



MINUTES OF MEETING

Financial Accounting Standards Advisory Council
December 1, 2005

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
Raymond J. Bromark

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

Stephen J. Cosgrove
Leslie Culbertson
Colleen Cunningham

Janet L. Pegg
Kevin B. Reilly
David B. Rickard

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

James R. Ryan
Joseph L. Sclafani
Rita J. Spitz

Joe Joseph
Marc E. Lackritz
Nellie Liang

Mary S. Stone
Arleen R. Thomas
E. Anson Thrower

Elizabeth F. Mooney

Michael R. Young

Members Not Attending

Gary P. Fayard
Donald D. Humphreys
Alan G. Levin

Scott M. Waite
David M. Walker
Gregory G. Weaver

Others Attending

Financial Accounting Standards Board:

Robert H. Herz, Chairman
George J. Batavick

Leslie F. Seidman
Edward W. Trott

Katherine Schipper

Donald M. Young

FASB Staff:

Suzanne Q. Bielstein, Director of Major Projects and Technical Activities

Russell G. Golden, Senior Technical Advisor

Kevin McBeth, Project Manager

Peter C. Proestakes, Project Manager

Danielle T. Zeyher, Project Manager

Brian M. Goetsch, Postgraduate Technical Assistant

Others:

Nelson Carvalho, Chairman, IASB Standards Advisory Council

Jenifer Minke-Girard, Senior Associate Chief Accountant, Securities and
Exchange Commission

Teresa S. Polley, Executive Director, FASAC

Gregory Scates, Associate Chief Auditor, Public Company Accounting Oversight
Board

Introduction

1. Mr. Swift called the meeting to order at 9:00 a.m. He noted that the following members' terms will end on December 31, 2005: Gary Fayard, Don Humphreys, Alan Levin, Ray Bromark, Janet Pegg, Joe Sclafani, and Mary Stone. He thanked them for their participation on FASAC.

Report of the FASB Chairman

2. Mr. Herz reported on the following matters:
 - (a) Progress on the revenue recognition project. The Board and staff are working together to develop, at the principles level, the allocated customer consideration approach. The Board and staff hope to issue a Preliminary Views in the second half of 2006 that will explain the principles behind this approach.
 - (b) The issuance of a milestone draft in the liabilities and equity project that explains the development of the ownership-settlement approach in determining the difference between liabilities and equity of an entity. The Board has completed its discussion on accounting for simple instruments and is close to completing its discussion on accounting for more complex instruments. The staff will then develop other approaches to compare with the ownership-settlement approach. The Board hopes to issue a Preliminary Views in late 2006.
 - (c) The status of two Exposure Drafts on projects related to FASB Statement No. 141, *Business Combinations*, including one on applying the acquisition method and one on noncontrolling interests. The Board has received approximately 220 comment letters. The staff is analyzing those letters now. The Board and the IASB held public roundtables in late

October and early November, two in Norwalk and three in London. Issuance of final standards is expected in late 2006.

- (d) The planned issuance of a Preliminary Views on Segments A and B of the financial performance reporting project in 2006.
 - (e) The Board's formal response to the June SEC report on off-balance-sheet transactions, which will be issued in early 2006. The FASB intends to respond to both the general recommendations made by the SEC and the specific items mentioned, such as the addition to the Board agenda of a major project on pension and OPEB accounting.
 - (f) The Board's involvement with the Enhanced Business Reporting Consortium. The Consortium is working toward the improvement of the reporting package that would include more forward-looking information, commentary on nonfinancial information, and key performance indicators. The FASB staff on the financial performance reporting project monitors the Consortium's activities and participates in its discussions as observers.
3. Mr. Smith reported on the following technical application and implementation activities:
- (a) The expected issuance of three final Statements related to FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*. The Statements on hybrid instruments and servicing rights are expected to be issued in the first quarter of 2006 with an effective date of September 15, 2006. Early application will be encouraged. The Statement related to qualifying special-purpose entities and isolation of transferred assets is expected to be issued in the second quarter of 2006.
 - (b) The issuance of FASB Staff Position FAS 115-1 and FAS 124-1, "The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments," in November 2005. It carries forward the disclosure requirements in EITF Issue 03-1 but nullifies the other specific requirements of the consensus for other-than-cost-method investments and makes reference to requirements of existing literature including SEC Staff Accounting Bulletin 59.
 - (c) The status of the Exposure Draft on the uncertain tax positions project. The Board has received approximately 115 comment letters. The Board has begun its redeliberations and expects to issue a final Interpretation in the second quarter of 2006. The effective date will be extended beyond the proposed date of year-end 2005.
 - (d) The activities of the resource group formed to help identify and address Statement 123(R) implementation issues.
 - (e) The status of the codification project. The mapping process, which assigns current accounting guidance to various topics, is almost complete; authoring will begin in early 2006.

Report of the SEC

4. Ms. Minke-Girard reported on the following matters:
- (a) The departure of Don Nicolaisen, former SEC chief accountant, in early November. Scott Taub has been named the acting chief accountant until a replacement for Mr. Nicolaisen is found.
 - (b) The upcoming departure of Andrew Bailey, deputy chief accountant of the Professional Practice Group in the Office of the Chief Accountant, in December.
 - (c) The SEC staff's continuing work on key priorities, including reducing complexity in financial reporting, promoting better utilization of technology for the benefit of investors, and preparing to review in 2006 the filings of foreign private issues, many of whom will be applying IFRS for the first time.
 - (d) The SEC staff's continuing work on its planned guidance on the quantification of errors in the financial statements. The SEC staff is taking into consideration the timing relative to year-end and will release the guidance as soon as possible.

Report of the PCAOB

5. Mr. Scates reported on the following matters:
- (a) The final Standing Advisory Group meeting of 2005 was held on October 5-6. The topics included the PCAOB's proposed standard-setting activities for 2006, the concept of reasonable assurance in audits, a panel discussion of engagement quality reviews in smaller registered firms, a panel discussion on communications with audit committees, a review of certain principles of audit reporting, and a discussion of emerging issues.
 - (b) The PCAOB is close to completing the 2005 inspections of registered firms. So far, over 250 firms have been inspected, including the 8 largest firms and 1 registered firm in Canada. Over 120 inspection reports have been issued relating to 2004 and 2005 inspections, including reports on each of the Big 4 firms for 2004.
 - (c) The PCAOB announced disciplinary proceedings against two registered firms whose audits of public clients were in violation of PCAOB rules and audit standards. Each firm's registration was revoked, and the sole shareholder of each firm was barred from being an associated person of a registered accounting firm. These two firms failed to exercise due care and professional skepticism and to obtain sufficient evidence to support their audit opinions.
 - (d) On November 22, the PCAOB approved a budget for calendar-year 2006 that will allow for a reduction in the support fees paid by publicly traded companies. The budget as approved contemplates approximately \$128 million in outlays for 2006. The budget also projects that the Board will

assess \$109 million in accounting support fees, compared with \$136 million in 2005.

- (e) To date, 1,587 public accounting firms have registered with the PCAOB, including 642 firms based outside the United States.
- (f) By the end of 2005, the PCAOB estimates total headcount to be 427 with an inspections staff of 200.
- (g) On November 30, the Board issued a report on Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements*. The report discusses issues identified in the course of the Board's monitoring of the firms' initial implementation of Auditing Standard No. 2. A similar report on fraud and fraud-related topics is expected to be issued in the near future.

Report of the IASB Standards Advisory Council

6. Mr. Carvalho reported on the following issues:

- (a) The trustees of the International Accounting Standards Committee Foundation revised the constitution in June 2005, with some significant changes made. Changes included a reduction in size of the Standards Advisory Council from 60 to 40 members, the appointment of Mr. Carvalho as the independent chairman to the council with a term lasting through 2008, and the rotation of two-thirds of the members of the council.
- (b) The IASB Standards Advisory Council holds two-day meetings three times each year. Meetings are attended by all IASB Board members, several trustees, and Council members; smaller break-out sessions are held during the course of the meeting.
- (c) A goal of the IASB Standards Advisory Council is to move toward eliminating the need for reconciliation between IFRS and national accounting standards.
- (d) Standards Advisory Council members also are encouraged to act as ambassadors of IFRS in their jurisdictions or industries.

Assets and Liabilities with Uncertainties

7. Mr. McBeth stated that the FASB and the IASB soon will be focusing on assets and liabilities in the conceptual framework, including the role of probability and uncertainty in defining, recognizing, and measuring them. The FASB recently issued an Invitation to Comment, *Selected Issues Relating to Assets and Liabilities with Uncertainties*. With regard to the Invitation to Comment, he noted that the discussion will focus on:

- (a) A renewed emphasis on establishing the existence of assets and liabilities with uncertainties according to asset and liability definitions before considering recognition and measurement issues.

- (b) The use of probability and uncertainty as part of measurement rather than recognition.
8. Council members expressed the following views:
- (a) One practical implication of the model is having more low-probability events reflected in the balance sheet. Disclosures about the range of possible outcomes and a worst-case scenario would be helpful.
 - (b) Some believe that having more high-value, low-probability liabilities on the balance sheet would lead to less meaningful financial statements. Others disagree and stated that a company that has a 20 percent chance of losing \$1 billion is very different from a company that does not have that risk; more transparency about that type of information is needed in the financial statements.
 - (c) It would be very difficult, if not impossible, for entities to estimate all possible outcomes and probabilities in many contingency situations.
 - (d) Liabilities for early-stage litigation are very difficult to value. Recognition of that type of uncertain liability raises the risk of it becoming a self-fulfilling prophecy.
 - (e) If disclosures about uncertainties and contingencies are inadequate, the Board should address that. Inadequate disclosure is not a reason to force recognition on the balance sheet.
 - (f) From a user standpoint, the Statement 5 model is not working. The proposed model would be an improvement but does raise issues about measurement error and volatility.
 - (g) Conceptually, the proposed model is a good start. The model needs to be tested on specific real-world transactions to determine whether it is operational.
 - (h) On a conceptual level, assets and liabilities should be treated the same way.
 - (i) Being able to recognize an asset such as one from a pending lawsuit could lead to manipulation of the balance sheet and earnings management.

Improving Lease Accounting

9. Ms. Zeyher stated that in September, the Board directed the staff to begin preagenda research work for a possible project on accounting for leases that might amend or replace FASB Statement No. 13, *Accounting for Leases*, and related guidance. She noted that the Board's action is in response to input from the following sources:
- (a) Criticism of Statement 13 by constituents, including members of FASAC and the User Advisory Council (UAC).
 - (b) The SEC's report on off-balance-sheet transactions.

- (c) The agreement in 2004 between the IASB and the FASB that the accounting for leases is in need of overhaul and that improvements should be made through a major project conducted jointly when resources permit.
 - (d) Responses to the 2005 FASAC survey, which ranked lease accounting as one of the top five areas that the Board should focus on. Issues that survey respondents believe need attention include the use of bright-line tests, the complexity of current accounting, and the lack of transparency.
10. Ms. Zeyher stated that the staff believes a project on improving lease accounting should be added to the agenda; the question is the timing and scope of the project. She noted that other projects such as the conceptual framework project and the IASB's project on leases should be considered in determining the timing and scope of a possible project. She summarized the following options for possible approaches:
- (a) Clean-Sheet-of-Paper Approach—This approach assumes that starting over is the best way to approach lease accounting. This approach is consistent with the FASB's three objectives—improvement and simplification of U.S. GAAP by principles-based standards grounded in the conceptual framework and convergence of accounting standards internationally. It could take one of the following three different forms:
 - Modified joint project with the IASB. Under this approach, the FASB would not directly participate in the research phase. Instead, the FASB would issue for comment the IASB discussion paper produced by the IASB's research project. The analysis of those comments would be the basis for a decision to add a standards-level project to the FASB's agenda.
 - A comprehensive joint project. The initial phase would be a joint research project with the IASB. Under this approach, the FASB and IASB would jointly develop a proposed conceptual lease accounting model. The research project would culminate in the issuance of a Preliminary Views by the FASB (and a discussion paper by the IASB) for comment by its constituents. The analysis of those comments would be the basis for a decision to add a standards-level project to the Board's agenda.
 - A comprehensive project for which the initial phase would be an FASB-only research project. Under this approach, the FASB would develop a proposed conceptual lease accounting model. The research project would culminate in the issuance of a Preliminary Views by the FASB for comment by its constituents. The analysis of that feedback would be the basis for a decision to add a standards-level project to the Board's agenda.
 - (b) Modernization Approach—This approach assumes that significant improvements to existing lease accounting could be made by “modernizing” the guidance in Statement 13. For example, some have

suggested eliminating or modifying the bright-line tests to focus more on the substance rather than the form of the transaction. This approach could include expanding the scope of Statement 13 to encompass other similar financing transactions, such as acquisitions of software systems and other intangible assets, as well as improving disclosure requirements.

- (c) **Combination Approach**—This approach balances the need for timely improvements to financial reporting with the Board's broader improvement, simplification, and convergence goals. Under this approach, the Board would undertake a comprehensive leasing project as described under the clean-sheet-of-paper approach. In addition to a first phase research project, the Board might also undertake one or more projects to deliver near-term incremental improvements in reporting by entities following U.S. GAAP. The comprehensive project could be undertaken jointly with the IASB, while the short-term improvements project would be an FASB-only project.

11. Ms. Zeyher asked the Council for input on the primary deficiencies in lease accounting, the timing of the project, and the type of project to undertake.

12. Council members expressed the following views:

- (b) The biggest deficiency in lease accounting is the inconsistency with the true economics of a lease transaction. Fair value should be an important consideration. The best approach is the clean-sheet-of-paper approach in a comprehensive joint project with the IASB.
- (c) Lease accounting should be addressed at the conceptual level first. Consider the definitions of assets and liabilities and whether those definitions encompass the rights and obligations of a lease. By looking to the definition of an asset, one can determine whether the lease is a conduit for essentially purchasing the leased item.
- (d) While a clean-sheet-of-paper approach may be the best way to fix the problems in Statement 13, that approach would take a significant amount of time, leaving the flawed guidance in Statement 13 in place for a long time. The combination approach could address some of the flaws in Statement 13 immediately.
- (e) Other projects, such as the project on pensions, are more important than a project on leases. Therefore, resources should not be pulled from those more important projects to start a project on leases.

Postretirement Benefit Obligations, Including Pensions

13. Mr. Batavick stated that in November 2005, the Board added a comprehensive project to the agenda to reconsider the accounting for postretirement benefits. As had been discussed at the September Council meeting, the project will have a phased approach. The initial phase will focus on the balance sheet, with a goal of a more faithful representation of the economic status of the postretirement plan; that is, requiring the recognition of

the overfunded or underfunded status of defined benefit plans (measured as the difference between the fair values of plan assets and the benefit obligation, that is, the projected benefit obligation for pensions and the accumulated postretirement benefit obligation for OPEBs). He noted that an Exposure Draft on this initial phase is expected to be issued by March 2006 with an effective date by the end of 2006. He asked Council members for their views on the following issues:

- (a) What implications do Council members see as a result of the initial phase?
- (b) Do Council members have any concerns about increased costs resulting from the implementation of the initial phase?
- (c) Do Council members see the need for additional reporting guidance on how to implement the initial phase?

14. Council Members expressed general support for the phased approach. Individual members also expressed the following views:

- (a) Inclusion of pension obligations on the balance sheet may result in violations of debt covenants and impact regulatory requirements and deferred taxes. Affected companies may need more time to address those issues, so the Board should provide ample time between issuance of a final standard and the related effective date.
- (b) The project will have public policy implications. The Board should be proactive in engaging the support of its constituents, especially investors and users of financial statements.
- (c) Sensitivity disclosures would be helpful, for example, the impact on the projected benefit obligation of a 1 percent change in the discount rate.

Adjournment

15. Mr. Swift thanked the Board and Council members for their participation and closed the meeting to public observation at 1:30 p.m. Council members attended a closed administrative session that adjourned at 2:30 p.m.