MINUTES

Financial Accounting Standards Board

To:	Board Members		
From:	Gibbons (ext. 446) and Duke (ext. 297)		
Subject:	Minutes of the July 27, 2005 Board Meeting: Conceptual Framework—Stewardship, Relationships between Qualitative Characteristics, and Definitions of Understandability and Materiality	**Date:**	August 3, 2005
cc:	Leisenring, Bielstein, Smith, Petrone, Mahoney, Polley, Lott, Gabriele, Carney, Sutay, Project Team, FASB Intranet, Upton, Hickey		

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: Stewardship, Relationships between Qualitative Characteristics, and the Definitions of Understandability and Materiality

Basis for Discussion: Agenda Paper 7, 7A, and 7B

Length of Discussion: 1:00 to 2:50 p.m.

Attendance:

Board members present: Herz, Batavick, Crooch, Schipper, Trott, and Young

Board members absent: Seidman

Staff in charge of topic: Abbate, Bullen, and Villmann

Staff at Board table: Bielstein, Johnson, Bullen, Bossio, Villmann, McBeth, Abbate, Duke, Gibbons, and Hague

Other participants: by phone: Willis

Summary of Decisions Reached:

The Board continued its deliberations on the joint FASB-IASB conceptual framework project. The Board discussed issues relating to (a) the definitions of stewardship and accountability and their relationships to objectives of financial reporting, (b) relationships between qualitative characteristics of financial reporting information and how they are used in building decision-useful financial reports, and (c) the definitions of understandability and materiality. The Board reached the following conclusions:

1. *Stewardship* and *accountability:* The Board agreed that stewardship or accountability should not be a separate objective of financial reporting by business entities in the converged framework. The Board agreed that the converged framework should clearly describe its meaning of *stewardship*, which encompasses management's responsibility not only for the custody and safekeeping of assets entrusted to it but also for their efficient and profitable use. As a consequence, the Board agreed that the converged framework should clarify that financial information useful for making investment, credit, and similar resource allocation decisions—the primary objective—would include financial information useful for assessing management's stewardship.

2. *Relationships between qualitative characteristics of financial reporting:* The Board agreed that staff should further develop a description of how qualitative characteristics of financial reporting information are used to build decision-useful financial reports. Board members observed that the different qualitative characteristics, which include relevance, faithful representation, comparability, understandability, and their sub-qualities, sometimes suggest different answers to standard setting and financial reporting issues. Previously, discussion of such differences has focused on hierarchy (that is, which characteristics prevail over others because they are ranked higher) or bargaining (that is, how much of one quality the Board is willing to "trade-off" to get more of another quality.) The Board agreed that it would be better to view consideration of the qualitative characteristics of financial reporting information as steps in a *process* that results in decision-useful financial reporting. Board members

suggested several improvements to the description and illustration of the process proposed by the staff.

3. *Understandability and materiality:* The Board discussed proposed definitions of understandability and materiality. Board members provided suggestions for improvement to the definition of understandability.

Objective of Meeting:

The Board discussed stewardship and accountability, the relationships among the qualitative characteristics, and the definitions of understandability and materiality. The objective of the meeting was to obtain the Board's decisions on these issues and to obtain approval—in concept—of the concepts and their relationships as revised. The objectives were met at the meeting.

Matters Discussed and Decisions Reached:

Stewardship and Accountability

1. Mr. Abbate began by stating that the staff discussed the meanings of stewardship and accountability and the implications of having such objectives in the converged framework. The findings are presented in Agenda Paper 7. Mr. Abbate asked whether the Board agrees with the staff's conclusion that providing information needed to assess stewardship and accountability should not be an explicit objective of financial reporting by business enterprises. Mr. Abbate then asked whether the Board agrees that financial information directed at a primary objective of providing information useful for making investment, credit, and similar (resource allocation) decisions also may be helpful in assessing management's stewardship and accountability, and whether the Board believes that the converged conceptual framework should acknowledge that point.

2. Mr. Abbate also summarized the decision the IASB reached on this issue at its July meeting.

3. Ms. Schipper agreed with the staff's analysis but cautioned against devoting too much effort (in the converged conceptual framework) to a

description of something that will not be an objective of financial reporting. She also expressed the importance of focusing on one objective: providing information useful for making decisions.

4. Mr. Young stated his belief that stewardship should be a guiding objective of financial reporting, stressing that the individual shareholder would otherwise be unable to assess management's stewardship.

5. Ms. Schipper stated that the governing board of a corporation, which is elected by the shareholders, is responsible for overseeing management. In contrast to outside investors who rely on financial reports to make investment decisions, a governing board has the power to demand the information necessary for it to determine whether management is fulfilling its stewardship role. The board need not rely on general purpose financial statements for information to use in carrying out its responsibilities for selecting, retaining, paying, and firing top management, because the board can require that internal reports be prepared for its use. The external financial reports are not the appropriate mechanism for communicating information on stewardship to the governing board.

6. Mr. Young expressed his concern about not providing information to the common shareholder whose interests should be protected by financial reporting.

7. Mr. Crooch stated his concern that including stewardship as an objective of financial reporting would require separating the results of a company between results that occur due to the performance of a company's management and results that arise from market forces.

8. Mr. Trott agreed with the staff's analysis but stated that a discussion of stewardship should not be included in the converged conceptual framework. He believes it should be contained in the basis for conclusions. Accountability of resources of a company is the responsibility of that company's internal control function and financial statements are indirectly related to that accountability.

9. Mr. Young questioned why the concept of stewardship would require isolating the impact of management decisions from other factors to assess stewardship. Ms. Schipper stated that stewardship does not require that separation, but the separation is logical in the minds of many constituents. Furthermore, separating the effects of management's actions from other factors is a necessary condition for focusing on items that are deemed to be controllable by management, and controllability appears to be a criterion used by some of the Board's constituents in determining stewardship. Mr. Young stated that he is unaware of any method by which effects of the state of the world may be separated from the effects of management's efforts.

10. Mr. Crooch asked Mr. Young how including stewardship in the converged conceptual framework would influence the financial statements. Mr. Young stated that including stewardship would introduce bias, but there is an inherent opposite bias since management prepares the financial statements. Including stewardship in the framework would enhance the user's perception of management's stewardship.

11. Mr. Bossio stated that there is no debate about the existence of an accountability of stewards. However, he suggested the discussion focus on the driving objective and how changing that objective would change financial reporting. He stated that people have different notions of stewardship, but that the staff believes the notion of stewardship as described in the memo[1] should not be an objective of financial reporting.

12. Ms. Schipper stated that with stewardship as an objective, management's intent would influence financial reporting more than it does today. Mr. Trott said that financial reporting with stewardship as an objective would result in more recognition of opportunity cost gains or losses.

[1] *Stewardship* encompasses management's responsibility not only for the custody and safekeeping of assets entrusted to it but also for their efficient and profitable use and for protecting them from unfavorable economic impacts of factors in the economy.

13. Mr. Batavick agreed with the staff's recommendation. He said it strikes the right balance and would include a discussion of how the information provided by financial reporting also is useful for assessing stewardship. He thought that stewardship should be in the body of the framework instead of the basis for conclusions and questioned why others might prefer otherwise.

14. Mr. Trott stated his preference for the body of the framework to be concise and operational and for it to focus on what the guiding objective would be. He would put items that do not rise to the level of an objective in the basis for conclusions since they would not be used by the Board in setting standards.

15. Mr. Herz reported the written views of Ms. Seidman. He stated that she agreed with the staff's recommendation and supported the use of wording similar to paragraph 53 of FASB Concepts Statement No. 1, *Objectives of Financial Reporting by Business Enterprises*, to describe why management and entity performance are not easily separated.

16. Mr. Herz also stated that he agreed equally with both the accountability and stewardship goals because the same information is provided in both cases. The information provided, though, is limited to the past and excludes forecasted information. The objective of financial reporting is to provide guidance on future cash flows, thus, he suggested forecasts should be provided to users. Financial reports provided today as at a point in time are incomplete and suboptimal to users by indirectly addressing the objective. He did not object to the staff's recommendation and agreed that information useful for investment decisions contains information useful for assessing other items, such as management's stewardship.

17. Five Board members agreed with the staff's recommendation (RHH, GJB, GMC, KAS, and LFS). Mr. Trott also agreed that stewardship should not be an objective of financial reporting, but added that any discussion of stewardship should be included in the basis for conclusions. Mr. Young

did not agree with the staff's recommendation; he felt that stewardship should be elevated to the objective level.

Relationships between Qualitative Characteristics

18. Mr. Bullen began the discussion of relationships between qualitative characteristics by setting forth the staff's recommendation that consideration of qualitative characteristics be viewed as steps in a *process* that result in decision-useful financial reporting. Mr. Bullen described Illustration 1: Using the Qualitative Characteristics for Standard Setting and to Build Decision-Useful Financial Reports, which can be found in Appendix 1. The illustration depicts the staff's proposed process.

19. Mr. Batavick stated that he preferred the recommended process approach over the hierarchy approach. He stated that under the hierarchy approach, he felt that sometimes only a couple of the qualitative characteristics were considered. The staff's approach seems more disciplined, with the flow of the process ensuring that all qualitative characteristics would be included in the discussion. He stated that the accounting for an economic phenomenon would be debated in each part of the process and that judgment would be required to determine the outcome. He added that he would like to see case examples on how the discussions may have occurred under this process for older standards, recent standards, and current projects.

20. Mr. Crooch stated that he considers the flow process to be a vast improvement over the current hierarchy. He stated that the secondary characteristics may need to be reordered, but that the idea is good. He stated that the process was not a Rosetta Stone, in that judgment will be required (that is, what is or is not understandable?). He also questioned why materiality was not considered until step seven. He stated that materiality should be considered more than once.

21. Ms. Schipper stated that there are two different types of materiality to be addressed. The first type is the materiality of an item that is included in

the financial statements. This type of materiality is contextual and entity specific. The second type is the materiality of the issue. This type of materiality pertains to whether a given financial reporting question or issue requires guidance. Materiality of the issue should be considered first, and by the standard setter. For example, the Board determined that accounting for servicing rights is a material issue and issued guidance for accounting for servicing rights. An entity that applies the guidance determines whether servicing rights are material to its financial statements.

22. Mr. Herz stated that for the purposes of the Board, the materiality of an issue involves the decision to add a project to the agenda. Materiality of an item is specific to the circumstances of a particular entity. Mr. Bullen stated that the staff did not intend the process to be used as an agenda decision tool; there is guidance for agenda decisions that differs from the staff's process for setting high-quality financial reporting standards. Ms. Shipper asked the Board how something that is economically trivial can possibly be decision useful.

23. Ms. Schipper then gave her analysis of the proposed process. In evaluating the top panel of the chart presented by the staff, Ms. Schipper noted that the chart specifies the order in which characteristics are to be considered. The chart requires that the starting point be items that are relevant. An alternative approach, taking representational faithfulness as the starting point, would identify the items that can be reasonably measured, and from those items select those that meet the relevance criterion. This option is ruled out in the staff's process and Ms. Schipper agrees with that approach.

24. Ms. Schipper noted that the process illustrated by the chart would replace previous thinking of the qualitative characteristics as being subject to trading-off or bargaining. She agrees with this restriction because she does not believe there is a rational way to trade-off characteristics that are inherently qualitative (that is, there are not units of relevance that can be

traded off or bargained against units of representational faithfulness). However, she also believes that the chart implicitly allows for trading-off or bargaining to be reintroduced because the chart requires consideration of whether there is a better alternative. Absent guidance on what might constitute a “better” alternative, the requirement to consider whether there is a better alternative for a given proposal is a stealth way of introducing trade-offs to the discussion.

25. Ms. Schipper disagreed with the staff’s treatment of comparability. Paragraph 27 of Agenda Paper 7A states that financial reporting standards that reduce comparability may be acceptable if they result in information that is more understandable, or if the reduced comparability somehow also either increases another financial reporting benefit or decreases a financial reporting cost. That paragraph contradicts paragraph 29, which states that reduced comparability would be appropriate *only* when compensated for by greater relevance, more faithful representation, or greater understandability.

26. Ms. Schipper questioned the reasoning that comparability might be sacrificed to increase representational faithfulness. Specifically, she questioned whether the same phenomenon can be depicted in two different ways that are equally faithfully representative.

27. Ms. Schipper also questioned how noncomparable accounting can increase understandability, since by definition noncomparable accounting means that similar items do not receive the same accounting treatment.

28. Finally, Ms. Schipper questioned paragraphs 22, 28, and 31, which imply that noncomparability can be compensated for by disclosure. She pointed out that the Board concluded in certain Concepts Statements and standards that disclosure is not an appropriate substitute for conceptually grounded recognition and measurement.

29. Ms. Schipper concluded that the process laid out in the chart should be used to order the questions the Board asks itself, but that the value of this

process to the Board is limited. Nothing in the process implied by the chart would assist the Board in (a) deciding between disclosure and recognition, (b) choosing a better alternative (or defining what attributes would make one alternative better than another), or (c) understanding the circumstances in which it is desirable to sacrifice comparability.

30. Mr. Trott supported pursuing the staff's recommendation, but suggested improving it into a more complete depiction of how the qualitative characteristics should be considered. Mr. Young also agreed that the process is an improvement, but believes that the Board should always ask itself whether there is a better alternative.

31. Mr. Herz reported the written views of Ms. Seidman. He stated that she agreed with the process but felt that timeliness should be considered as part of the cost-benefit analysis.

32. Mr. Herz agreed that the process is a more useful method of thinking about the thought process and that its discipline will help the Board consider all qualitative characteristics. Mr. Herz agreed with Mr. Batavick's suggestion of testing the process with some case examples.

33. Mr. Trott stated that timeliness should be considered in box 3 of the process rather than box 13 because timeliness is linked to a faithful representation, which is depicted in box 3. Mr. Herz stated that Ms. Seidman would place timeliness in box 6, connecting it with the cost-benefit assessment. She observed that if an accounting approach such as pension valuation was very time consuming, perhaps another alternative would provide useful information but be timelier. Ms. Schipper discussed two notions of timeliness including (a) timely dissemination of information to users and (b) timely recognition of changes in economic conditions, as reflected in a measurement (or remeasurement) that is representationally faithful. The notion that would be appropriate to consider in box three is the second notion, ensuring that up-to-the minute information is used.

34. Mr. Bullen reported that an IASB member had stated that because information is not timely does not mean the information is not decision useful—another limitation of the process. Mr. Bullen summarized by saying that all Board members generally support the recommendation, but each Board member has some suggestions for improving the process. Mr. Bullen agreed to improve the process and test it with some case examples to determine its effectiveness.

Understandability and Materiality

35. Ms. Villmann introduced the third topic—understandability and materiality—as discussed in Agenda Paper 7B. Discussion centered on the definition of understandability. This discussion was based on the Board's request for the staff to refine the proposed definition of understandability in order to replace the phrase "perceive its significance." The staff recommends the phrase "perceive its significance" be replaced with the phrase "comprehend the meaning of the information." The full definition of understandability proposed by the staff is in paragraph 5 of the memorandum.

36. Mr. Trott agreed that the refined definition is an improvement, but that it could be improved further. He recommended the following changes:

    a. The phrase "willingness to study" should be in the first sentence rather than the second sentence.

    b. The definition of understandability should consider the fact that different financial information is relevant to different users, and users should understand the information that is relevant to them. Users must make an active decision to understand the information. Thus, information the user uses in its decision-making process must be capable of making a difference.

    Mr. Crooch agreed with Mr. Trott's analysis.

37. Mr. Young stated that "reasonable diligence" is a subjective term. The amount of effort that a user should exert to understand the financial statements should be limited. If too much effort is required, users will not devote the time and effort to understanding the information and

understandability of the information presented in the financial statements will decrease. Including the expression "reasonable diligence" in the definition of understandability gives the Board too much power to create overly complex standards.

38. Mr. Trott stated that understandability refers to the understandability of the information presented, not the standard itself (that is,, a user does not need to understand the details of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, in order to understand that derivatives are presented at fair value).

39. Mr. Herz agreed with Mr. Young and stated that it is important to be able to understand the standards and that "reasonable diligence" is biased in favor of the Board and to the detriment of the user. Mr. Batavick agreed with Messrs. Herz and Young and added that the last sentence of the proposed definition of understandability would be redundant if the changes proposed by Mr. Trott were to be made.

40. Mr. Trott stated that in order to increase understandability, complexity may be necessary to better represent the information. Mr. Bossio added that when considering understandability, the Board should focus primarily on the quality of information rather than on the characteristics of the user.

41. Mr. Herz stated that understandability is related to transparency. The underlying transaction may be very complex but the user should be able to understand how the accounting represents the phenomenon.

42. Ms. Schipper stated that research suggests there are three characteristics needed for a person to understand information:

    a. Basic knowledge of the subject matter

    b. Problem solving skills

    c. Desire to understand the information.

Standards should be written for users who possess all three of these characteristics and should not be written for users who lack one or more of them.

43. Mr. Young stated that the Board should consider the most efficient way to increase the user's understanding. Mr. Herz stated that the focus should be on faithfully representing the information. Mr. Bullen noted that in an earlier meeting, the terms *clear* and *concise* were added as sub-elements of understandability, which seems to address Mr. Young's concern that users should be able to efficiently understand the information.

44. Ms. Schipper stated that in certain cases (that is, accounting for pensions), the information in the financial statements is not a faithful representation of an economic phenomenon and a financial statement user would have to make calculations based on information presented in the footnotes to arrive at the faithful representation. She suggested that understandability would be increased by presenting the faithful representation, rather than the information that could be used to arrive at it.

45. No Board member indicated disagreement with the proposed definition of materiality, with several explicitly agreeing with it.

<u>Follow-up Items:</u>

The staff will develop case examples of how the deliberations for past and recent deliberations would have occurred under the proposed process and will further refine the process flowchart and definition of understandability.

<u>General Announcements</u>:

None.

Appendix 1—Illustration 1: Using the Qualitative Characteristics for Standard Setting and to Build Decision-Useful Financial Reports