *Employers' Disclosures about Pensions and Other Postretirement Benefits*.

He stated that the Exposure Draft is expected to result in the issuance of a final Statement in December that would be effective as of this year-end. He stated that the Board would like input from the Council on the perceived benefits that would result from the increased disclosures as well as any perceived deficiencies in the Exposure Draft. In addition, he noted that the Board hoped to receive Council members' feedback on the potential addition of a broader-scoped project that would address pension recognition and measurement. Such a project might be similar in scope to those that are currently under consideration by the UK and the IASB.

Council members thanked the Board for their work on the Exposure Draft, stating that the requirements would provide financial statement users with a better understanding of companies' pension plan activities and with better information for analyzing these activities. In addition, they generally encouraged the Board to consider requiring several additional disclosures within the final Statement. Among these proposed additions, several Council members supported the inclusion of a breakdown of pension expense by income statement line item. They noted that this

disclosure would facilitate their margin analyses and forecasts. They added that it is currently unclear how a company's pension expense affects its operating and financing margins.

Council members also generally supported an additional requirement to provide a sensitivity analyses based on discount rate and compensation rate changes. They noted that these analyses would enable them to understand the effects of changes to these rates. One Council member suggested that this sensitivity be performed over a narrow range of rate changes, to facilitate comparability among companies.

Council members proposed other additions to the proposed disclosure standard, including the duration of the obligation and demographics of the workforce, recognition of pension-related items in the statement of cash flows, a description of how plan assets are measured, interim disclosure of plan asset values, a history of discount rates used, and the measurement date. They noted that this information should be easily accessible to companies because they use it for their own internal analyses.

Several Council members encouraged the Board not to eliminate the currently required reconciliations of plan assets and obligations, noting that they provide users with a more complete picture of a company's pension-related activity.

One Council member questioned whether increased disclosures about companies' investments in plan assets would change companies' investment behavior. Board members noted that the FASB's goal is not to influence management behavior, but to provide users with transparent information.

Several Council members noted that concerns about excessive disclosures arise because current measurement guidance is flawed, which leads to information that lacks transparency. They encouraged the Board to pursue a broad-scoped project on pension recognition and measurement. Some members noted that, if given actual pension gains and losses, they might exclude those numbers from their forecasts; however, some felt that the increased transparency would be helpful.

Equity-Based Compensation

Mr. Crooch described the Board's decisions reached to date in this project, including the decision that stock options will be treated as an expense measured based on the grant date fair value of the option or other equity-based award. This expense would be recognized in the income statement over the service period using a modified grant-date approach similar to the approach described in FASB Statement No. 123, *Accounting for Stock-Based Compensation*. He noted that the Board has devoted substantial time to identifying the measurement methods that would best represent the fair value of equity-based compensation awards. The Option Valuation Group, established for this project, helped the Board identify and consider alternative means of measuring fair value.

Mr. Crooch noted that the Board is considering whether to require disclosure of the inputs used by companies in their valuations. He noted that the Board's next step will be to conduct field visits with companies to understand the costs and efforts expected to be incurred to comply with the proposed Statement. In addition, the Board expects to issue an Exposure Draft during the first quarter of 2004. He stated that the Board would like input from the Council on how they use the information on equity-based compensation once it is available in the financial statements.

Council members expressed varying views regarding how their analyses might be affected by the inclusion of additional information on equity-based compensation in the financial statements.

Some members noted that they already use pro forma footnote information or recognized expense (for companies who already recognize stock compensation expense) to include an estimate of total options expense in their valuations. They generally supported the inclusion of this item in the income statement and noted that, even if not all users plan to include this measure in their analyses, providing users with this information will give them better information to do their valuations.

On the other hand, certain Council members noted that when analyzing companies that already treat equity-based compensation as an expense, they prefer to exclude the expense from their analyses because it is noncash in nature. Some other members believe that it may be too difficult to reasonably estimate the fair value of stock options and that not recognizing items with such uncertain values may be more appropriate.

Mr. Crooch noted that the Board decided that companies should use a valuation model which produces the best estimate of fair value given their specific circumstances. He asked Council members to comment on whether they have a preference for a particular valuation model (i.e., Black Scholes or a Binomial model) and how they would take into account the use of different valuation models by different enterprises.

Some Council members supported the Board's decision, noting that a company's management is in the best position to choose the model that best represents the value of their options. On the other hand, several Council members preferred the use of a single model, which they said would minimize the possibility for manipulation. One member agreed with this noting that, although a binomial method may result in a better measure, requiring the Black Scholes model might reduce subjectivity and thus be simpler to apply.

Mr. Crooch asked Council members to discuss whether disclosure of inputs to valuation models should be required. Council members generally agreed that disclosure of this information would be valuable in analyzing companies' reported compensation expense. They noted that this information could be used to replicate the compensation expense being presented, to make comparisons of compensation expense among different companies, and to compare compensation expense of the same company across periods. One Council member believed that presenting a sensitivity analysis of compensation expense using different volatility assessments could be a useful disclosure.

Mr. Crooch noted that the FASB and IASB are considering different requirements for the recognition of income tax effects of equity-based compensation, and he asked for Council members' feedback on which method is preferable. Under the FASB approach, income tax effects of temporary differences are generally recognized in the income statement. However, a) if realized tax benefits from equity awards exceed the recorded tax benefits based on the cumulative amount of recognized stock-based compensation expense, the difference is directly credited to additional paid-in capital (APIC) and b) if realized tax benefits from equity awards are less than the recorded tax benefits based on the cumulative amount of stock-based compensation expense recognized, the difference (that is, the excess deferred tax asset) is written off to the income statement to the extent that it cannot be offset by excess tax benefits previously recorded in APIC from other equity awards. Under the IASB approach, all tax effects would be recognized in the income statement.

One Council member stated that the operating component of tax expense should be kept separate from the financing component of tax expense, and he stated that he would only support the IASB

approach if the two components were kept separate. Otherwise, he noted, he prefers the FASB approach. Another Council member stated a different view, noting that she prefers the IASB approach because she would not want to give up the informational benefits of including all tax effects in the income statement. One Council member noted that he would be supportive of the IASB's method if exercise date measurement was used in determining the fair value of the equity-based compensation awards.

Mr. Crooch asked Council members whether disclosures should be added to describe equity-based compensation, and one member stated her preference for requiring an enterprise to report the fair value of all equity-based compensation awards outstanding at each reporting date. Certain Council members discussed share repurchase arrangements and the potential utility of disclosing information related to expected share repurchases. Those Council members generally agreed that information related to expected share repurchases is unreliable.

Regarding transition guidance for the proposed Statement, Council members generally agreed that the FASB should specify one transition method. They generally agreed that retrospective treatment should be used, noting that the information necessary to meet this requirement should be readily available; however, they cautioned Board members that they may encounter resistance to this idea from the preparer community.

Performance Reporting

Mr. Schieneman stated that the Board's performance reporting project focuses on the display of the basic financial statements, but it is not intended to change any recognition and measurement provisions. He noted that the project is currently focusing on the income statement but will eventually address the display of all of the basic financial statements, both interim and annual. In addition, he noted that a key focus of the project is convergence with the IASB, which is conducting a similar project.

Mr. Schieneman described some of the key decisions reached in the project, such as the introduction of one statement of comprehensive income that would eliminate the two-statement approach described in FASB Statement No. 130, *Reporting Comprehensive Income*. In addition, he noted that a company's business category will be defined using a management approach. This means that items included in this category will be determined by management to represent only their core or main business activities. The financing category, he noted, would be based upon the notion of net debt, which would be defined as all liabilities, net of cash and cash equivalents. Therefore, the financing category would include: 1) expenses incurred related to the passage of time for all types of liabilities; 2) income attributable to cash and cash equivalents related to the passage of time; and 3) gains and losses arising from the issuance, restructuring, and extinguishment of debt. Mr. Schieneman noted that FASB staff members had asked several companies to apply the Board's decisions, as well as some working principles developed by the staff, to their own income statements. He showed Council members the resulting statements of comprehensive income and described the effects of the display changes. He asked Council members for their reactions to these changes, including their reactions to the elimination of net income, the management approach, applying the notion of net debt to the financing category, and whether and how the financial statements should be further disaggregated.

Mr. Schieneman described a few of the differences in each of the FASB and IASB projects. Among these, the two Boards have defined the business and financing categories differently; in particular, the IASB plans to use its business category to capture all residual items that do not

meet the definition of financing activities, while the FASB plans to use the nonbusiness/nonfinancing category to capture residual items. He asked Council members for feedback on these differences.

Council members expressed concern about similar transactions and events that would be reported in separate categories, such as equity in earnings of an equity method investee (which could be reported either in the business category or the other nonbusiness/nonfinancing category). They challenged the Board to determine whether the benefit of separation into categories exceeded the benefit of a combined presentation. In addition, Council members asked how various line items would be affected by the new classifications. Ms. Sullivan responded that, for field test participants, a decision tree was provided to determine how various revenues, expenses, gains, and losses might be displayed based upon the management approach.

Several Council members supported the notion of having companies use their discretion to determine the classification of revenues, expenses, gains, and losses on their financial statements. Some members, however, expressed concern that companies might have different ideas of what constitutes their “core business” and noted that this may lead to manipulation of earnings.

Some Council members expressed concern about how the tax effects of items now seen as extraordinary or nonrecurring would be treated. There was some support expressed for the UK approach, which would present amounts on a pre-tax basis. One Council member noted that an important measure in their analysis is the determination of not only the pre-tax effect of certain types of transactions and events but also the after-tax value. He also expressed that nonrecurring items should require different display treatment from ongoing operations.

Regarding the use of net debt as the basis for the financing category, Council members expressed some concern that net debt could make companies with very different debt capital structures look similar on the face of the statement. Some also noted that a financing division could be considered integral to the sales process for some companies. A few Council members favored more information to describe the nature of the cash or cash equivalents included in the netting process.

Some Council members expressed reservations about the proposal to move items out of other comprehensive income into the general income statement. They noted that many of those items do not provide information on the future earnings potential of companies. They noted that they would exclude most other comprehensive income items as well as items that they perceive as nonrecurring from their analyses. Some Council members suggested that the Board develop a conceptual definition to describe items such as nonrecurring charges and revenues and expenses. One Council member noted that comprehensive income, as a line item by itself, would probably not be a factor in users’ analyses.

Some Council members favored the retention of net income. Others believed that, as long as items of other comprehensive income were displayed as separate line items, they would have sufficient information to perform their analyses.

Council members encouraged the Board to focus on providing additional guidance on disaggregation.

Revenue Recognition

Ms. Schipper described the reasons for the revenue recognition project. She explained that one of the current criteria for revenue recognition is that it is earned, which has led to a voluminous

amount of transaction- and industry-specific guidance. She asked for Council members' reactions about comparability of financial statements given this industry- and transaction-specific revenue recognition guidance.

Ms. Schipper described the two approaches that the Board is considering for defining revenues; one approach is based upon the notion of performance, and the other approach is based upon the notion of liability extinguishment. Ms. Schipper provided Council members with an example illustrating the two approaches and asked for Council members' reactions to them.

In addition, she noted that the Board's new guidance will focus on reporting performance obligations at their fair values. She asked Council members whether they agree that fair value is the most relevant measure of those obligations.

Council members asked the Board to continue to clarify the definition of revenues and to further explore the impact of the two approaches on transactions. One Council member suggested that the Board consider carrying an example forward for several accounting periods to understand the effects of each approach over a longer span of time. Some Council members agreed that the degree to which an entity bears risk for an activity should be a consideration in whether revenue should be recognized for completion of that activity.

Some Council members cautioned that fair values for performance obligations, in practice, may be difficult to identify. One Council member recommended that the Board follow a conservative approach noting that, when there is doubt whether or not revenue should be recognized, a company should defer recognition. However, Board members analogized this approach to the completed contract method, which other Council members noted does not accurately reflect the economics of a transaction.

The Board asked Council members whether revenue should be recognized for the selling effort. Some Council members expressed concern about this. They noted that the amount considered by the Board to be attributed to selling efforts could also arise, in part, from a number of other activities, such as marketing and distribution or general and administrative activities.

Conclusion

Mr. Schieneman thanked Council members for their participation in the meeting and for the useful feedback they had given the Board. He indicated that the Board's involvement with the user community will be an ongoing process. He stated that the Board appreciates Council members' involvement not only in the Council meetings but also in the various projects to which each Council member has been assigned. He stated that he looked forward to seeing Council members again at the next meeting.

The meeting was adjourned at 4:00 p.m.