



MINUTES OF MEETING

Financial Accounting Standards Advisory Council
June 22, 2006

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

Members Attending

Richard J. Swift, Chairman
Richard H. Booth
James L. Brown

Edward E. Nusbaum
Klaus D. Patzak
Samuel J. Ranzilla

Leslie Culbertson
Colleen Cunningham
Timothy J. Curt

Kevin B. Reilly
David B. Rickard
Steven A. Rogers

Robert E. Friedman
Charles L. Hall
Gregory J. Jonas

Rita J. Spitz
Arleen R. Thomas
E. Anson Thrower

Marc E. Lackritz
Richard D. Levy
Elizabeth F. Mooney

Scott M. Waite
Brent A. Woodford
William L. Yeates

John B. Morse, Jr.
Mark W. Nelson

Michael R. Young
Gregory G. Weaver

Members Not Attending

Stephen J. Cosgrove
Joe Joseph

Nellie Liang
Thomas J. Linsmeier

Others Attending

Financial Accounting Standards Board:
Robert H. Herz, Chairman
George J. Batavick
G. Michael Crooch

Katherine A. Schipper
Leslie F. Seidman
Edward W. Trott

FASB Staff:

Joanne L. Bennett, Postgraduate Technical Assistant
 Suzanne Q. Bielstein, Director of Major Projects and Technical Activities
 Jeffrey D. Cropsey, Project Manager
 Victoria A. Lusniak, Assistant Project Manager
 Kevin H. McBeth, Project Manager
 Stuart J. Moss, Practice Fellow
 Brooke E. Richards, Project Manager
 Larry W. Smith, Director of Technical Application and Implementation Activities

Others:

Robert F. Dacey, Chief Accountant, Government Accountability Office
 Teresa S. Polley, Executive Director, FASB Advisory Groups, Financial
 Accounting Standards Advisory Council
 Scott Taub, Acting Chief Accountant, Securities and Exchange Commission
 Thomas Ray, Chief Auditor, Public Company Accounting Oversight Board

Introduction

1. Mr. Swift called the meeting to order at 9:00 a.m. He stated that FASAC is in the process of seeking nominations for new members for 2007 and encouraged members to provide the names of candidates by June 30. He noted that Ms. Schipper's term as an FASB Board member would end as of June 30 and thanked her for her participation over the years. He stated that Tom Linsmeier, who held one of the academic seats on FASAC, will replace Ms. Schipper on the Board. He announced that the FAF Board of Trustees appointed Terry Warfield from the University of Wisconsin to replace Mr. Linsmeier on FASAC.

Report from the FASB Chairman

2. Mr. Herz reported on the following matters:
 - a. The recent issuance of the FASB Exposure Draft, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans*, which addresses the first phase of the FASB's comprehensive reconsideration of the accounting for postretirement benefit obligations. The comment period ended on May 31, 2006, and the FASB has received approximately 240 comment letters. The FASB will hold two public roundtable meetings on June 27, 2006, and redeliberations will begin in July.
 - b. The progress on the business combinations project. The Board began redeliberations on the FASB Exposure Drafts, *Business Combinations*, and *Consolidated Financial Statements, Including Accounting and Reporting of Noncontrolling Interests in Subsidiaries*, at the beginning of 2006. The Board reaffirmed some of the basic principles in those

Exposure Drafts and will continue its redeliberations through the end of 2006.

- c. The status of the revenue recognition project. The staff continues the development of a customer consideration approach at the principles level, similar to EITF Issue No. 00-21, "Revenue Arrangements with Multiple Deliverables." The Board is currently resolving issues on revenue recognition of various deliverables in multi-element contracts, as well as revenue recognition in long-term contracts. A joint FASB-IASB Preliminary Views is planned for issuance in early 2007.
- d. The expected issuance of a final Interpretation on uncertain tax positions in July 2006.
- e. The status of Phase 1 of the fair value option project. The Board issued an Exposure Draft, *The Fair Value Option for Financial Assets and Financial Liabilities*, in January 2006; more than 70 comment letters have been received and analyzed, and a public roundtable will be held on June 26, 2006. The Board will begin redeliberations in August and anticipates issuing the final standard in the fourth quarter.
- f. The activities of various international standard setters. In April, the FASB and IASB held a joint meeting in London. The Boards discussed the following joint projects: revenue recognition, business combinations, and the conceptual framework. The Boards also discussed a potential joint project on lease accounting. Although the Boards have authorized the IASB and FASB staffs to begin work on the project, the project has not been formally added to the Boards' agendas because the IASB Board has to consult with its advisory group. At their respective Board meetings in July, the FASB and IASB Boards will formally consider adding the lease accounting project to their agendas. In May 2006, Messrs. Herz and Crooch and Ms. Bielstein met in Tokyo with representatives of the Accounting Standards Board of Japan to discuss international convergence of accounting standards and particular current projects.
- g. Activities in Washington D.C.:
 - (1) Mr. Herz testified at a House Subcommittee on Capital Markets hearing on accuracy and transparency in financial reporting. The main topics at the hearing were issues of complexity in financial reporting, XBRL, the use of fair value as a measurement attribute, and earnings guidance.
 - (2) Mr. Herz and Sir David Tweedie of the IASB testified at a Senate Committee on Banking, Housing, and Urban Affairs hearing on pensions and other postretirement benefits, as well as international convergence issues.
- h. Personnel matters. Jeff Mahoney has left the FASB and taken a position as general counsel for the Council of Institutional Investors. Christopher Allen has been hired as Mr. Mahoney's replacement. Mr. Allen had been

Director of the Office of Federal Relations for the National Association of State Treasurers.

3. Mr. Smith reported on the following technical application and implementation activities:
 - a. The status of the codification project. The mapping phase is nearly complete. Accordingly, the authoring phase has begun, along with the related editing phase. Upon completion of the editing phase, the Board plans to issue the codification document for an extended public verification process in late 2007.
 - b. The status of the AICPA Accounting Standards Executive Committee (AcSEC) project on loan losses. The AcSEC project began as a recognition and measurement project but was changed to a disclosure-only project at the request of the FASB. The FASB is awaiting the final version of the document for clearance to issue it for a 90-day comment period.
 - c. A change in the EITF process. Tentative conclusions of the EITF are now exposed for a 30-day comment period. FASAC members and other constituents are encouraged to review the tentative conclusions and provide the FASB with comments.
 - d. Recent EITF discussions. At the June EITF meeting, the Task Force reached tentative conclusions on EITF Issues No. 06-4, "Accounting for Deferred Compensation and Postretirement Benefit Aspects of Endorsement Split-Dollar Life Insurance Arrangements," and No. 06-5, "Accounting for Purchases of Life Insurance—Determining the Amount That Could Be Realized in Accordance with FASB Technical Bulletin No. 85-4." The Task Force encourages constituents to review those tentative conclusions on the FASB website and provide comments.
4. Mr. Batavick reported on the private company initiative:
 - a. In June 2006, the FASB and AICPA issued an Invitation to Comment, *Enhancing the Financial Accounting and Reporting Standard Setting Process for Private Companies*, with a 60-day comment period ending on August 15, 2006.
 - b. The Invitation to Comment includes two main proposals:
 - (1) The first proposal addresses the improvement and enhancement of the processes at the FASB to better consider the private company sector. For example, exposure documents would contain questions specifically targeted at private companies.
 - (2) The second proposal addresses the establishment of a committee with 11 unpaid members and 1 paid chairperson. The purpose of this committee is to follow Board deliberations and to provide input on the deliberations and all Exposure Drafts. The first goal of that committee is to set the criteria for exceptions to current and

proposed GAAP for private companies based on different user needs, relevancy of the information to users, and cost-benefit considerations. Committee members will be vetted by both the FASB and the AICPA and will include individuals from the user-investor, practitioner, and preparer communities.

- c. The Board encourages constituents to comment on all aspects of the Invitation to Comment, including the composition of the committee and the compensation arrangements for the committee.
5. Ms. Seidman reported on the April 24, 2006 meeting of the International Swaps and Derivatives Association (ISDA):
 - a. Several FASB Board members and members of the ISDA met to discuss the shortcut method and the simplification of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*.
 - b. ISDA members asked the Board to address specific practice issues related to the application of the shortcut method and four or five other practice issues related to hedge accounting.

Report from the SEC

6. Mr. Taub reported on the following matters:
 - a. The SEC Advisory Committee on Smaller Public Companies has made recommendations to the SEC, including several recommendations about internal control reporting. Specifically, the committee recommended full exemption from internal control reporting for companies with market capitalizations less than \$125 million and partial exemption from the auditor internal control reporting requirements for companies with market capitalizations between \$125 million and \$780 million. The SEC and PCAOB held a roundtable discussion in May 2006 on Section 404 of the Sarbanes-Oxley Act, following the second year of compliance for accelerated filers. The SEC also obtained feedback through responses submitted on its website. The SEC issued a press release in May 2006 that described several actions the SEC plans to take on internal control reporting, including (1) providing nonprescriptive guidance in the form of a Concepts Release for management on how to assess internal control effectiveness and (2) extending the compliance date for internal control reporting requirements for nonaccelerated filers from fiscal years ending after July 15, 2007, to fiscal years ending after December 15, 2007. The SEC also will consider requiring only management's assessment of internal controls for the first year for nonaccelerated filers and then both management's and auditor's assessments thereafter.
 - b. The Committee of Sponsoring Organizations of the Treadway Commission (COSO) issued a document with proposed guidance on the application of the COSO internal control framework in smaller public company

- environments in the fall of 2005. The final guidance is expected to be issued in the summer of 2006.
- c. Personnel matters:
- (1) SEC Commissioner Glassman decided not to stand for a second term. Pending a Senate confirmation vote, Kathleen Casey will be Ms. Glassman's replacement. Upon approval, that change will take place in July 2006.
 - (2) Federal Reserve Board Governor Mark W. Olson has been appointed Chairman of the PCAOB. Mr. Olson will assume that position in July 2006.
- d. SEC Proposed Rules:
- (1) Executive Compensation and Related Party Disclosure. The proposal requires significant changes to executive compensation disclosures while retaining the basic format that had been in place since the early 1990s. The SEC received more than 20,000 comment letters. The SEC expects to finalize the proposal by the end of the third quarter and have the final Rule effective by the end of the 2006 proxy season.
 - (2) Termination of a Foreign Private Issuer's Registration of a Class of Securities Under Section 12(g) and Duty to File Reports Under Section 15(d) of the Securities Exchange Act of 1934. Respondents stated in the comment letters that the proposed rule does not provide adequate assistance and constituents would like the SEC to provide further guidance on this issue. The SEC expects to finalize the proposal by the end of the third quarter.
 - (3) Internet Availability of Proxy Materials. The SEC is attempting to finalize the proposed rule in time for the 2006 proxy season.
- e. XBRL. The SEC continues to study the use of XBRL as a means of making information included in SEC filings more accessible to investors, analysts, and other users of those filings. The SEC held an Interactive Data Roundtable on June 12, 2006, and received input on the usefulness of XBRL and how the SEC could encourage the development of XBRL. The SEC is working to remove obstacles to encourage broader market usage of XBRL. The SEC is not drafting rules that would require the use of XBRL at this time.
- f. Backdating of stock options. Mr. Taub noted that backdating stock options to make it appear they were granted before they actually were granted raises significant corporate governance and integrity issues that go beyond the accounting issue. Another method that companies use to grant stock options is "spring-loading," whereby companies schedule the option grants at a time when they anticipate that their stock prices would rise. Mr. Taub clarified that "spring-loading" differs from backdating and that the Commission staff views those two issues separately.

Report of the PCAOB

7. Mr. Ray reported on the following matters:

- a. Mark W. Olson will become the Chairman of the PCAOB in July 2006. Bill Gradison, current acting Chairman, will remain on the PCAOB. Kayla J. Gillan, PCAOB Board member, has been reappointed.
- b. On May 17, 2006, following the joint SEC-PCAOB roundtable, the PCAOB announced a four-point plan to improve auditors' implementation of the internal control reporting provisions of the Sarbanes-Oxley Act. Those four initiatives include:
 - (1) Amend PCAOB Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements*. While preserving the principles of Auditing Standard 2, the PCAOB plans to consider amendments that would ensure that the auditors' primary focus during an integrated audit is on areas that pose higher risk of fraud or material error. The amendments to be proposed would reinforce the PCAOB's expectation that the integrated audit be conducted in the most efficient manner, while achieving the objectives of the standard, by incorporating key concepts contained in the guidance issued by the PCAOB on May 16, 2005. The PCAOB also plans to revisit and clarify the auditor's role, if any, with respect to evaluation of the process that a company uses to reach its own conclusion about the effectiveness of company controls.
 - (2) Reinforce auditor efficiency through PCAOB inspections. As the PCAOB described in a statement issued May 1, 2006, the PCAOB's 2006 inspections of registered public accounting firms will focus on the firms' efficiency in conducting internal control audits, as emphasized in the PCAOB's May 2005 Policy Statement.
 - (3) Provide guidance and education for auditors of small companies. The PCAOB plans to develop or facilitate development of implementation guidance for auditors of smaller public companies. In addition, the PCAOB plans to explore various means of facilitating opportunities for auditors of smaller public companies to obtain effective training on auditing internal control over financial reporting.
 - (4) PCAOB forums on auditing in the small business environment. The PCAOB will hold a total of eight forums during 2006 for the auditors, directors, and financial officers of smaller public companies. In addition to providing general education about PCAOB issues, the PCAOB will use these forums to monitor real-time reaction to the various internal control-related implementation changes that are announced throughout the year.

- c. The PCAOB's Standing Advisory Group (SAG) met in Washington D.C. on June 12-13, 2006. SAG discussed:
 - (1) The staff's recommended changes to Auditing Standard 2
 - (2) Implementation of Section 404 and Auditing Standard 2, which included company-level controls and auditor's involvement in management's assessment of internal controls.
 - (3) Implication of information disclosed over the past two years about internal control weaknesses and the Research Synthesis Program related to auditing fair value and auditors' risk assessments.
 - (4) Backdating of stock options; the group recommended that the PCAOB consider developing some guidance related to that issue.
- d. The PCAOB's rules on auditor independence, tax services, and contingent fees were approved by the SEC in April 2006.
- e. In June 2006, the PCAOB released staff questions and answers (Q&A), "Adjustments to Prior-Period Financial Statements Audited by a Predecessor Auditor," to provide guidance to auditors that are auditing adjustments to prior-period financial statements that were audited by another auditor.
- f. The reporting framework for periodic reporting by registered accounting firms proposed by the PCAOB includes two types of reporting obligations. First, the proposal would require each registered firm to provide basic information once a year about the firm and the firm's issuer-related practice over the most recent 12-month period. Second, the proposal identifies certain events that, if they occur with respect to a registered firm, must be reported by the firm within 14 days.
- g. As of June 6, 2006, 1,674 firms were registered with the PCAOB; 967 are U.S. registered firms. The 707 non-U.S. registered firms are located in 81 countries. Since inception of the PCAOB, 113 firms have withdrawn their registration.

Conceptual Framework

- 8. Mr. Crooch stated that the conceptual framework project is a joint project with the IASB and is intended to resolve the issues with the existing conceptual framework in addition to creating a conceptual framework that will be consistently applied to all of the Boards' projects. Mr. Crooch noted that in July 2006, the Boards each will publish for public comment an IASB Discussion Paper and FASB Preliminary Views, *Conceptual Framework for Financial Reporting: Objective of Financial Reporting and Qualitative Characteristics of Decision-Useful Financial Reporting Information*.
- 9. The second phase of the project deals with the elements of financial statements. The Board has nearly completed its deliberations on the

definitions of assets and liabilities. The next phase of the project will address measurement.

10. Mr. McBeth noted that in April 2006, the Board approved a plan for the measurement phase of the conceptual framework project. The plan envisions filling the accounting measurement void in the existing conceptual framework by defining the various measurement bases, describing their strengths and weaknesses, and providing a conceptual foundation for determining the circumstances in which the measurement bases can provide the most useful information for various decision makers. The staff identified two measurement base families: historical cost and current value. The historical cost family includes original transaction price, original entry value, accumulated cost, allocated cost, amortized cost, and combinations of accumulated, allocated, and amortized costs. The current value family includes current cash equivalent, replacement cost, reproduction cost, deprival cost, entry value, exit value, fair value, net realizable value, and value in use.
11. Mr. McBeth asked the Council whether there are measurement base families other than historical cost and current value. He also asked whether there are measurement bases other than the ones the staff has identified.
12. Council members expressed the following views:
 - a. The Board should consider entity-specific measurement.
 - b. The Board should determine how certain items would fit into the two measurement base families, such as deferred tax assets and liabilities, contingent assets and liabilities, and items within FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan*, where partial adjustments are made to fair value.
 - c. The Board should consider the potential interdependencies between the measurement and recognition criteria. In addressing the various appropriate measurement criteria, would an entity have to consider the recognition criteria that created the measurement issue, such as items considered in FASB Statement No. 5, *Accounting for Contingencies*?
 - d. The Board should consider the following two broad categories of measurement issues: (1) estimates of future cost, which do not use fair value or historical cost, and (2) mechanical computations, such as the calculation of deferred assets, pensions, and other postretirement benefits. The two measurement base families do not seem to consider items in those two categories.
 - e. Conceptually, a conflict exists between the accounting and legal professions in reporting the effects of litigation. While financial reporting requires transparency and objectivity in measuring and reporting contingencies related to litigation, the legal profession's approach to litigation is secrecy and privileged information. The Board must determine how to reconcile the two.

- f. The Board should take the time to understand, communicate, and test the decision-usefulness of the various measurement attributes.
- g. While the measurement bases identified are useful to consider individually, the Board and staff should consider the ramifications of the bases used in combination in an entity's financial reporting so as to avoid unintended consequences that may cause mechanical adjustments.

Liabilities and Equity

- 13. Ms. Schipper stated that the discussion would focus on the first two principles in the summary of principles for the ownership-settlement approach:
 - a. Linking instruments as one for accounting purposes if the instruments are part of the same arrangement (linkage).
 - b. Substantive features of instruments for classification purposes.
- 14. Ms. Schipper noted that an entity might view liability versus equity as two alternative treatments for financial instruments with qualifying conditions attached to those two alternative treatments. Those qualifying conditions take the form of the definitions of liability and equity. The linkage principle is an outcomes-oriented principle. The linkage principle states that an entity should link—that is, account for as a single instrument—two or more instruments that are part of the same arrangement if accounting for the instruments individually differs from accounting for them as if they were a single instrument with the same or similar outcome (or possible outcomes).
- 15. Ms. Schipper stated that instruments are part of the same arrangement if the instruments are interdependent. The Board has proposed the following two ways to address interdependency:
 - a. Contractual interdependency is interdependency that is evident by a contract. That is, the exercise of one instrument depends on the exercise of the other.
 - b. The instruments have interacting payoff structures and are entered into at or near the same time with the same or a related counterparty or an agent acting on behalf of a counterparty.
- 16. Ms. Schipper noted that the substantive features principle is the Board's attempt to describe substantive features in terms of outcome, which makes it an outcomes-oriented principle. A settlement feature is substantive if the feature has more than a remote likelihood of affecting an instrument's outcome and more than a minimal effect compared with other features within an instrument.
- 17. Ms. Schipper stated that the Board will develop alternative approaches to compare with the ownership-settlement approach. Some of those alternative approaches are (a) a narrower view of equity—that is, less linkage is needed

if equity is sufficiently large or small, and (b) the reassessed expected outcomes approach, which is based on contingent claims asset pricing.

18. Ms. Schipper referred Council members to the questions in the discussion materials and asked for their views.

19. Council members expressed the following views:

- a. Preparers and issuers would prefer certainty in determining whether the instrument they are issuing is equity or debt. The notion of reevaluating and possibly changing the classification of an instrument at each reporting period is disconcerting.
- b. The liabilities and equity project is moving in the right direction in linking the accounting and economics of a transaction—that is, the accounting for the transaction reflects the economics of the transaction. When dealing with two different entities, if those entities are linked to the same transactions, the same judgment should be applied to those transactions.
- c. Classification of financial instruments into liability and equity components is needed because of the structuring that takes place in the market. The challenge of writing this guidance is to write it in a principles-based manner that prevents structuring without causing undue confusion in plain vanilla business arrangements. The linkage principle is written in such a manner. The substantive-features principle should be intuitive because entities should know to account for substantive items and not to account for nonsubstantive items.
- d. The Board should consider how entities might interpret the term *substantive*. Some entities might view 5 percent as substantive and other entities might not.
- e. The substantive-features and linkage principles should not be unique to this project. Whenever an entity enters into transactions at or near the same time with related counterparties or intersecting futures, the entity should account for those transactions together.
- f. The proposed approach is extremely complex and will have other consequences, but it is headed in the right direction in terms of moving toward principles-based accounting.
- g. There should be symmetry in accounting between the holder and the issuer. Hence, if a change in circumstances requires the holder to reclassify the instrument, the Board should consider how that would affect the issuer of that instrument.

Insurance Risk Transfer

20. Mr. Crooch stated that under current accounting guidance, insurance contracts with both insurance components and financing components generally are accounted for as either insurance or financing in their entirety. Accounting for an entire contract as either insurance or financing places

significant pressure on determining the minimum level of risk transfer that satisfies the significant risk transfer condition required for insurance contract accounting. Mr. Crooch noted that the Board added the insurance risk transfer project to its agenda to address reported alleged abuses of accounting for certain insurance contracts, including reinsurance contracts.

21. Mr. Cropsey stated that in May 2006, the Board issued the Invitation to Comment, *Bifurcation of Insurance and Reinsurance Contracts for Financial Reporting*, for a 90-day comment period. He noted that the Board has not deliberated the issues in the Invitation to Comment. The Invitation to Comment is intended to gather information from constituents to assist the Board in its future deliberations. Mr. Cropsey noted that the Board is seeking comments from all parties to an insurance contract including policyholders, insurers, and reinsurers, as all of those parties could be affected by the bifurcation of insurance contracts.
22. Mr. Cropsey stated that bifurcation of insurance contracts would divide some or all insurance contracts into two components: insurance and financing. Components that transfer significant insurance risk would be accounted for as insurance. For policyholders, premiums would be expensed during the contract period; the occurrence of an insured event would generate an insurance recovery that would be recorded as a gain in the income statements. Components that represent financing arrangements would be accounted for as deposits. For policyholders, premiums would be recorded as an asset; the recovery from an insured event would be a reduction to the deposit with no income statement benefit.
23. Mr. Cropsey asked Council members whether bifurcating an insurance contract into insurance and financing components would provide more understandable and decision-useful information than accounting for the entire contract as either insurance or financing.
24. Council members expressed the following views:
 - a. The Board should consider requiring all reinsurance contracts to be accounted for as financings rather than bifurcating them. In many cases, the insurance element is incidental to the contract.
 - b. The Board needs to define the meaning of *significant risk transfer* and determine the threshold prior to moving forward with the bifurcation issue.
 - c. There are financing elements and risk transfer elements in reinsurance contracts. In dealing with bifurcation of reinsurance contracts, the Board is dealing with a broader issue than just finite risk insurance. Perhaps the Board should focus on symmetry in accounting for finite insurance. If both parties to the transaction have symmetrical accounting treatment for those contracts, then there would be no need for bifurcation.
 - d. The Board will need to consider whether bifurcation can be applied to the various types of insurance contracts. Life, property, and health insurance

contracts have different features and elements. It may not be possible to obtain the information needed to bifurcate all types of insurance contracts.

Financial Statement Presentation

25. Ms. Lusniak stated that the financial statement presentation project is a joint project with the IASB and is being conducted in three phases. The Boards have completed their initial deliberations on the issues in Phase A, which addresses what constitutes a complete set of financial statements and requirements to present comparative information. Phase B addresses the fundamental issues of presentation of information on the face of the financial statements. The Boards are currently deliberating the issues in this phase and anticipate issuing a Preliminary Views by the end of 2006 or beginning of 2007.
26. Ms. Lusniak noted that in Phase B, the staff and Board have developed seven working principles, including the cohesiveness of the financial statements; comparability over time; comparability across entities; liquidity; financing, operating, and other activities; measurement; and disaggregation. She asked for input on the principles of cohesiveness of the financial statements and disaggregation of information.
27. Council members expressed the following views:
 - a. The project provides companies the opportunity to experiment with different formats if the SEC and users of financial statements are willing to allow for some inconsistencies among companies. There are pros and cons to each presentation format, but the project is moving in the right direction.
 - b. The nature of a business varies across different industries; companies within each industry should be able to present their financial statements in a manner that best illustrates the nature of the industry so as to provide financial statement users with the most appropriate information.
 - c. Segregation of financing activities in the statement of earnings and comprehensive income and statement of cash flows makes sense. However, segregation of financing activities in the statement of financial position seems arbitrary because cash is fungible and hence there is not much value in segregating financial liabilities from other liabilities.
 - d. The desire for disaggregation of information will eventually cause entities to issue two income statements—one that reports by function and another that reports by nature.
 - e. The Board needs to address segment reporting to increase the usefulness of financial statements. The Board should allow for a management approach and integrate segment reporting within the presentation of the financial statements. European companies have switched from reporting

the income statement by nature to reporting by function. This is because reporting by function provides more comparability to U.S. companies and is favored for internal control purposes because people are responsible for each function but not for specific types of expenses. Reporting by function also provides the information necessary to compute financial ratios.

- f. The presentation formats are different from current requirements but not necessarily better. Depending on the business models within each entity, sometimes reporting by function is better and other times reporting by nature is preferred. Also, depending on the size of a company, the liquidity of its assets could vary. The staff should clarify the meaning of *presented in order of liquidity*.
- g. The methods proposed in the paper will not achieve comparability. Currently, there is a lack of consistency as to which items are categorized in operating expenses or selling, general, and administrative costs.
- h. Although it is difficult for preparers of financial statements to differentiate between their operating and financing cash flows, users of financial statements find that information helpful in their analysis of a company. Comparability is also important to users, and allowing companies to choose the method in which to present information on the face of the financial statements is disastrous for users of financial statements.
- i. Distinguishing operating profit from financing in financial statements might pose a problem for certain industries, such as financial institutions, whereby financing is one of the primary operating functions.
- j. From a user perspective, there should be consistency in financial reporting, especially within industries. It should not matter whether entities within an industry report by function or nature. This project should strive for consistency in financial reporting, especially within similar industries.

Derivatives Disclosure

28. Mr. Smith stated that the derivatives disclosure project was added to the Board's agenda in March 2005. Constituents have expressed concerns about the inadequacy of current required disclosures for derivatives. This issue is difficult to address narrowly because entities use derivatives to manage risks. To the extent that entities disclose the types of derivatives the company is using but do not disclose the types of risks the company is hedging, some constituents would argue that the company is providing an incomplete representation of the company's financial position, and others would argue that the company should address all of the risk exposures relative to the company's financial instruments. Mr. Smith noted that the staff must adhere to the Board's decision at the July 6, 2005 Board meeting, when the Board agreed that the scope of the project should be limited to derivatives accounted for in accordance with Statement 133 and related hedged items.

29. Mr. Moss noted that the staff had established a resource group of approximately 20 individuals from varied backgrounds—public accounting, preparers, both equity and credit analysts, and academic professionals. The staff compiled a list of potential incremental disclosures from various sources, including:
- a. Disclosures in FASB Statement No. 119, *Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments*, that were not carried forward to Statement 133.
 - b. Disclosures in the Exposure Draft for Statement 133 that were not carried forward to the final standard.
 - c. IFRS 7, *Financial Instruments: Disclosures*.
 - d. SEC requirements.
 - e. Comments from constituents.
30. Mr. Moss stated that the staff sent that list to the resource group to solicit input on the potential disclosures and project objectives. Based on that input and discussion among the staff, the staff compiled a comprehensive list of proposed enhanced disclosures and established the following three disclosure objectives:
- a. To provide an understanding of how and why an entity uses derivatives.
 - b. To provide transparency into the overall financial statement impact of derivatives.
 - c. To provide insight into how entities account for derivatives.
31. Mr. Moss stated that one of the main changes in the proposed disclosures compared with current requirements is the disclosure of information by the derivatives' major underlying rather than just its accounting designation. Based on the feedback from the resource group, the proposed disclosures would provide more information on the methods and reasons an entity uses derivatives. Mr. Moss requested Council member input on the proposed disclosures and whether the staff should provide specific guidance on the financial statement presentation and classification for derivatives and related gains and losses.
32. Council members expressed the following views:
- a. The additional proposed disclosures might require a considerable amount of time and manpower to gather the required information. The Board should consider field testing the proposed disclosures to ensure that the information is useful to users of financial statements.

- b. The usefulness of the proposed disclosure about instances in which an entity is accounting for derivatives in accordance with Statement 133, whereby it could have elected the normal purchase and normal sale exception, seems questionable.
- c. The proposed disclosure on where and in what amount derivatives and related gains and losses are recorded could be misleading for large financial institutions that have trading desks in which derivatives are integrated into the overall management of those trading desks. In those situations, the financial institution should disclose not only the derivatives portion but the entire trading activity. Those financial institutions are not tracking the derivatives and cash instruments separately, and requiring the disclosure of only the derivative instruments but not the cash instruments could result in incomplete and misleading information.
- d. The relevant measurement should not be the derivatives but the class of risks. Focusing on disclosing the value of the derivatives as opposed to the value of the risks and the class of risks might be misleading and irrelevant.
- e. The Board should consider broadening the scope of the project to require disclosures on all the risks an entity has rather than only the risks that the entity chooses to hedge.
- f. The proposed disclosures should be incremental to the current required disclosures in Statement 133. The proposed disclosures also should apply to entities that use derivatives to both manage risks and make a profit. The staff should organize the proposed disclosures in a manner that allows entities to explain whether they are using derivatives for risk management or profit-making.

ADJOURNMENT

33. Mr. Swift thanked the Board and Council members for their participation and closed the meeting to public observation at 2:30 p.m. Council members attended a closed administrative session that adjourned at 3:00 p.m.