



MINUTES OF MEETING

Financial Accounting Standards Advisory Council
March 23, 2006

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

Members Attending

Richard J. Swift, Chairman
James L. Brown
Stephen J. Cosgrove

Mark W. Nelson
Edward E. Nusbaum
Klaus D. Patzak

Leslie Culbertson
Timothy J. Curt
Robert E. Friedman

Samuel J. Ranzilla
David B. Rickard
Steven A. Rogers

Charles L. Hall
Gregory J. Jonas
Richard D. Levy

Arleen R. Thomas
E. Anson Thrower
Scott M. Waite

Thomas J. Linsmeier
Elizabeth F. Mooney
John B. Morse, Jr.

Brent A. Woodford
William L. Yeates
Michael R. Young

Members Not Attending

Richard H. Booth
Colleen Cunningham

Nellie Liang
Kevin B. Reilly

Joe Joseph
Mark E. Lackritz

Rita J. Spitz
Gregory G. Weaver

Others Attending

Financial Accounting Standards Board:
Robert H. Herz, Chairman
G. Michael Crooch
Leslie F. Seidman

Katherine A. Schipper
Donald M. Young

FASB Staff:

Suzanne Q. Bielstein, Director of Major Projects and Technical Activities
 Linda A. MacDonald, Director of Planning, Development and Support Activities
 Larry W. Smith, Director of Technical Application and Implementation Activities
 Ronald J. Bossio, Senior Project Manager
 Kevin H. McBeth, Project Manager
 Stefanie A. Tamulis, Project Manager
 Jeffrey J. Johnson, Project Manager
 Karen E. Gibbons, Postgraduate Technical Assistant

Others:

Scott Taub, Acting Chief Accountant, Securities and Exchange Commission
 (SEC)
 Thomas Ray, Chief Auditor, Public Company Accounting Oversight Board
 (PCAOB)

Introduction

1. Mr. Swift called the meeting to order at 9:00 a.m. He welcomed the nine new council members and announced that James Ryan resigned from the council and that his position will be filled within the next year.

Report from the FASB Chairman

2. Mr. Herz reported on the following matters:
 - a. The issuance of FASB Statements No. 155, *Accounting for Certain Hybrid Financial Instruments*, and No. 156, *Accounting for Servicing of Financial Assets*. Statements 155 and 156 allow for fair value accounting for certain items.
 - b. The issuance of the FASB Exposure Draft, *The Fair Value Option for Financial Assets and Financial Liabilities*.
 - c. The posting of several final and proposed FASB Staff Positions (FSPs) to the FASB website.
 - d. The addition to the agenda of a project to address the permitted activities of a qualifying special-purpose entity (SPE) in the context of servicer discretion. The Board agreed to provide interpretive guidance in the form of an FSP.
 - e. The progress on the revenue recognition project. The Board previously pursued a fair value approach but is currently exploring a customer consideration approach at the principles level. A discussion document is planned for issuance in late 2006. The revenue recognition project is expected to help with reconciling different industry accounting practices for transactions with similar economics.

- f. The status of the derivatives disclosures project. The Board is consulting with a working group to consider the different approaches for improving disclosures for derivatives.
- g. The issuance of an Exposure Draft for Phase I of the pension project is expected by March 31, 2006. The comment period will be 60 days.
- h. The redeliberations for the uncertain tax positions project, which are finalized with the exception of required disclosures. The FASB Exposure Draft, *Accounting for Uncertain Tax Positions*, contained a *probable* recognition threshold, but the Board decided on a *more-likely-than-not* threshold during redeliberations. The issuance of the final document is planned for June 2006.
- i. The discussions on lease accounting. The Board will discuss whether to add a project on that topic during April 2006.
- j. The creation of an investor task force, which, among other things, will help in addressing industry-specific matters.
- k. Personnel matters:
 - (1) Jeff Mahoney will be leaving his position as counsel to the Chairman. Candidates to replace Mr. Mahoney are currently being interviewed.
 - (2) Linda MacDonald has rotated into the position of director of planning, development, and support, previously held by Kim Petrone. Ms. Petrone will be rotating in as a senior project manager on the performance reporting project.
 - (3) Jeffrey Mechanick has been hired as a project manager and will be focusing on the development of accounting standards for not-for-profit entities.
- l. The activities of various international standard setters. In February, the FASB and IASB issued a memorandum of understanding that describes the plans for continuing convergence activities. The next FASB and IASB joint Board meeting will be held during the third week of April in London. The Canadian Accounting Standards Board recently agreed to move to International Financial Reporting Standards (IFRS) over a five-year period. In February, China issued its first set of accounting standards that are based on IFRS.
- m. The FASB's response to the SEC study on off-balance sheet arrangements.
- n. The Board's continued pursuit of a principles-first approach to developing accounting standards. The codification project will help reveal the extent to which current standards are based on principles.
- o. The purpose of the private company initiative. The efforts directed at this initiative will not seek to create two sets of standards for different entities. Rather, this initiative will involve a process of focusing on differences

within existing GAAP that may be justified due to different user needs or cost-benefit considerations.

3. Mr. Smith reported on the following technical application and implementation activities:
 - a. The issuance of industry guidance. Since the American Institute of Certified Public Accountants (AICPA) has agreed to not use the Accounting Standards Executive Committee (AcSEC) for the purposes of issuing GAAP, the FASB has undertaken to provide specific industry guidance. In particular, the FASB hired Jeffrey Mechanick to address issues unique to not-for-profit entities. The Board also is providing accounting guidance related to the oil and gas industry, the mining industry, planned major maintenance activities, the brokerage industry (accounting for 12(b)(1) fees), stable value funds, accounting lending activities for various loan products (FSP on SOP 94-6-1, "Terms of Loan Products That May Give Rise to a Concentration of Credit Risk"), financial guarantees, leveraged leases, life settlements, and risk transfer.
 - b. The genesis of industry issues. These are being brought to the FASB's attention by the AcSEC staff (when the Audit Guides are overhauled) as well as by the SEC staff, banking regulators, and liaison groups.
 - c. The status of the GAAP hierarchy project. This project is complete pending action by the PCAOB to remove the GAAP hierarchy from its literature.
4. Ms. Bielstein reported on the next steps for the joint short-term convergence projects on research and development and impairment described in the IASB and FASB's memorandum of understanding:
 - a. Research and development. The plan is to have a decision as to the scope of that project by the end of 2006. The SEC is to provide an analysis of the differences between U.S. GAAP and IFRS in accounting for research and development.
 - b. Impairment. The Canadian Accounting Standards Board has done work in this area, and the Boards will be working during the second quarter of 2006 to determine the scope of a possible project.

Report of the SEC

5. Mr. Taub reported on the following matters:
 - a. Personnel matters. John White began this week as the new Director of Corporation Finance, replacing Alan Beller who left the Commission staff.
 - b. Internal control reporting. On May 10, 2006, the SEC and PCAOB will host a roundtable on Section 404 of the Sarbanes-Oxley Act (Section 404), following the second year of compliance for accelerated filers. The focus will be on how the current year compliance process compared to last year's.

- c. Smaller public companies. The SEC is expecting to receive in April final recommendations from its Advisory Committee on Smaller Public Companies. The Committee's approximately 30 recommendations on how to apply Section 404 and other securities regulations to smaller public companies have been on the SEC's website for comment.
- d. Principles-based standards. The SEC staff continues to support principles-based standards but has been a little disheartened by the lack of a principles-based approach by some to implementation of recent standards as evidenced by numerous requests for implementation guidance and apparent transaction structuring. The SEC staff will continue to consider reasonable judgments made by companies.
- e. IFRS financial statements. Approximately three hundred sets of IFRS statements with reconciliation to U.S. GAAP are expected to be filed this year with the SEC. The SEC staff will be assessing the content and usefulness of the information and will be looking at IFRS application across companies and countries to observe application consistency.

Report of the PCAOB

6. Mr. Ray reported on the following matters:

- a. Personnel matters:
 - (1) William McDonough left his position as chairman in December 2005. Bill Gradison was appointed as acting chairman and chief executive.
 - (2) Doug Carmichael left the position of chief auditor and director of professional standards in late January. Tom Ray was appointed to succeed Mr. Carmichael as chief auditor and director of professional standards.
 - (3) Laura Phillips and Jennifer Rand were promoted to deputy chief auditor positions.
- b. Auditing Standard No. 4, *Reporting on Whether a Previously Reported Material Weakness Continues to Exist*, was approved by the SEC and is now effective.
- c. Rules on auditor independence, tax services, and contingent fees that were adopted by the PCAOB last year were published by the SEC for public comment. The comment period will end April 3.
- d. The PCAOB's Standing Advisory Group (SAG) met in Washington D.C. on February 9, 2006. SAG discussed:
 - (1) Using the work of a specialist
 - (2) Consideration of materiality in planning the audit and evaluating possible misstatements
 - (3) The effect on auditor independence on the limitation of liability agreements contained in audit engagement letters.

- e. The PCAOB is accepting written comments on lessons learned from implementation of the Section 404 provisions for purposes of the May 10, 2006, SEC and PCAOB roundtable.
- f. The PCAOB issued two reports on its inspections of accounting firms:
 - (1) The first report details the process for determining whether a registered firm has satisfactorily addressed quality control concerns. Quality control concerns shall not be made public provided those criticisms are addressed within twelve months to the satisfaction of the PCAOB.
 - (2) The second report describes efforts undertaken by the four largest accounting firms to address quality control concerns during initial limited inspections. Each of those firms addressed quality control concerns to the PCAOB's satisfaction and those concerns will remain nonpublic.
- g. As of March 14, 2006, over 1,600 firms were registered with the PCAOB. Nine hundred and fifty nine of those firms are U.S. firms, and the remainder are located in about 80 countries. One hundred and one firms have withdrawn registration from the PCAOB.
- h. In response to questions from FASAC members, Mr. Ray noted that, while the PCAOB does not have a formal policy on convergence of auditing standards, the PCAOB supports current international convergence efforts and considers applicable international standards in its standard-setting process. In addition, Mr. Ray summarized actions the PCAOB has taken in response to criticism from the implementation of section 404 of the Sarbanes-Oxley Act of 2002, and to calls for more implementation guidance related to Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements*.

Business Combinations

- 7. Ms. Tamulis stated that the business combinations project is in the redeliberations phase and that the Exposure Draft is based on the following two principles:
 - a. *Recognition principle*: The acquirer should recognize all of the assets acquired and liabilities assumed on the acquisition date. Assets acquired and liabilities assumed must meet the definition of an asset or a liability in the FASB Concepts Statements.
 - b. *Fair Value measurement principle*: The acquirer should measure each asset acquired and liability assumed at fair value as of the acquisition date.
- 8. Ms. Tamulis noted that under the *recognition principle* in the Exposure Draft on business combinations, certain items would be accounted for as follows as of the acquisition date:

- a. In-process research and development would be recognized as an asset rather than immediately expensed.
 - b. Transaction costs would not be recognized as assets.
 - c. Restructuring costs would not be recognized as liabilities.
9. Ms. Tamulis noted that under the *fair value measurement principle* in the Exposure Draft on business combinations, certain items would be accounted for as follows as of the acquisition date:
- a. Receivables would be measured at fair value rather than at the present value of amounts to be received less a valuation allowance.
 - b. Contingent assets and liabilities would be measured at fair value rather than in accordance with FASB Statement No. 5, *Accounting for Contingencies*.
 - c. If the business combination is a bargain purchase (fair value of net identifiable assets and liabilities exceeds consideration paid), the acquirer would recognize a gain on the acquisition date rather than allocating the excess to particular assets.
 - d. Goodwill is an exception to this principle because it can only be calculated as a residual (the fair value of the business (generally the price paid) less the fair value of the net identifiable assets of the business).
10. Council members expressed the following views on the approach in the Exposure Draft on business combinations:
- a. The accounting for in-process research and development is appropriate for late stage products in which it is more likely than not that the research and development efforts will come to fruition. However, in high-risk industries, in which the probability of research and development being successful is low, it may not be appropriate to recognize an asset.
 - b. In the case of contingencies, it is troubling that the accounting for the same contingency would be different if the contingency is acquired in a business combination.
 - c. It is troubling that a gain may be recognized in the case of a bargain purchase. Furthermore, if substantial restructuring is required and an acquisition is a bargain purchase, a gain would be recognized upfront and a related loss would be recognized in the future.
 - d. The quality of the principles is called into question when an exception is made, for example, for goodwill. Also, it is inconsistent that the exception does not also apply to negative goodwill.
 - e. The propose changes may result in decreased comparability among entities in particular industries, for example, in the case of loan losses carried at fair value (without a reserve) after an acquisition. Coverage ratios will be distorted, and no systems are in place to track loans at fair value.

- f. The accounting for restructuring costs seems to depart from the fair value principle. In many cases, a business that is acquired cannot operate without restructuring and the acquirer assumes this liability upon acquisition. The company's cost for those items is the best estimate of the fair value. In addition, the accounting for those items is inconsistent with the accounting for contingencies.
- g. Cooperatives (credit unions) have unique capital structures, and mergers in this industry can be considered a merger of equals—there is no acquirer. It is difficult to measure at fair value the credit union and to determine the acquirer. The proposals will eliminate mergers of smaller sized credit unions.
- h. Accounting for deferred taxes is problematic under the Exposure Draft on business combinations. For example, if an oil and gas company acquires assets and there are significant differences between the book basis and tax basis of the assets, deferred taxes are recorded at gross, and if goodwill cannot be recorded, the offset will go to unproved reserves. The fair value of this asset will be distorted.

Fair Value Measurement

- 11. Ms. Seidman stated that the purpose of this project is to provide guidance for measuring fair value when other standards require or permit a fair value measurement attribute. The proposed fair value measurement Statement, once finalized, may result in a change in practice for some entities applying fair value measurement under other accounting pronouncements. Some of the changes under the proposed fair value measurement Statement include:
 - a. A change in terminology from *willing buyer and seller* to *marketplace participants*.
 - b. A notion that creditworthiness should be included in the fair value of an entity's liabilities.
 - c. A clarification of the fair value hierarchy, which is intended to bring order to the way the inputs in a fair value measurement are viewed.
 - d. A framework for additional disclosures that will be required for fair value amounts.
- 12. Ms. Seidman stated that in the case of the fair value of a derivative instrument based on unobservable inputs, the Board is engaged in ongoing discussions about the appropriateness of recognizing a gain at contract inception. Board members have different views, but all Board members would be supportive of clearer disclosure in cases in which derivatives are valued with unobservable inputs. This issue will be discussed with the Investor Task Force and User Advisory Council.
- 13. The pre-meeting materials indicated that the proposed fair value measurement Statement would be effective for 2007 fiscal years. However,

Ms. Seidman reported that the Board recently decided to defer the effective date by one year.

14. Council members expressed the following views:

- a. The effective date of the Statement should precede that of the business combinations and fair value option projects, since those projects permit or require fair value measurements.
- b. The Board should consider working with continuing professional education providers to teach the material in this project using an approach similar to the one used in the codification project.
- c. Fair value measurement is disconcerting when the unobservable data that are involved as estimates become greyer. Recognition of day-one gains is also troubling. These issues may create relevance and comparability concerns.
- d. This is only one of many areas in which numbers in the financial statements are developed from unobservable inputs. Requiring additional disclosures in the case of fair value measurement values with unobservable inputs may skew other values that also are developed from unobservable inputs. A disclosure framework at the conceptual level should be developed to aid in developing disclosures.
- e. Precluding blockage discounts violates the principles; fair value is not always determined by multiplying price by quantity.
- f. The Board is willing in the business combinations project to allow recognition of a day-one gain for bargain purchases. Does this mean the Board is willing to allow day-one gain or loss recognition in other areas (for example, due to the difference between exit value and cost in the case of debt issuance costs)?

Fair Value Option

15. Ms. Seidman stated that creation of a fair value option would permit an entity to achieve an offset accounting effect by measuring at fair value related assets and liabilities currently measured using different measurement attributes. Under a fair value option, entities may mitigate volatility in earnings without having to apply complex hedge accounting provisions.
16. The project is somewhat convergent with IFRS, as the IASB currently has a fair value option (there are differences in scope). Most financial assets and financial liabilities will be eligible for a fair value option, and the Board is seeking feedback on the applicability of a fair value option to nonfinancial assets and nonfinancial liabilities in the Notice for Recipients to the Exposure Draft for Phase 1, which was issued January 25, 2006.
17. Council members expressed the following views:

- a. If creditworthiness of an entity decreases, does that company record a gain when marking its liabilities to fair value? Taken further, is there a large gain recognized when a company files for bankruptcy?
- b. The treatment alternative is somewhat surprising, and the Board should increase consistency by requiring election of the fair value option on other than an instrument-by-instrument basis. For example, the election should be by class or by year.
- c. Cherry picking is likely to occur, and the fair value option may result in different accounting treatment for similar transactions, especially at transition. For example, if a company is about to violate a debt covenant, that company may elect the fair value option to write down the debt or write up an equity-method investment. This election may be appropriate if it is narrowly applied (for example, limited to hedging relationships).
- d. The fair value option under IFRS has been limited over time and the scope in this project is not likewise limited. How will the differences in scope be reconciled?
- e. Earnings from actual cash flows and those that relate from fair value adjustments should be presented separately.

Conceptual Framework: Invitation to Comment, *Selected Issues Related to Assets and Liabilities with Uncertainties*

- 18. Mr. McBeth stated that the staff completed an analysis of the comments received on the Invitation to Comment, *Selected Issues Related to Assets and Liabilities with Uncertainties*. The comments did not differ substantially from the comments the IASB received on IAS 37, *Provisions, Contingent Liabilities and Contingent Assets*.
- 19. Respondents to the Invitation to Comment expressed varied views on the issue of stand-ready rights and obligations. All respondents agreed that stand-ready obligations exist, but respondents analyzed stand-ready obligations differently. The staff has developed four possible categories of stand-ready obligations, ranging from least inclusive, category 1, to most inclusive, category 4:
 - a. Category 1: Stand-ready obligations supported by a present contract
 - b. Category 2: Stand-ready obligations supported by existing statutory or regulatory law or a present contract
 - c. Category 3: Stand-ready obligations supported by a current lawsuit, existing statutory or regulatory law, or a present contract
 - d. Category 4: Stand-ready obligations supported by expected future sacrifices.
- 20. Council members expressed the following views:

- a. Council members generally agreed that categories 1 and 2 meet the definition of a liability.
- b. Statement 5 guidance falls between categories 3 and 4, and the approach for stand-ready obligations should as well. Stand-ready obligations should not include category 4, which implies that a liability can arise when there is no existing obligation.
- c. In practice, the tendency may be to first identify a future payout and then find some stand-ready obligation that relates to it. The notion of stand-ready obligations seems like a device to move consideration of probability from recognition to measurement, such that the liability is measured at fair value.
- d. Categories 2 and 3 are essentially the same. A lawsuit generally arises from a violation of existing law.
- e. It does not make sense to omit common law by specifying “existing statutory or regulatory law.” It would be preferable to include common law by using the phrase “existing law.”
- f. There should be a distinction between legitimate and frivolous lawsuits. An entity should not be able to affect another entity’s balance sheet by filing frivolous lawsuits. (Under the Statement 5 approach, these lawsuits would have no effect if the likelihood of adverse judgment is remote). Valuing lawsuits at fair value may become a self-fulfilling prophecy or a floor for the actual settlement.

21. Council members raised the following questions:

- a. If a company enters into a contract to purchase another company, but approval is needed to execute the purchase, has a liability been created?
- b. If a questionable industry practice is emerging, but a suit has not yet been filed, when does the liability arise?
- c. Was it intentional to omit a *past events* notion from the four categories?
- d. How would an amendment to a pension plan that would increase benefits for retirees be analyzed?

Conceptual Framework: Objective of Financial Reporting

22. Ms. Schipper stated that the purpose of today’s discussion on this topic is to seek feedback from council members on the objective of general purpose external financial reporting (GPEFR) by business entities. The objective that the IASB and FASB have tentatively agreed to is as follows:

The objective of general purpose external financial reporting is to provide information that is useful to present and potential investors and creditors and other capital market participants in making rational investment, credit, and similar resource allocation decisions.

23. Ms. Schipper noted the following characteristics of the definition:

- a. It focuses on external users of financial reports who lack the authority to prescribe the information that they require and whose decisions pertain to resource allocation decisions.
- b. The focus is on resource allocation decisions; therefore, the focus cannot be on providing information to determine “whether management has carried out its duties to existing owners.”¹
- c. The objective does not imply that GPEFR is intended to provide an estimate of an entity’s value. One of the sentences in Colleen Cunningham’s article in *Financial Executive* could be read as implying that the FASB might have a valuation objective in mind; that is not an implication of the tentative objective.

24. Ms. Schipper asked Council members whether they agree with the tentative objective. She then asked, if they disagree, how would they describe that objective and what are the implications for GPEFR of that objective?

25. Council members expressed the following views or concerns:

- a. The concepts in the proposed objective are appropriate with the following modifications:
 - (1) *Similar* is vague and unnecessary.
 - (2) The phrase *other capital market participants* (which is ambiguous) should be replaced with *and their advisors* to keep the focus on investors and creditors.
- b. The objective does not add sufficient clarity and only captures a small fraction of what financial statements are intended to accomplish. The objective does not indicate the kind of information that financial reporting provides.
- c. It is unclear why the objective distinguishes between present and potential investors.

¹Colleen Cunningham, Colleen. “Financial Statements are Trying to Do Too Much”,. *Financial Executive*., February 2006.

- d. The objective may not be relevant to private companies since they often do not have *potential* investors. The objective should remain general enough so that it is relevant to private companies and small- and medium-sized enterprises. This will also help avoid the creation of piecemeal standards in the future.
- e. The focus on current and potential shareholders is appropriate. The CFA Institute approach, which focuses the objective on existing common shareholders, incorrectly assumes that the needs of creditors are a subset of the needs of common shareholders. For example, creditors have different concerns during distress or bankruptcy than common shareholders.
- f. The objective lacks a reasonableness threshold and could imply that investors should have access to a company's general ledger. The objective is also too broad as it could be read to mean that external financial reporting should focus on future-looking information, such as a company's internal forecasts and budgets, since such future-looking information would likely be helpful in making current and future decisions.
- g. The objective should capture management's stewardship responsibilities.
- h. The development of the objective of financial reporting should be an iterative process as the Board makes decisions about other aspects of the conceptual framework.
- i. Financial reporting should provide more forward-looking information, and the objective should not preclude that.