

MINUTES



To: Board Members
From: Gagon (ext. 322)
Subject: Minutes of November 24, 2004 Board Meeting
Date: January 5, 2005
cc: Smith, Bielstein, Petrone, Leisenring, Project Team, Golden, Swift, Polley, Gabriele, Vincent, Getz, Intranet (e-mail)

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

Topic: GAAP Hierarchy

Basis for Discussion: Board Memorandum dated November 10, 2004

Length of Discussion: 1:00 p.m. to 1:35 p.m.

Attendance:

Board members present:	Herz, Trott, Schipper, Batavick, Crooch (by phone), Seidman, and Schieneman
Board members absent:	None
Staff in charge of topic:	McBride
Other staff at Board table:	Smith, Golden, and Gagon
Outside participants:	None

Summary of Decisions Reached:

Consistent with the Board's initiatives aimed at improving the quality and transparency of accounting and financial reporting standards and the standard-setting process, the Board decided to undertake a project to move the generally accepted accounting principles (GAAP) hierarchy from Statement on Auditing Standards No. 69, *The Meaning of Present Fairly in Conformity with Generally Accepted Accounting Principles in the Independent Auditor's Report*, to an FASB standard. The Board's decisions will be released for public comment in an Exposure Draft of a proposed Statement of Financial Accounting Standards.

The Board previously stated in its *FASB Response to SEC Study on the Adoption of a Principles-Based Accounting System* that creating two levels of literature (authoritative and nonauthoritative) and elevating the conceptual framework within the GAAP hierarchy are key elements of the Board's goal of improving the quality of the GAAP hierarchy and, therefore, the quality and transparency of standards and the standard-setting process. The Board, however, observed that some of its other projects (such as the conceptual framework project and the codification project) address issues that are related to the GAAP hierarchy and decided to limit the scope of this project.

The Board considered whether to create two levels of literature (authoritative and nonauthoritative) and decided not to create two levels of literature at this time; the Board expects that this issue will be addressed under its codification project. Instead, the Board decided to maintain the qualitative characteristics of literature and practices that constitute the GAAP hierarchy that are presented in paragraph .05 of SAS 69.

While the Board agreed not to create two levels of literature at this time, it discussed the need to describe in the proposed Statement its long-range plans to reduce the multiple levels of literature to just two levels, authoritative and nonauthoritative. In connection with this discussion, the Board agreed that *authoritative literature* will include literature that is subject to (1) deliberation by the Board or its designee, (2) public exposure, and (3) final clearance by the Board. The Board acknowledges that the foregoing definition of authoritative literature is consistent with the qualitative characteristics of category (a) GAAP in SAS 69.

The Board also acknowledges that while the SEC and the Sarbanes-Oxley Act identify the FASB's role as the preeminent accounting standard setter in the private sector, the SEC retains the authority to establish accounting and financial reporting standards as it

sees fit. Therefore, authoritative literature for public companies includes official SEC staff views. The Board has instructed the FASB staff to consult with the SEC staff to determine the specific SEC literature to be included as authoritative.

The Board considered whether its Statements of Financial Accounting Concepts should be designated as authoritative literature, since they meet the definition of authoritative literature, but decided not to address that issue at this time; the Board expects to address that issue under its conceptual framework project.

Finally, the Board observed that Rule 203 of the AICPA's Code of Professional Conduct prohibits an auditor from expressing an opinion or stating affirmatively that the financial statements are presented in conformity with GAAP if such statements contain any departure from GAAP that have a material effect on the statements taken as a whole, unless the auditor can demonstrate that due to unusual circumstances the financial statements would otherwise have been misleading. This raises the issue of whether management should have the ability to represent that its financial statements are presented in accordance with GAAP in the unusual instances in which application of GAAP results in financial statements that are, in management's judgment, misleading. The Board believes that application of GAAP should result in relevant and reliable financial information and, therefore, management cannot represent that its financial statements are presented in accordance with GAAP if such financial statements contain a departure from GAAP.

In summary, the Board will issue an Exposure Draft of a proposed Statement of Financial Accounting Standards, which will reflect the following decisions:

1. The qualitative characteristics presented in paragraph .05 of SAS 69 will be presented in the Board's proposed Statement.
2. The new definition of authoritative literature will supplement the qualitative definition currently included in category (a) of the GAAP hierarchy.
3. Statements of Financial Accounting Concepts will continue to be ranked below category (d) of the GAAP hierarchy.
4. Management cannot represent that its financial statements are presented in accordance with GAAP if such financial statements contain a departure from GAAP.

The Board's decisions do not result in a change in the SAS 69 GAAP hierarchy.

Objective of Meeting:

The objective of the meeting was for the Board to decide whether to add a project to its agenda to move the GAAP hierarchy from SAS 69 into an FASB Statement and consider certain improvements to the GAAP hierarchy. The objective of the meeting was met.

Matters Discussed and Decisions Reached:

Background

1. Mr. McBride began the meeting by stating that in response to concerns about the quality and transparency of financial reporting, the Board issued a proposal in October 2002 entitled “Principles-Bases Approach to U.S. Standard-Setting.” He stated that the proposal enumerated initiatives that the Board could undertake to improve the quality of standards and the standard-setting process. Shortly thereafter, the SEC issued a study entitled “Study Pursuant to Section 108(d) of the Sarbanes-Oxley Act of 2002 on the Adoption by the United States Financial Reporting System of a Principles-Based Accounting System.” Consistent with that study, Mr. McBride stated that the Board has since taken on a number of initiatives aimed at improving the quality of FASB standards and the standard-setting process.
2. Mr. McBride stated that the objective of the meeting was to ask the Board to consider another initiative to improve the GAAP hierarchy. He stated that today, the GAAP hierarchy resides in SAS 69. The SAS 69 GAAP hierarchy provides guidance on how an auditor should resolve matters in cases in which there is a conflict between accounting principles relevant to the circumstances from one or more authoritative categories. This conflict resolution approach has historically been necessary because of the multitude of standard setters issuing different forms of literature, such as:
 - a. FASB Statements
 - b. AcSEC Statements of Opinions
 - c. EITF Consensuses, and
 - d. AICPA Accounting and Auditing Guides.

3. Mr. McBride continued by stating that the SAS 69 hierarchy has drawn some criticism because of its complexity and because it ranks the Concepts Statements, which are subject to the same level of due process as FASB Statements, below industry practices that are widely recognized as generally acceptable but are not subject to due process. Therefore, Mr. McBride stated that the staff believes that the Board has to appropriately scope a project to improve the GAAP hierarchy. He stated that to that end, the staff would ask the Board to deliberate several issues at the Board meeting. Those issues are each discussed individually below.

Issue 1—Add a Project to the Agenda to Address the GAAP Hierarchy

4. Mr. McBride stated that the staff recommends that the Board undertake a project to move the GAAP hierarchy from the auditing literature to FASB literature. He stated the following reasons to support the staff's recommendation:
 - a. In April 2003, the SEC reaffirmed its relationship with the FASB in a Policy Statement that affirms the FASB's role as the preeminent accounting standard setter in the private sector. Rule 203 of the AICPA's Code of Professional Conduct also designates the FASB as the preeminent accounting standard setter. Therefore, the Board has the responsibility to establish and determine the accounting and financial reporting literature that constitutes GAAP.
 - b. The SEC stated its expectation that the Board undertake this project in its study, to which the Board has indicated its intention to accept this project.
 - c. The SAS 69 GAAP hierarchy is directed at auditors. The GAAP hierarchy should be primarily directed at the management of an entity, since it is management, and not the auditors, that are responsible for selecting the appropriate accounting policies. SAS 69 cannot achieve that objective since it is an auditing standard.
5. The Board unanimously agreed with the staff's recommendation to add a project to its agenda to move the GAAP hierarchy from the auditing literature to FASB literature.

Issue 2—The Board’s Goals for the GAAP Hierarchy

6. Mr. McBride stated that the Board stated in its October 2002 Proposal that creating two levels of literature, authoritative and nonauthoritative, and elevating the conceptual framework within the GAAP hierarchy are key elements of the Board’s goal of improving the quality of the GAAP hierarchy. Therefore, in order to more fully develop these goals, the staff divided Issue 2 into three sub-issues for the Board’s consideration.

Issue 2.1—The Meaning of Authoritative Literature

7. Mr. McBride stated that authoritative literature is not defined in SAS 69; however, a pronouncement’s authority is generally determined by the extent to which it is subject to due process. He stated that due process generally means the process used to develop the pronouncements, which includes three key steps:
 - a. Deliberation by the Board or its designee (such as the EITF)
 - b. Exposure to constituents
 - c. Clearance by the Board prior to final issuance.
8. Mr. McBride stated that the staff believes that due process provides the most meaningful basis for determining what constitutes authoritative literature. With respect to the first and third steps, the Board has the responsibility of establishing and improving standards and, therefore, the standards promulgated by the Board or its designee and cleared by the Board should be designated as authoritative.
9. Mr. McBride also stated that the staff acknowledges the SEC’s role in standard setting. He stated that under securities law, including the Sarbanes–Oxley Act of 2002, the SEC has the responsibility to develop accounting standards for public companies. While the SEC has recognized the Board as the preeminent standard setter, the SEC retains the authority to establish accounting and financial reporting standards as it sees fit, and communicates its official views through forms such as Staff Announcements or Staff Accounting Bulletins. Therefore, the staff recommended that authoritative literature be defined under the GAAP hierarchy as follows:

Literature that is deliberated by the Board or its designee, exposed to constituents, and receives final clearance by the Board. For public companies, authoritative literature would also include official SEC staff views.

10. Ms. Schipper asked how the proposed definition would apply to EITF consensuses that are not exposed for public comment and that were reached in the pre-Board clearance era. Mr. McBride stated that if no changes are made to the EITF process and the consensus is not exposed for public comment, then it would not be designated as authoritative literature. Mr. Golden also stated that this definition would be for literature going forward and that existing literature that did not meet the proposed definition would continue to apply the existing GAAP hierarchy as currently prescribed in SAS 69. Mr. Smith stated that once the codification project is completed, the FASB would then bring the previous literature in as authoritative.
11. Additionally, Mr. Herz pointed out that the staff will have to work with the SEC to better determine what “official staff views” would mean per the proposed definition.
12. The Board all agreed with the staff’s recommendation.

Issue 2.2—Whether the Conceptual Framework Should Be Designated as Authoritative Literature

13. Mr. McBride stated that now that the Board has defined the meaning of authoritative literature, the Board needs to consider whether the conceptual framework should be designated as authoritative. He stated that the conceptual framework meets the definition of authoritative literature, even though the Concepts Statements currently explicitly state that they do not constitute GAAP. Mr. McBride stated that the SEC recommended in its Study that the conceptual framework be designated as authoritative literature once improvements to the framework have been completed.
14. Mr. McBride stated that the Board has recently added the conceptual framework project to its agenda. That project will not only address improvements, but also convergence with the IASB’s conceptual framework. He stated that the staff observes that the IASB gives certain conceptual guidance higher standing in the IASB hierarchy than the SAS 69 hierarchy. Because the Board’s goal is to converge its concepts with those of the IASB, the Board will need to consider whether and how to converge its hierarchy under that project.

15. Therefore, the staff recommended that the Board not change the status of the conceptual framework in the GAAP hierarchy at this time. The staff believes this recommendation is consistent with the SEC's recommendation that the Board first improve the Concepts Statements before it elevates them in the GAAP hierarchy.
16. The Board agreed with the staff's recommendation that the Board should not change the status of the conceptual framework in the GAAP hierarchy at this time.

Issue 2.3—Whether the GAAP Hierarchy Should Provide Management with the Ability to Depart from GAAP in Cases in which Application of a Specific Requirement in Authoritative Literature Might Result in Misleading Financial Statements

17. Mr. McBride stated that Rule 203 of the AICPA's Code of Professional Conduct prohibits an auditor from expressing an opinion or state affirmatively that the financial statements are presented in conformity with GAAP if such statements contain any departure from GAAP that have a material effect on the statements or data taken as a whole, unless the auditor can demonstrate that due to unusual circumstances the financial statements would otherwise have been misleading. This raises the issue of whether management should have the ability to represent that its financial statement are presented in accordance with GAAP in the unusual instances in which application of GAAP results in financial statements that are, in management's judgment, misleading.
18. Mr. McBride stated that the staff recommends that the GAAP hierarchy not provide management with the ability to depart from GAAP. The staff believes that the application of authoritative literature results in financial statements that contain relevant and reliable information. Mr. McBride also pointed to the SEC's recommendation in its Study, which states, in part, that a "true and fair override is not a necessary component of a principles-based or objectives-oriented standard setting system."
19. Mr. Herz stated that conceptually he does not agree with the staff's recommendation; however, for practicality reasons, he stated that he would not object with the staff's recommendation. He stated that he conceptually believes that there should be room for management to make judgments about GAAP, but that the judgments would have to be tightly regulated. He stated that regulation is a process that the FASB cannot really deal with. He stated that occasionally

entities may come across some GAAP that is not appropriate for the specific facts and circumstances and that management should have some discretion in those circumstances. However, he understands the practical issues associated with allowing management discretion to not follow GAAP and, therefore, stated that he does not object to the staff's recommendation.

20. Ms. Seidman stated that the potentially untenable situation may be caused by the fact that auditors are allowed to use discretion to depart from GAAP under Rule 203, but management would not be allowed to use discretion under the GAAP hierarchy. She stated that the Board may wish to focus on working with the AICPA to eliminate Rule 203. Mr. Golden mentioned that if management complies with GAAP, then auditors will not need to invoke Rule 203.
21. The Board agreed with the staff's recommendation that the GAAP hierarchy not provide management with the ability to depart from GAAP.

Issue 3—Whether the Board Should Make Any Immediate Changes to the SAS 69 GAAP Hierarchy as Part of the Project to Move it Into FASB Literature

22. Mr. McBride stated that the next issue the Board needed to address was whether the Board should make any immediate changes to the GAAP hierarchy, as stated under SAS 69, in this project. He stated that the staff recommends that the Board not create two levels of literature or make changes to the GAAP hierarchy at this time.
23. Mr. McBride stated that the staff observes that the form of literature that the Board uses to issue authoritative literature may change over time, and, therefore, recommends that the Board replicate the principles of the GAAP hierarchy outlined in paragraph .05 of SAS 69, and not bring the examples of literature that meet the principles of each category that are provided in paragraph .10 of SAS 69. The staff believes that providing the definition of authoritative literature, which is consistent with the qualitative aspects of category (a) literature in SAS 69, enables the Board to prospectively issue literature using multiple forms (such as FASB Staff Positions and EITF consensuses) that is equivalent of category (a) in the GAAP hierarchy.
24. The Board all agreed with the staff's recommendation not to make any changes to the GAAP hierarchy at this time.

Transition and Effective Date

25. The last item discussed was the transition and effective date and the form of the proposed guidance. Because this project should not have a significant impact on current practice, the Board made the following decisions at this meeting concerning the transition and effective date and the form of the guidance of the proposed Statement:
- a. The comment period should end around May 15, 2005.
 - b. The guidance should be issued in the form of a FASB Statement.
 - c. The guidance should be effective for the first reporting period after issuance.
26. Ms. Seidman also requested that in the FASB's effort to communicate to constituents the decisions reached in this project, the FASB should make it very clear that it is the Board's intention that this project is not intended to change current practice or GAAP—the Board is simply taking the current GAAP hierarchy out of auditing literature and placing it in FASB literature.

Follow-up Items:

None

General Announcements:

None