MINUTES

Financial Accounting Standards Board

To: Board Members

From: Project Team (Martin, x354)

Subject: Minutes of the January 14, 2009 Conceptual Framework (Phase A, Phase C & Phase D) Board Meeting

Date: January 20, 2009

cc: Leisenring, Bielstein, Golden, Proestakes, Stoklosa, Allen, Posta, Glotzer, Klimek, Lott, Gabriele, Sutay, Project Team, FASB Intranet, Upton, Lian, Hague, Villmann, Willis, GASB: Reese

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: Phase A: Objective and Qualitative Characteristics
Phase C: Measurement
Phase D: Reporting Entity

Basis for Discussion: Memorandum 79 (Agenda Paper 4)
Memorandum 80 (Agenda Paper 5)
Memorandum 81 (Agenda Paper 9)

Length of Discussion: 10:20 a.m. to 11:45 a.m., 12:45 p.m. to 2:30 p.m.

Attendance:

FASB members present: Herz, Linsmeier, Seidman, Siegel, and Smith

IASB members present: Leisenring

Staff in charge of topic: Lian, Kawanishi, McBeth

Other staff participating: Lott, Bossio, Mathys, Martin

Summary of Decisions Reached:

Objective and qualitative characteristics

The Board redeliberated some of the issues arising from the FASB Exposure Draft, *Conceptual Framework for Financial Reporting: The Objective of Financial Reporting and Qualitative Characteristics and Constraints of Decision-Useful Financial Reporting Information*.

The Board decided to:

1. Continue to use the term *faithful representation* to refer to the characteristic that had been labeled *reliability* in the existing framework
2. Continue to classify relevance and faithful representation as fundamental characteristics
3. Clarify that the components of faithful representation (neutrality, completeness, and freedom from error) are not absolutes. For example, the phrase *freedom from error* is not intended to imply that financial statements must be 100 percent accurate
4. Continue to classify verifiability, comparability, timeliness, and understandability as enhancing characteristics

5. Continue to describe materiality and cost as constraints on financial reporting.

Measurement

The Board discussed which possible measurement methods should be included in the conceptual framework and tentatively decided to include the following categories:

1. Actual or estimated current prices (which will become past prices in future periods if an item is not remeasured)
2. Actual past entry prices adjusted for interest accruals, depreciation, amortization, impairments, and similar things
3. Other prescribed computations based on discounted or undiscounted estimates of future cash flows (which would include value in use and fair-value-based measurements, among other things).

Reporting entity

The Board redeliberated some of the issues arising from the FASB Preliminary Views, *Conceptual Framework for Financial Reporting: The Reporting Entity*.

The Board decided to:

1. Continue to use a description of a reporting entity, rather than a definition of a reporting entity.
2. Revise the description of a reporting entity to read as follows:

   > A reporting entity is a circumscribed area of economic activity whose financial information has the potential to be useful to present and potential equity investors, lenders, and other capital providers in making decisions in their capacity as capital providers.

3. Update the list of capital providers in the description of a reporting entity if any changes are made to the list of the primary users of financial information in *Chapter 1: The Objective of Financial Reporting*.

4. Clarify that an entity that is currently inactive can be a reporting entity if it is capable of or authorized to conduct economic activities.

Implications of the Description of a Reporting Entity

The Board also tentatively affirmed the following decisions:

1. A reporting entity need not be a legal entity.
2. A legal entity could, but not necessarily would, meet the description of a reporting entity.
3. A branch or segment of a legal entity could, but not necessarily would, meet the description of a reporting entity.

Group Reporting Entity

The Board tentatively affirmed its previous decision that control should be used as the basis for determining the composition of a group reporting entity. Consolidated financial statements based on a control entity model are appropriate for most reporting entities, but combined financial statements for entities under common control may be appropriate in some cases.

The Board tentatively decided that:

1. Risks and rewards should not be used as a standalone model but observed that risks and rewards might be useful for implementing the controlling entity model in some circumstances.
2. Possible models other than the controlling entity model and the common control model would not be part of the conceptual framework.

Consolidated and Parent-Only Financial Statements

The Board tentatively decided that:

1. Consolidated financial statements are general purpose financial statements because they are most likely to provide decision-useful information to the greatest number of primary users.

2. Parent-only financial statements of entities with subsidiaries are not general purpose financial statements. They are either special purpose financial statements or information to supplement general purpose financial statements.

Objectives of the Meeting:

The objectives of the meeting were to (1) redeliberate the proposals in Chapter 2 of the Exposure Draft, *An improved Conceptual Framework: Chapter 1: The Objective of Financial Reporting and Chapter 2: Qualitative Characteristics and Constraints of Decision-useful Financial Reporting Information*, (2) continue developing an approach to selecting from among measurement bases, (3) redeliberate some aspects of the Discussion Paper, *Preliminary Views on an improved Conceptual Framework for Financial Reporting: The Reporting Entity*. The objectives were met.

Matters Discussed and Decisions Reached:

ISSUE 1: QUALITATIVE CHARACTERISTICS

1. **Staff Recommendation:** As noted during December 2008 meeting, most respondents to the Exposure Draft agreed with the proposals in *Chapter 2: Qualitative Characteristics and Constraints of Decision-useful Financial Reporting Information*. Ms. Lian recommended no changes to the proposals in the Exposure Draft, but noted the staff expects to further clarify some areas in drafting the final chapter.
2. **The Board Vote**: The Board unanimously voted to (a) continue to use the term *faithful representation* to refer to the characteristic that had been labeled *reliability* in the existing framework; (b) continue to classify relevance and faithful representation as fundamental characteristics; (c) clarify that the

components of faithful representation (neutrality, completeness, and freedom from error) are not absolutes, (d) continue to classify verifiability, comparability, timeliness, and understandability as enhancing characteristics; and (e) continue to describe materiality and cost as constraints on financial reporting.

Board Comments

3. Mr. Siegel suggested that the final Chapter should explain why understandability is an enhancing qualitative characteristic rather than a fundamental qualitative characteristic. Mr. Linsmeier concurred with this suggestion and added that the final document should explain why some qualitative characteristics are classified as either fundamental or enhancing.
4. Mr. Linsmeier noted that information that is relevant and faithfully represented but not understandable to any group of users would not be useful. Therefore, he suggested that the final Chapter explains what level of knowledge the Boards assume users should have. Mr. Leisenring stated that it is improbable that information that is relevant and faithfully represented would not be understandable to any group of users. Mr. Leisenring further stated that the goal should be to maximize the number of users that can understand the information presented.
5. Mr. Linsmeier stated that the conceptual framework should make clear whether the Boards believe that information that is relevant and faithfully represented should also possess all enhancing qualitative characteristics, at least at a minimum level. If the information presented does not possess one of the enhancing characteristics in any degree, the relevance and faithful representation of the information should be critically reevaluated.
6. Mr. Lott suggested that the final Chapter explain that not all enhancing qualitative characteristics are similar. For example, understandability and comparability could be improved by changing the presentation of information, but the same is not true for verifiability. Mr. Linsmeier agreed that the ability to verify often is not present whenever current values or historical cost

allocations are based on future estimates of cash flows, patterns of benefits, useful lives, accrual estimates, etc. Mr. Lott agreed and indicated that differences about whether the enhancing characteristics are expected to be met at a minimum level should be explained in the final document.

ISSUE 2: MEASUREMENT

Reducing the Number of Potential Measurement Bases

7. **Staff Recommendation**: Mr. McBeth recommended reducing the number of measurement bases to choose from in the conceptual framework as a way to simplify, and thus improve, the current mixed-basis measurement system. Mr. McBeth proposed eliminating the following measurement bases: past prices, future prices, and value in use.

Board Comments

8. Mr. Siegel objected to elimination of past prices as a measurement basis because past prices may be useful in measuring certain financial instruments.
9. Mr. Leisenring supported elimination of forecast future entry prices and forecast future exit prices.
10. Mr. Linsmeier noted that if forecast future prices are eliminated from the inventory of measurement bases, they still can be used as inputs for other measurement attributes.

11. Mr. Herz objected to elimination of value in use as a measurement basis because he considers value in use to be a particularly useful measurement attribute in achieving the primary objective of the financial reporting, which is to provide information that is useful in making decisions about the future cash flows.

12. Mr. Linsmeier asked whether value in use is not an estimation of the current price.

13. Mr. Herz noted that prices assume an exchange, while value in use reflects estimates of future cash flows. Current market price may be a good estimation of the value in use, but that is not always the case.

14. Mr. Leisenring observed that value in use is arrived at through a prescribed present value computation.

15. Mr. Linsmeier suggested retaining value in use as a measurement basis under the name of prescribed present value computation.

16. Ms. Seidman agreed with Mr. Leisenring's proposal. Ms. Seidman further noted that prices should not be the only measurement attributes considered by the Board. Some of the other candidates worth considering would be measurement attributes that utilize more entity-specific cash flows.

17. Mr. Herz observed that the valuation community utilizes the concept of the investment value, which is not a market-based measure. Mr. Herz suggested the concept of the investment value may be similar to the value in use measurement attribute and the staff may find it useful to explore the conceptual basis of the investment value used by the valuation community.

Considering Remaining Measurement Bases

18. **Staff recommendation**: Mr. McBeth recommended the Board reconsider two aspects of the current use of adjusted past prices in the context of improving the mixed-basis measurement system: the practice of defaulting to adjusted past prices when current prices are not used for remeasurement, and adjustments to current-value impairments. Mr. McBeth presented two possible alternatives: (a) leaving the past entry prices unadjusted and (b) using adjusted past entry prices as estimates of current prices. Mr. McBeth additionally proposed the Board consider limiting measurement at initial recognition to current entry price and remeasurement to current exit price.

Board Comments

19. Mr. Herz supported the staff view that write down of the assets that were originally recorded at cost to current value creates a mixture of historical cost and current value models, which may result in information that is not very decision-useful. Mr. Herz further stated that in his view historical cost model may be appropriate in some circumstances, such as for determining the profit margin on the sale of goods, but in most cases current value would provide more decision-useful information.

20. Mr. Linsmeier stated that allowing downward adjustments to assets and liabilities and disallowing upward adjustments represents a downward bias and conflicts with the concept of neutrality.

21. Mr. Smith observed that adjustments to the current-value impairments, such as depreciation, provide decision-useful information by allocating the remaining cost of the asset to future production.

22. Ms. Seidman objected to limiting the remeasurement to current exit price and referred to the point made earlier by Mr. Herz that prices are more appropriate when an exchange is involved, and an exchange does not typically accompany a remeasurement. Ms. Seidman supported the staff proposal to limit the measurement at initial recognition to current entry price.

23. Mr. Linsmeier observed that under certain circumstances a measurement basis other than entry price may be more appropriate. One example of such a case would be a manufacturer’s inventory, which is a cost accumulation.

24. Mr. Lott concluded the discussion by proposing a possible way forward for the staff: to divide the measurement bases into four categories per the Board discussion (current price, a measure that is a current value estimate, adjustments of past amounts, and undiscounted future cash flows) and evaluate each of the categories against the objective of decision-usefulness.

25. No one disagreed with Mr. Lott’s suggestion and Mr. Linsmeier expressed his agreement. He also noted that the Board would like the staff to develop

guidance for making choices not only among the categories, but also among measurement attributes within each category.

ISSUE 3: REPORTING ENTITY

Description vs. Definition

26. **Staff recommendation:** Mr. Kawanishi noted that many respondents to the Discussion Paper considered the broad description to be a broad definition. In fact, many respondents referred to the definition of a reporting entity, even though the Discussion Paper made it clear that the Boards' intention was to provide a broad description of a reporting entity rather than a precise definition. Mr. Kawanishi stated that there is little benefit, if any, in distinguishing between whether the Boards are providing a description or a definition of the reporting entity or whether it is broad or precise. Given that many respondents considered the broad description to be a broad definition, Mr. Kawanishi recommended that, from now on, the Boards consider the broad description to be a definition but that no special emphasis be placed on whether that definition is broad or precise.

27. **Board vote:** The Board rejected the staff recommendation by a unanimous vote. The Board observed that description and definition are not identical terms and definition is a more prescriptive and precise of the two. Based on this distinction, the Board decided that the conceptual framework should provide a description.

Circumscribed Area of Business Activities

28. **Staff recommendation:** Mr. Kawanishi recommended that the Board expand the idea of a *circumscribed area of business activity* by saying that the area will usually be circumscribed by legal or contractual rights or, in their absence, by an effective mechanism of sanctions.

29. **Board vote:** The Board rejected the staff recommendation by a unanimous vote.

Business Activities

30. **Staff recommendation:** Mr. Kawanishi recommended the Boards change the term *business activity* in the description of a reporting entity to the term *economic activity.* Mr. Kawanishi noted this would allow to avoid confusion as to whether the term *business activities* in the description of a reporting entity has the same meaning as that of *business* as defined in FASB Statement No. 141 (revised 2007), *Business Combinations,* or IFRS 3 (revised 2008), *Business Combinations,* and alleviate concerns raised by several respondents who noted that the term *business activity* is (or could be) inappropriate in the not-for-profit context.

31. **Board vote**: The Board agreed with the staff recommendation by a unanimous vote.

Inactive Entities

32. **Staff recommendation**: Mr. Kawanishi stated that a reporting entity should be determined based on the economic activities the entity is capable of or authorized to conduct. In other words, the entity does not necessarily need to have actually conducted the economic activity – the ability to engage in the activity should suffice when circumscribing the area of economic activities. Mr. Kawanishi recommended that the Boards clarify that a reporting entity should be determined based on the economic activities the entity is capable of or authorized to conduct.

33. **Board vote:** The Board agreed with the staff recommendation by a unanimous vote.

Capital providers

34. **Staff recommendation:** Mr. Kawanishi recommended that any changes to the list of primary users of financial reports in *Chapter 1, The Objective of*

Financial Reporting, be carried over to the definition of a reporting entity in Phase D.

35. **Board vote:** The Board agreed with the staff recommendation by a unanimous vote.

Implications of the Description of the Reporting Entity

36. **Staff recommendation**: Mr. Kawanishi recommended the Boards continue to support that a reporting entity need not be a legal entity and a branch or segment of a legal entity could meet the description of a reporting entity, and clarify that a legal entity likely would, but not necessarily, meet the definition of a reporting entity.

37. **Board vote:** The Board agreed with the staff recommendation by a unanimous vote, subject to following wording modification: a legal entity could, but not necessarily would, meet the description of a reporting entity, and a branch or segment of a legal entity could, but not necessarily would, meet the description of a reporting entity.

Group Reporting Entity

38. **Staff recommendation:** Mr. Kawanishi recommended that the forthcoming Exposure Draft not prioritize among the controlling entity model and the common control model, but acknowledge that the controlling entity model would be used in most cases and the common control model in some cases.

39. **Board vote:** The Board unanimously voted to affirm its previous decision that control should be used as the basis for determining the composition of a group reporting entity and that consolidated financial statements based on a control entity model are appropriate for most reporting entities, but combined financial statements for entities under common control may be appropriate in some cases.

40. **Staff recommendation:** Mr. Kawanishi recommended that the forthcoming Exposure Draft not discuss the risks and rewards model as a standalone model but discuss it in the context of complementing the controlling entity model (if appropriate). Mr. Kawanishi also recommended that the forthcoming Exposure Draft not discuss other possible models (that is, models other than the controlling entity model and the common control model), as those models

would be more appropriately addressed at the standards level or by each jurisdiction, if necessary.

41. **Board vote:** The Board agreed with the staff recommendation by a unanimous vote.

Consolidated and Parent-Only Financial Statements

42. **Staff recommendation**: In the deliberations that led to the DP, the Boards decided not to reach a conclusion as to whether parent-only financial statements constitute general purpose financial statements. However, the staff was of the view that this issue is one of the most important issues to be addressed in the reporting entity phase of the conceptual framework and, therefore, recommended the Boards make a decision on this issue. Mr. Kawanishi recommended the Boards include the following in the forthcoming Exposure Draft: (a) consolidated financial statements represent a set of financial statements that are most likely to provide decision-useful information to the greatest number of primary users, and (b) parent-only financial statements, by themselves, do not constitute general purpose financial statements but should be viewed as either special purpose financial statements or additional information to general purpose financial statements. Mr. Kawanishi also recommended that the forthcoming Exposure Draft not discuss whether, and if so, how parent-only financial statements should be presented. Also, Mr. Kawanishi recommended the financial statements of an entity that does not have a subsidiary, affiliate, or venturer's interest in a jointly controlled entity should be considered consolidated financial statements.

43. **Board vote**: The Board agreed with the staff recommendations by a unanimous vote, except for the recommendation to consider the financial statements of an entity that does not have a subsidiary, affiliate, or venturer's interest in a jointly controlled entity as consolidated financial statements,

which was rejected by a unanimous vote. The Board members stated that such wording may be misleading to some users.

Board Comments:

44. Mr. Linsmeier observed that general purpose financial statements have to reflect the economics that drive generation of returns to capital providers, which includes the synergies and interactions between parent and subsidiaries. Because information on such synergies and interactions would not be included in the parent-only financial statements, such statements should not be considered general purpose financial statements.
45. Ms. Seidman proposed the forthcoming Exposure Draft should include discussion of circumstances under which the consolidated financial statements would be appropriate and discussion of circumstances under which the combined financial statements would be more appropriate.

Follow-up Items:

None.

General Announcements:

None.