

MINUTES



To: Board Members

From: Short-Term Convergence—Phase 1
Varian (ext. 353)

Subject: Minutes of the March 2, 2005 Board Meeting **Date:** March 9, 2005

cc: Bielstein, Smith, Leisenring, Swift, Polley, Gabriele, FASB Intranet,
Project Team (J. Johnson, McKenna, Varian, Vincent), McGeachin
(IASB via e-mail)

The Board meeting minutes are provided for the information and convenience of constituents who want to follow the Board's deliberations. All of the conclusions reported are tentative and may be changed at future Board meetings. Decisions become final only after a formal written ballot to issue a final Statement or Interpretation.

Topic: Redeliberation of 2003 Exposure Draft, *Accounting Changes and Error Corrections*

Basis for Discussion: Memorandum Accounting Changes 2

Length of Discussion: 9:00 a.m. to 10:10 a.m.

Attendance:

Board members present: Herz, Batavick, Crooch, Schipper, Seidman,
Trott and Young

Board members absent: None

Staff in charge of topic: J. Johnson

Other staff at Board table: Bielstein, Cassel, McKenna, Varian

Outside participants: Jim Paul (IASB, by phone)

Summary of Decisions Reached:

The Board redeliberated certain issues related to the provisions of the FASB Exposure Draft, *Accounting Changes and Error Corrections*, issued in December 2003. The Board decided to:

- a. Require that retrospective application consider the direct effects of a change in accounting principle and the related income tax effects of the change. Indirect effects on items based on income before taxes or net income, such as profit sharing expense and certain royalties, that would have been recognized if the newly adopted accounting principle had been followed in prior periods shall not be included in the retrospective application. Adjustments relating to indirect effects should be reported in the period in which the adjustment is actually recorded and disclosed in accordance with the disclosure requirements of the final Statement. The Board also asked the staff to clarify that this guidance also applies to cases in which a limited retrospective application is used because full retrospective application is impracticable.
- b. Require disclosure of the portion of any indirect effect recorded in the current period that is attributable to each specific prior period presented, if it is practicable to determine that information.
- c. Clarify that the reference to depreciation, amortization, and depletion in the proposed Statement refers only to methods of allocating costs of long-lived, nonfinancial assets and not to other uses of those terms in GAAP.
- d. Retain the Opinion 20 restatement requirement for a correction of an error, without providing an impracticability exception.

Objective of Meeting:

The objective of the Board meeting was to redeliberate certain remaining issues related to the Exposure Draft, *Accounting Changes and Error Corrections*.

Matters Discussed and Decisions Reached:

1. Mr. Johnson began by stating the first of four questions to be considered—Should retrospective application consider only the direct effects and related income tax effects of a change in accounting principle, or should it also consider other nondiscretionary adjustments? He presented an example of a nondiscretionary adjustment as a profit sharing agreement that requires a payment of 10% of net income as a bonus. He stated that in 2004 the bonus was properly accrued, and in 2005 management makes a voluntary election to change an accounting principle that must be retrospectively applied, which causes the net income of 2004 to increase. He noted that the profit sharing agreement explicitly requires an incremental bonus payment if net income of a prior period was to change in a subsequent period. He stated that the question was whether this incremental bonus accrual should be carried back to the prior period.
2. Mr. Johnson presented two alternatives to the issue. View A would require that the incremental bonus accrual be retrospectively adjusted because the prior period should be presented as if the new accounting principle had always been in place. View B would require that the incremental bonus be recorded in the period of change because there is no obligating event, and therefore, no liability until management voluntarily decides to change an accounting principle. He recommended View B. He stated other practical reasons for a View B approach. He stated that most cases will not be as clear-cut as the example given. For example, he questioned which approach should be used when the profit-sharing agreement does not explicitly state what should be done when net income of a prior period changes due to a change in accounting principle. He stated that it would be unclear whether the decision to make the incremental payment would be discretionary or nondiscretionary in most cases. He further stated when the staff asked practice about this, each practice professional he contacted stated that a clearly nondiscretionary adjustment is very rare.

3. Mr. Johnson stated that IAS 8, *Accounting Policies, Changes in Accounting Estimates and Errors*, is silent on this issue. However, he stated that certain staff at the IASB believe that one should retrospectively adjust for consequential effects on profit sharing and royalty agreements in situations where it is clear the the contract requires adjustment of payment.
4. Mr. Crooch questioned why the Board should require retrospective application for direct effects and not require retrospective application for indirect effects. He stated that this inconsistent application would decrease the benefit that results with retrospective application. He suggested that retrospective application be required for all effects of a change in accounting principle actually recorded unless it is not possible to determine the related periods that are affected.
5. Mr. Trott stated stated that he was concerned about the staff recommendation (View B) in cases where it is clear that it is a nondiscretionary adjustment; however, because he believes that those cases are very rare, he stated that he supports the staff recommendation.
6. Mr. Batavick stated that he supported View A. In retrospectively applying a change in accounting principle, he stated that if an asset or a liability needs to be established as a result of an indirect effect, whether discretionary or nondiscretionary, he believes that effect should be applied retrospectively. He further stated that he believes that treatment is consistent with what is currently required in Opinion 20 for cumulative effect adjustments. He noted that View A would allow for a consistent earnings trend.
7. Mr. Young stated that he favored intraperiod consistency, but he further stated that he would support the staff recommendation if additional disclosure of the indirect effects was required.
8. Ms. Seidman stated that this issue is a difficult balancing act between practicability and transparency. She stated that she supports the staff recommendation with clarifying language stating that adjustments relating to

indirect effects that are actually recorded should be reported in the period of change and disclosed in accordance with the disclosure requirements of the final Statement.

9. Ms. Schipper stated that she agrees with the staff recommendation because the event that gives rise to the recognition of an indirect effect is the decision to change an accounting principle, and therefore, the indirect effect should be recorded in the period of change.
10. Ms. Seidman suggested that the final Statement clarify that this guidance also applies to cases in which a limited retrospective application is used because full retrospective application is impracticable.
11. Mr. Herz stated that he supports the staff recommendation unless the effect is clearly nondiscretionary, in which case, he prefers View A—retrospective application for the nondiscretionary, indirect effect. He noted that it could be argued the nondiscretionary adjustments are direct effects. He further stated that his view would limit retrospective application to nondiscretionary adjustments that are explicitly required in contracts.
12. Six Board members agreed to a clarified staff recommendation (View B)—adjustments relating to indirect effects should be reported in the period in which the adjustment is actually recorded and disclosed in accordance with the disclosure requirements of the final Statement. The Board also asked the staff to clarify that this guidance also applies to cases in which a limited retrospective application is used because full retrospective application is impracticable. Mr. Batavick objected.
13. Mr. Johnson stated the second question—Should additional disclosure regarding the indirect effects of an accounting change be required? He stated that paragraph 19 of the Exposure Draft requires disclosure of the effect of the change on each financial statement line item affected in the current period as well as the periods that have been retrospectively adjusted. To the extent that a nondiscretionary adjustment that would have been

required in a prior period is actually recorded in the period of change, or subsequent to the period of change, disclosure of the effect is required. He stated that a few respondents recommended adding a requirement that entities that have significant nondiscretionary items should disclose that the effects of an accounting change on prior period are not representative of the effects going forward. He recommended that additional disclosure requirements not be included in the final Statement.

14. Mr. Young stated that he believes additional disclosure requirements should be included in the final Statement that require entities to describe the allocation to prior periods of the of the indirect effects recorded in the current period. Mr. Herz agreed.
15. All Board members agreed that disclosure of the portion of any indirect effect recorded in the current period that is attributable to each specific prior period presented should be required, if it is practicable to determine that information.
16. Mr. Johnson stated the third question—Should the final Statement require that a change in the method of amortization and depletion be treated as a change in accounting estimate effected by a change in accounting principle? Although the Exposure Draft uses the words depreciation, amortization and depletion to describe what should be accounted for as a change in accounting estimate, he stated the the Board only discussed the issue within the context of depreciation. He further stated that one staff member believed that including amortization and depletion in the Exposure Draft was an inappropriate expansion of the Board's decision. In addition, Mr. Johnson stated the Exposure Draft states that a change in accounting estimate should be accounted for prospectively. He stated that the Board intended to carry forward the requirements of Opinion 20 for a change in estimate, which states that the effect of an accounting estimate should be accounted for in (a) the period of change if the change affects that period only or (b) the period of change and future periods if the change affects both. He stated that staff will include that language in drafting the final Statement and delete the reference

to prospective application for a change in accounting estimate. In addition to that change, he recommended that the staff draft be modified to clarify that the reference to depreciation, amortization, and depletion refers only to methods of allocating costs of long-lived, non financial assets and not to other uses of those terms in GAAP. All Board members agreed with the staff recommendation.

17. Mr. Johnson stated the final question—Should the final Statement include an impracticability exception to the retrospective restatement requirement for correction of an error in prior period financial statements? He stated that IAS 8 has an impracticability exception for error corrections, and therefore, if an entity cannot restate they can use a cumulative effect adjustment. He further stated that Opinion 20 requires restatement for correction of an error. He noted that if an entity cannot restate, they cannot comply with US GAAP, and therefore, they would have an audit issue. He recommended that the proposed Statement be finalized as currently drafted, without an impracticability exception for error corrections.

18. Ms. Seidman questioned whether the IASB was concerned that the SEC would be unwilling to accept financial statements that did not restate error corrections. Ms. Beilstein stated that the IASB staff is aware of the issue, and is planning to discuss it with the SEC.

19. All Board members agreed with the staff recommendation.

Follow-up Items:

None.

General Announcements:

None.