

REVISED MINUTES



To: Board Members

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

Subject: Minutes of the December 22, 2004 Board Meeting **Date:** January 7, 2005

cc: Bielstein, Smith, Petrone, Leisenring, Swift, Polley, Gabriele, Thompson, Sutay, FASB Intranet, Project Team (J. Johnson, McKenna, Varian, Vincent), McGeachin (IASB)

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 1

Length of Discussion: 8:30 a.m. to 9:30 a.m.

Attendance:

Board members present: Herz, Batavick, Crooch, Schieneman (by phone), Schipper, Seidman, and Trott

Board members absent: None

Staff in charge of topic: McKenna

Other staff at Board table: Bielstein, Cassel, Hansen, J. Johnson

Outside participants: Henry Rees (IASB, by phone), Leisenring

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. Affirm its decision to require retrospective application for discretionary changes in accounting principle.
- b. Affirm its decision to require retrospective application for changes in accounting principle mandated by new pronouncements of the FASB and other standard setters, unless a different transition approach is mandated by the individual pronouncement.
- c. Clarify the distinction between the terms *restatement*, which is due to correction of an error in previously issued financial statements, and *retrospective application*, which is due to a change in accounting principle or a change in the reporting entity.
- d. Modify the impracticability guidance to acknowledge that retrospective application is impracticable if an entity is unable to apply the requirement after making every reasonable effort to do so.
- e. Affirm its decision that a change in accounting principle should be applied retrospectively to pre-change interim periods and that impracticability of that requirement should not be asserted.
- f. Carry forward into the final Statement the description of a change in estimate effected by a change in accounting principle that is contained in paragraph 11 of APB Opinion No. 20, *Accounting Changes*.
- g. Clarify that management should be able to establish that information to develop significant estimates would have been available when an affected transaction would have been recognized in the financial statements to apply an accounting change retrospectively. However, management need not have actually prepared or documented estimates contemporaneously with the preparation of the financial statements at that time.
- h. Clarify the basis for the Board's conclusion that a change in depreciation method is a change in accounting estimate effected by a change in accounting principle by including the following within paragraph A6 of the basis for conclusions:

The objective of depreciation accounting is to allocate the cost of tangible capital assets over the expected useful life of that asset in a manner that best represents the pattern of consumption of the expected benefits. Therefore, the Board affirmed that the pattern of

consumption of the asset being depreciated dictates the depreciation method used.

- i. Retain the disclosure requirements in the final Statement as proposed in the Exposure Draft.

The Board also decided that the provisions of the final Statement will be effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005.

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. Ms. McKenna stated that the first issue is whether the final Statement should retain the proposed requirement that retrospective application be required for all discretionary changes in accounting principle. She stated that the Board received a number of comment letters recommending that the final Statement retain the approach in APB Opinion No. 20, *Accounting Changes*. She stated that several comment letters argued that discretionary changes in accounting principle should not be applied retrospectively because they are more like changes in accounting estimates effected by a change in principle and also that requiring retrospective application may deter some entities from switching to a more relevant accounting principle. She noted that the Board's initial decision was based on the belief that retrospective application provides more useful financial information and that that decision was made considering the guidance in FASB Concepts Statement No. 2, *Qualitative Characteristics of Accounting Information*, related to neutrality. Ms. McKenna stated that each of the arguments cited by constituents was rejected by the Board in favor of retrospective application. She recommended that the Board affirm its decision to require retrospective application for changes for all discretionary changes in accounting principle. All Board members agreed.

2. Ms. McKenna stated that several comment letter respondents recommended that retrospective application should apply only to discretionary changes in accounting principles and not to changes mandated by newly issued requirements because of the volume of new pronouncements issued by the FASB, the EITF, the SEC and the AICPA. However, she recommended that the Board affirm their initial decision that retrospective application apply to both voluntary and mandatory accounting changes. She also recommended that the final Statement more clearly state that retrospective application is required only in those instances in which a new pronouncement does not provide different transition requirements. That is, each standard-setting body will have the opportunity to deviate from the framework proposed by this Statement, especially in those instances in which the costs of retrospective application are expected to exceed the benefits. Ms. McKenna stated that the specific changes to the document are outlined in the Board memo and, if the Board agrees, will be implemented during drafting.
3. Ms. Seidman stated that she views retrospective application guidance for mandated changes in accounting principle as guidance for the Board and not guidance for preparers. She stated that the Board's decisions on transition provisions are largely based on practical issues and considered in the cost-benefit analysis. She noted that including this guidance would be an administrative burden on the Board because the Board would then have to justify departure in every new standard and specify alternative transition in many more circumstances (such as EITF issues and FSPs). She stated that her first preference would be to delete the reference to mandated changes in accounting principle in the final Statement. She stated that her second preference would be to include in the basis for conclusions that retrospective application is the benchmark that is used by the Board when determining transition for new standards.
4. Ms. Schipper stated that the objective of accounting for accounting changes, whether discretionary or mandated, is to increase comparability and consistency of financial statements. She stated that the usefulness of

retrospective application should be more clearly articulated in the final Statement. She stated that retrospective application should be the rebuttable presumption for mandated changes with differing transition justified by the standard setter. Messrs. Trott and Batavick agreed stating that this benchmark for standard setters of retrospective application for mandated changes needs to be more clearly articulated in the final standard section as well as in the basis for conclusions.

5. Mr. Johnson stated that a possible solution to this issue is to include in the final Statement something that states that mandatory changes are applied according to the Statement provided that there is transition guidance in the particular Statement, and if there is not transition guidance in a particular Statement, this Statement should be applied. He stated that the basis for conclusions could provide reasons that the Board believes could justify a departure from retrospective application.
6. Mr. Herz asked whether any Board members objected to affirming the decision to require retrospective application for changes in accounting principle mandated by new pronouncements of the FASB and other standard setters, unless a different transition approach is mandated by the individual pronouncement if the final Statement is drafted to more clearly articulate this requirement. Ms. Seidman objected.
7. Ms. McKenna stated that a number of respondents requested that the Board clarify whether the indirect effects of applying a change in accounting principle should be reflected retrospectively as well as the direct effects. She recommended that this point be clarified in the final Statement as follows:

Retrospective application shall 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 considered in the retrospective application.

8. Ms. Seidman stated that she was concerned that the Board has not had a robust discussion about the reasons why indirect effects should not be included. Several Board members agreed. Mr. Herz asked whether any Board members objected to the staff further researching indirect effects of a change in accounting principle and related disclosures, specifically, how indirect effects are addressed elsewhere in FASB literature. No Board members objected. The Board directed the staff to conduct the additional research and report back at a future Board meeting.
9. Ms. McKenna stated that some respondents suggested that the final Statement more strongly differentiate between the terms *restatement*, which is due to correction of an error and changes in a reporting entity, and *retrospective application*, which is due to a change in an accounting principle. She recommended adding the following sentence to the definition of an error in paragraph 2(g) of the final Statement:

Correction of an error is reported in *restated* financial statements.

Additionally, she recommended adding the following to the definition of *retrospective application* in paragraph 2(h):

Retrospective application is distinguished from *restatement*. The latter term is used in this Statement to refer to the recasting of previously issued financial statements to reflect a change in the reporting entity or the correction of an error.

Finally, she recommended revising paragraph A9 to better reflect the Board's decision related to use of the term *restatement*. Paragraph A9 would read:

The Board noted that, in some cases, the IASB and the FASB use different terms to describe the same principle, for example, the term *retrospective application* as used by the IASB is synonymous with the term *retroactive restatement* as used in Opinion 20. The

Boards believe that whenever possible, it is preferable to use the same terms to reduce the potential for inconsistent application of accounting pronouncements. Thus, the Board decided to use the term *retrospective application* to describe the reporting of a change in accounting principle and to use the term *restatement* only to reflect a change in the reporting entity or the correction of an error. The Board concluded that terminology would better differentiate between changes in amounts reported for prior periods related to an accounting change and those related to the correction of an error.

10. Mr. Batavick suggested that this issue also be addressed in the summary of the final Statement.
11. Mr. Herz suggested that another term besides *restatement* be used for a change in reporting entity.
12. All Board members agreed to the staff's recommendation as well as Messrs. Batavick's and Herz's suggestion.
13. Ms. McKenna stated that many respondents recommended that retrospective application be deemed impracticable when it would involve undue cost or effort. She stated that during initial deliberations, the Board concluded that retrospective application results in greater consistency and enhances the usefulness of the financial statements. She stated that the Board believes that consistency in financial statement presentation is particularly important in assessment of trends in financial information and therefore decided to limit the use of the impracticability exception. She stated that the Board also decided that the benefits of consistent application of accounting principles in comparative financial statement outweigh the cost of retrospective application, including the potential dilution of public confidence in financial statements. She recommended that the final Statement take the approach used by the IASB in IAS 8, *Accounting Policies, Changes in Accounting Estimates and Errors*, and incorporate the following sentence into the final Statement:

Applying a requirement is impracticable when the entity cannot apply it after making every reasonable effort to do so.

She stated that if the recommendation is accepted, paragraph 11 of the final Statement would read as follows:

It shall be deemed impracticable to apply the effects of a change in accounting principle retrospectively if any of the following conditions exist:

- a. ~~The effects of retrospective application are not determinable.~~ After making every reasonable effort to do so, the entity is unable to apply the requirement.
- b. Retrospective application requires assumptions about management's intent in a prior period.
- c. Retrospective application requires significant estimates as of a prior period, and it is not possible to objectively determine whether information used to develop those estimates would have been available at the time the affected transactions or events would have been recognized in the financial statements or whether information arose subsequently.

All Board members agreed.

14. Ms. McKenna stated that some respondents asked the Board to discuss issues caused by this Statement related to auditor independence with the PCAOB, the SEC, and/or the AICPA. She stated that those respondents are concerned that circumstances could arise in which the audit firm that previously opined on the financial statements for a period that was subsequently retrospectively adjusted may be unable or unwilling to update the previously issued audit opinion. She stated that the staff is discussing this issue with the SEC and the PCAOB and will keep Board members informed of the outcome of those discussions.

15. Ms. McKenna stated that several respondents requested that the Board clarify the interrelationship between paragraphs 11 and 22 of the Exposure Draft. She stated that they believe those paragraphs contradict each other because there may be specific circumstances in which an entity is unable to

retrospectively apply an accounting policy change in an interim period of the year in which the accounting policy change was made. However, she stated that the staff does not agree that the two paragraphs are inconsistent. Ms. McKenna stated that paragraph 22 refers specifically to interim reporting requirements, which are currently addressed by FASB Statement No. 3, *Reporting Accounting Changes in Interim Financial Statements*. She stated that the prohibition against asserting impracticability of retrospective application to pre-change interim periods simply carries forward the requirement in paragraph 10 of Statement 3, which requires that pre-change interim periods be restated even when the change in accounting principle is adopted via cumulative effect adjustment. Accordingly, she recommended that the Board affirm paragraph 22 as proposed. All Board members agreed.

16. Ms. McKenna stated that several respondents were concerned that the Statement, as exposed, requires reporting entities to have made estimates at the time the affected transactions or events would have been recognized in the financial statements in order to determine whether that information would have been available at the time. To be responsive to constituents' concerns, she recommended adding a footnote to paragraph 11c that would read as follows:

Management must be able to determine whether information to develop significant estimates would have been available when the affected transactions would have been recognized in the financial statements. However, management does not need to have documented the estimates that would have been made at the time of the transaction.

All Board members agreed.

17. Ms. McKenna stated that several respondents recommended that the final Statement clarify what is meant by a *change in accounting estimate affected by a change in accounting principle* and that the basis for conclusions include

a discussion of the conceptual basis for this decision. She recommended inserting the paragraph into the basis for conclusions:

In some instances, it is difficult to distinguish between a change in an accounting principle and a change in an accounting estimate. For example, a company may change from deferring and amortizing a cost to recording it as an expense when incurred because future benefits of the cost have become doubtful. The new accounting method is adopted because there has been a change in estimated future benefits. Changes of this type are often related to the continuing process of obtaining additional information and revising estimates. Therefore, the Board decided that these types of changes, that is, changes in estimates effected by a change in accounting principle, should be treated as changes in estimates for purposes of applying this Statement.

All Board members agreed.

18. Ms. McKenna stated that footnote 2 of the Exposure Draft specifies that a change from one depreciation method to another should only be made on the basis that the new depreciation method better reflects the pattern of consumption of the expected benefits of the asset. She stated that one respondent recommended that the basis for conclusions discuss the principle behind this change. She stated that other respondents disagree with the Board's decision, arguing that other valid reasons for changing depreciation methods exist, including enhancing comparability with competitors. She recommended finalizing the guidance as proposed but also recommended including the following wording to paragraph A6 in the basis for conclusions:

The objective of depreciation accounting is to allocate the cost of tangible capital assets over the expected useful life of that asset in a manner that best represents the pattern of consumption of the expected benefits. Therefore, the Board affirmed that the pattern of consumption of the asset being depreciated dictates the depreciation method used.

She stated that the staff believes the proposed disclosures reflected in the Exposure Draft are adequate and appropriate for the reasons given in the basis for conclusions. Therefore, she recommended that the Board finalize those disclosure requirements as proposed.

19. Ms. Seidman stated that her preference is to delete footnote 2 from the final Statement because she believes that there are other valid reasons for changing a depreciation method other than for the reason that a different depreciation method better reflects the pattern of consumption of the expected benefits of the asset. For example, she stated that she believes that changing a depreciation method to industry standard is a valid reason to change methods. She stated that she prefers that the standard just state that changing depreciation methods should be based on the idea that is preferable to do so. Mr. Schieneman agreed.

20. Mr. Johnson stated that the staff spoke with the SEC staff on this issue. He stated that the SEC staff believes that changing a depreciation method to align with industry practice does not justify preferability. He quoted a 2000 SEC training manual that stated the following:

The staff has objected to change from one acceptable method to another acceptable method if the registrant and its independent accountants can not demonstrate that the new method is preferable. Conforming to industry practice may not justify a change if industry practice is not the preferable method.

21. Ms. Seidman stated that her concern was that there was no way to objectively determine the preferability in the initial selection of a depreciation method absent an accounting standard.

22. Mr. Herz asked whether any Board members objected to the staff's recommendation. Ms. Seidman and Mr. Schieneman objected.

23. Mr. Johnson stated that staff will clarify in the final Statement that a method of depreciation that initially requires accelerated depreciation and then at a

specific point requires a switch to straight line depreciation, the switch is part of the method and does not constitute a change in method.

24. Ms. McKenna stated that some respondents recommended that the final Statement require disclosures above those proposed in the Exposure Draft while others think the disclosures proposed place an undue burden on preparers without a significant benefit to users. She recommended that the disclosures be finalized as proposed. All Board members agreed.

25. Ms. McKenna recommended that the transition provisions be finalized as proposed. However, she stated that given that the final Statement will be issued subsequent to December 15, 2004, which was the proposed effective date, she recommended that the provisions of the final Statement be effective for accounting changes and corrections of errors made in interim or annual periods beginning after June 15, 2005. She stated that the staff anticipates issuing this document in the first quarter of 2005 and believes that a June effective date will provide reporting entities with adequate time to understand the new provisions. She stated that some Board members were in favor of a December 15, 2005 effective date given that this proposed Statement is not extremely urgent to financial reporting. Six Board members agreed to a December 15, 2005 effective date. Mr. Crooch objected.

Follow-up Items:

The staff will further research indirect effects of a change in accounting principle and related disclosures. Specifically, the staff will look at how indirect effects are handled elsewhere in FASB literature. In addition, the staff will continue discussing the effects of the Statement with the SEC and the PCAOB staffs.

General Announcements:

None.