



Recent Activities at the FASB

American Accounting Association

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The views expressed in this presentation are my own, and do not represent positions of the Financial Accounting Standards Board. Positions of the Financial Accounting Standards Board are arrived at only after extensive due process and deliberation.

Overview - I

- Process issues
 - International convergence & SEC proposals
 - SEC Advisory Committee (“complexity initiative”)
 - Codification project
 - Private company reporting
- Joint FASB/IASB projects
 - Fair value: measurement guidance and fair value option
 - Financial statement presentation
 - Financial instruments: liabilities and equity
 - Revenue recognition
 - Leases
 - Mary Barth will cover remaining joint projects

Overview - II

- FASB only projects
 - Pensions and other postretirement benefits
 - Derivatives and hedging
 - Transfer of financial assets: revision of SFAS 140
- Inquiries relating to other items on FASB agenda

Process issues – international convergence

- February 27, 2006: public release of "memorandum of understanding" between the FASB and IASB
 - Reaffirm joint commitment to work together to achieve a single set of high quality accounting standards that can be used in all jurisdictions
 - Three guidelines
 - Convergence is best achieved by developing high quality common standards over time
 - Trying to eliminate differences between two standards that are *both* in need of improvement is not the best use of resources—instead, an improved standard should be developed in common
 - Convergence should occur by replacing weaker standards with stronger ones

Process issues – international convergence

- Narrow convergence projects – FASB topics
 - Fair value option (completed; discussed later)
 - Investment properties (on agenda; no substantive decisions thus far)
 - Research and development (on agenda to capitalize purchased R&D not acquired in business combination; ED expected this year)
 - Subsequent events (on agenda; brings guidance in U.S. auditing literature into U.S. GAAP & eliminates differences with IFRS; ED expected this year)
- Narrow convergence projects – IASB topics
 - Borrowing costs (indicates when interest is capitalizable; IFRS this year)
 - Government grants (on hold pending completions of liabilities project)
 - Joint ventures (ED this year; Mary will discuss later)
 - Segment reporting (completed)
- Narrow convergence projects – Joint topics
 - Impairment (agenda decision expected this year)
 - Income taxes (converges differing exceptions to basic principles permitted in two literatures; ED expected this year)
 - EPS (converges eps denominator; ED expected this year)

Process issues – international convergence

Goals set for 2008

- Issue converged standards on accounting for
 - Business combinations (completed standard but not fully converged)
 - Fair value measurement (FASB completed; IASB deliberating)
- Progress on consolidation policy (IASB taking lead; FASB to follow)
- Projects underway, with due process documents expected
 - Liabilities and equity (FASB taking lead; IASB to follow; on track)
 - Financial statement presentation (on track)
 - Postretirement benefits — each board taking different approach; joint steps forward yet to be determined
 - Revenue recognition (on track)
- Projects in pre-agenda research
 - Leases — make agenda decision (completed; project underway)
 - Derecognition—issue a due process document (on track)
 - Financial instruments—issue due process document (on track)
 - Intangible assets—make agenda decision (on track)

Process issues – SEC proposals affecting international convergence

- Proposing release issued recommending eliminating the 20-F reconciliation requirement for foreign private issuers filing in U.S. under full IFRS
- Concept release issued exploring whether U.S. registrants should have option to file with SEC using full IFRS rather than U.S. GAAP
- Potential to have very important impact on the ultimate goal of a common global financial reporting language
- Key questions to consider
 - What is the desired end game: a single set of standards or a common reporting language?
 - What is the optimal standard setting structure to achieve the goal?
 - What changes in infrastructure globally and nationally need to be undertaken to reach desired end game?
 - What time period is needed to make the necessary changes?
 - Are we ready now?

Process Issues - SEC Advisory Committee

- Established by SEC, FASB, PCAOB
- Focus on improving U.S. reporting system by increasing usefulness of reported information and reducing complexity.
- Committee composition:
 - Chair — Robert Pozen, Chairman, MFS Investments
 - 13 to 17 members from key parties in reporting system
- Subgroups to examine issues such as:
 - Process for developing standards and regulations, including cost/benefit of certain current requirements
 - Process for providing formal and informal interpretations and application guidance
 - Process of regulating compliance by companies and auditors with standards and regulations, including impact of audit firms, SEC and PCAOB.
 - Other environmental factors that create unnecessary complexity and reduce transparency to investors
 - Current systems for delivery and access of financial information and potential greater use of technology
 - Impact of international convergence and possible use of IFRS on these issues

Process issues – codification project

- Intent of project
 - Reorganize U.S. GAAP by topic matter
 - Include *all* pertinent guidance on topic in one place
 - *Example:* Guidance on revenue recognition currently appears in over 200 pieces of authoritative literature. In a codified database, it would be grouped by topic
 - Intent is *not* to change any of the content
 - Extensive quality control procedures
 - Similar to GAAP guides and to Canadian GAAP
 - Intent is to create a searchable electronic database
 - Ultimately, will eliminate GAAP hierarchy
 - All guidance in the codified GAAP database will be authoritative
 - Release of database for verification (a one-year period) expected early 2008

Process issues - Private company reporting

- Standard setting
 - No current proposals for wholesale recognition and measurement differences for private companies
 - Differences will continue to be based on:
 - Differences in user needs
 - Cost-benefit considerations
 - *New approaches to make such evaluations:*
 - Established Private Company Financial Reporting Committee in consultation with AICPA to provide private company input on these issues in standard setting process
 - Include specific requests for comments on these matters in all due process documents
 - Discuss private company issues in public meetings of the FASB and explain the basis for reaching a conclusion that there should or should not be differences in U.S. GAAP for private companies

Joint FASB/IASB Projects

- Fair value: measurement guidance and fair value option
- Financial statement presentation
- Financial instruments: liabilities and equity
- Revenue recognition
- Leases

Fair value definition

Definition: Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

Key attributes:

- Does not require an actual transaction
- Does not require that a market exist
- Based on information that is current at the measurement date, including information about the dispersion of possible outcomes
- Not intended to capture the most likely ultimate settlement amount; therefore, not consistent with SFAS 5, which defers recognition until a probability threshold is met, and then (per Interpretation 14) records the most likely settlement amount

Statement 157

Fair Value Measurements

- Reasons for Statement
 - Explain measurement objective when the measurement attribute is fair value
 - Increase the consistency and comparability of fair value measurements
 - Increase the usefulness of disclosures about measurements
- Standard does not propose extending the use of fair value measurements. Decisions about measurement attributes will continue to be made within each standard
- Effective date: Fiscal years beginning after November 15, 2007

Statement 157

Fair Value Measurements

Framework for measuring fair value from the perspective of the reporting entity:

- a. Identify the particular asset or liability; consider level at which the asset or liability is aggregated or not (unit of accounting).
- b. Identify ***Highest and Best Use*** for an asset or ***Lowest Price*** to transfer (not settle) a liability.
- c. Based on b., identify the ***Valuation Premise*** (either in-use or in-exchange) to determine whether the asset or liability should be valued individually or within larger group.
- d. Determine the principal market (or if that is not known the most advantageous market) for the exchange of the asset or liability considering a, b and c.
- e. Determine the valuation technique(s) (market, income or cost approach) that market participants would use to determine a price (consider availability of inputs).

Statement 157

Fair Value Measurements

- d. Exclude transaction costs.
- e. Use observable inputs (Level I and II) to the extent possible.
- f. Determine unobservable inputs (Level III) about assumptions market participants would use based on the best information available; including assumptions about ***Risk Premiums***, highest and best use (if asset) and nonperformance risk (if liability).
- g. Inputs based on the reporting entity's data, if that is the best information available, shall be adjusted if there is data available without undue cost and effort indicating that market participants would use different inputs.

Statement 157

Fair Value Measurements

Disclosures about Fair Value:

- a. Provide information about **Level** of inputs used to make recurring and nonrecurring fair value measurements in the financial statements.
- b. Provide information in annual financial statements, about valuation technique(s) used.
- c. For measurements based on Level III inputs, provide more information about amounts of reported numbers subject to potentially greater measurement error.

Fair Value Disclosures

- Fair value measurements by level in the fair value hierarchy

Fair Value at Reporting Date

<u>(\$ in 000's)</u> <u>Description</u>	<u>12/31/XX</u>	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>
Trading securities	\$ 115	\$ 105	\$ 10	
Available-for-sale securities	75	75		
Derivatives	60	25	15	\$ 20
Venture capital investments	10			10
Total	<u>\$ 260</u>	<u>\$ 205</u>	<u>\$ 25</u>	<u>\$ 30</u>

Fair Value Disclosures

- For recurring fair value measurements using significant unobservable inputs (Level 3), a reconciliation of beginning and ending balances

(\$ in 000's)	<u>Level 3 Fair Value Measurements</u>		
	<u>Derivatives</u>	<u>Venture Capital Investments</u>	<u>Total</u>
Beginning balance	\$14	\$11	\$25
Total gains and losses (realized/unrealized)			
Included in earnings	11	(3)	8
Included in OCI	4		4
Purchases, issuances, and settlements	(7)	2	(5)
Transfers in/out of Level 3	(2)	0	(2)
Ending balance	<u>\$20</u>	<u>\$10</u>	<u>\$30</u>
Change in unrealized gains or losses in earnings relating to assets still held	<u>\$ 7</u>	<u>\$ 2</u>	<u>\$ 9</u>

Statement 157

Fair Value Measurements

- Goal: use observed prices if available; otherwise, use techniques, models and assumptions that market participants would use

Observations:

- Fair value measurement is based on an economic measurement objective (exit price); allocated transaction amounts have no similar economic foundation
- Fair value estimation errors can be assessed against economic facts and economic conditions in ways that allocation errors cannot
- Discipline for choosing techniques and inputs is provided by the requirement to use techniques and assumptions that market participants would use

Measurement: One Perspective

- Net income = Cash +/- accruals/deferrals +/- estimates +/- fair value changes
- SEC enforcement actions demonstrate that vast majority of accounting manipulations are in accruals/deferrals and estimates
- Fair values also subject to manipulation if prices cannot be observed
- Each type of manipulation has caused market problems
 - Types sometimes differ in up and down markets
- Accounting manipulation can not be focused or blamed on one type
- The issue needs to be addressed within broader context of attempting to provide (imperfect) financial information that best facilitates business and capital market allocations
 - Will involve tradeoff between relevance, comparability and reliability
 - Best accounting will differ depending on circumstances
 - I will discuss these issues further at two other sessions at this conference

Statement 159

Fair Value Option for Financial Instruments

- Statement 159 permits entities to elect (on a instrument-by-instrument basis) to account for financial (and certain selected nonfinancial) instruments at fair value with changes in fair values recorded in income
 - *Intent* is to alleviate the most problematic outcomes associated with a mixed attribute measurement model
 - Could create different problems (e.g., reporting less volatility in financial statements than actual)?
 - Effective date: Fiscal years beginning after November 15, 2006. Election to apply the Option will require adoption of the Fair Value Measurements Standard as of that date

Question to consider: This treatment alternative decreases comparability. What is best way to mitigate the problems associated with noncomparability? *Potential answer:* Fair value accounting for all financial instruments

Financial Statement Presentation (FSP) Project

- Purpose: Establish a common, high-quality standard for presentation of information in the financial statements.
- Scope:
 - All business entities (public and private)
 - All financial statements
 - Form, content, classification and display
 - Aggregation into totals and subtotals

FSP Project Advisory Groups

- Joint International Group (JIG)
 - Assist in identifying project issues and developing proposed solutions
 - Senior professionals with extensive experience in and responsibility for preparation, analysis, audit, and regulation of financial statements
- Financial Institution Advisory Group (FIAG)
 - Assist in addressing presentation issues from the perspective of those who analyze and prepare financial institution financial statements

FSP Project Objective

- To present information in the financial statements in ways that improve the ability of investors, creditors, and others to:
 - Understand an entity's present and past financial position
 - Understand the past operating, financing, and other activities that caused an entity's financial position to change
 - Use that financial statement information (along with information from other sources) to assess the amounts, timing, and uncertainty of an entity's future cash flows

FSP Project Phases

- Phase A (IASB: Drafting final standard; FASB: Deliberations complete):
 - Complete set of financial statements
 - Comparative information
- Phase B (Currently deliberating):
 - Categories in each financial statement
 - Totals, subtotals
 - Other comprehensive income (and recycling)
 - Statement of cash flows (direct vs. indirect method)
- Phase C (Not started):
 - Interim financial information

Phase A – Decisions

- A complete set of financial statements consists of:
 - Statement of financial position at the beginning and at the end of the period
 - Statement of comprehensive income
 - Statement of cash flows
 - Statement of changes in equity
- All shown with equal prominence
- A minimum of two annual periods of complete financial statements must be provided

Phase A – Status

- IASB published Exposure Draft in March 2006
 - Decided to permit comprehensive income to be presented in either one or two statements
 - Similar to FASB Statement No. 130, *Reporting Comprehensive Income*
 - Redeliberated in December 2006
 - Expected to publish amendment to IAS 1 in 2007
- FASB to expose Phase A decisions at the same time as Phase B decisions

Phase B – Working Principles

Financial statements should present information in a manner that:

1. Portrays a cohesive financial picture of an entity
2. Separates an entity's financing activities from its business and other activities and further separates financing activities into transactions with owners in their capacity as owners and all other financing activities
3. Helps a user assess the liquidity of an entity's assets and liabilities (the Boards expressed interest in adding the concept of solvency to this working principle)
4. Helps a user understand:
 - a. The basis on which assets and liabilities are measured
 - b. The uncertainty in measurement of individual assets and liabilities
 - c. What causes a change in reported amounts of assets and liabilities

Phase B – Working Principles

Financial statements should present information in a manner that:

5. Disaggregates line items if that disaggregation enhances the usefulness of that information in predicting future cash flows
6. Will help investors, creditors, and others to assess
 - a. An entity's ability to generate future cash inflows
 - b. An entity's ability to meet its obligations, its ability to pay dividends, and its need for external financing
 - c. The difference between cash transactions and accrual accounting
 - d. The effects of noncash activities during the period on an entity's financial position

Tentative Views: Working Format

- Proposed Sections
 - *Business* further broken down into Operating and Investing categories
 - *Financing* further broken down into Financing Asset and Financing Liability categories
 - *Equity*
 - *Discontinued Operations*
 - *Income Taxes*
 - Note: No Extraordinary Items Section
- Primary perspective: Distinguishing between an entity's "value creating" (business) and "funding" (financing and equity) activities

Tentative Views: Working Format

- Cohesiveness is the governing principle
- Classification of assets and liabilities drives classification of changes in those items in
 - The statement of comprehensive income
 - The statement of cash flows
- Classification based on how an entity manages its business
 - Explain, as a matter of accounting policy, basis for classifying assets and liabilities
- Benefit: Clarifies relationships among financial statements' line items; facilitating financial analysis

Tentative Views: Working Format

Statement of Financial Position	Statement of Comprehensive Income	Statement of Cash Flows
<i>Business</i> •Operating assets and liabilities •Investing assets and liabilities	<i>Business</i> •Operating income •Investing income	<i>Business</i> •Operating cash flows •Investing cash flows
<i>Financing</i> •Financing assets •Financing liabilities	<i>Financing</i> •Financing income •Financing expenses	<i>Financing</i> •Financing asset cash flows •Financing liability cash flows
<i>Equity</i>		<i>Equity</i>
<i>Discontinued operations</i>	<i>Discontinued operations</i>	<i>Discontinued operations</i>
<i>Income taxes</i>	<i>Income taxes</i>	<i>Income taxes</i>
	Statement of Changes in Equity	32

Tentative Views: Business Section

- Includes assets and liabilities not related to financing an entity's business activities. Broken into two categories:
 - *Operating Category*: Includes business assets and liabilities that management views as integral to its main business activities (plus any asset or liability not otherwise classified)
 - *Investing Category*: Includes business assets and liabilities that management views as not integral to its main business activities

Tentative Views: Financing Section

- Includes financial assets and liabilities that management views as part of the financing of the entity's business activities
- An entity should consider whether the item
 - Is interchangeable with other sources of financing
 - Can be characterized as independent of specific business activities

Tentative Views: Equity Section

- Includes all equity items, such as:
 - Common stock
 - Preferred stock
 - Retained earnings
- Report transactions with equity owners in their capacity as owners:
 - Dividends
 - Treasury stock
 - Issue of shares

Tentative Views: Diversified Entities

- Classification and presentation principles apply equally to financial institutions and non-financial entities
- Classification in business and financing section will be permitted to vary for entities with multiple reporting segments
 - Changes in classifications will be considered change in accounting policy

Tentative Views: Income Tax Section

- Considers taxes a discrete managerial function often unrelated (or only arbitrarily related) to specific line items
- Consequences:
 - No more intraperiod tax allocation
 - Discontinued operations and OCI items shown on a pretax basis
 - Additional income tax disclosures to report differences in effective tax rates across asset classes and tax jurisdictions etc.

Tentative Views: Discontinued Operations Section

- Effects of a discontinued *component of an entity* reported as a discontinued operation only if that component is an *operating segment* (as defined in SFAS 131 and IFRS 8)
- Report additional information in the notes for all discontinued *components of an entity* (as defined in SFAS 144 and IFRS 8)

Tentative Views: Disaggregation

Statement of Comprehensive Income

- Present line items by function (primary activity)
 - Sales, Services, Cost of Sales, R&D, Marketing
- Further breakdown by nature of items important in understanding the business (possibly in notes)
 - Labor, Materials, Depreciation, Amortization, Pension costs
- Separately report any expense important in understanding operating results not related to a functional line item

Tentative Views: Other Comprehensive Income

Long-term goal:

- Recognize all current period non-owner changes in assets and liabilities in one of the functional sections or categories
 - Consequence: Subset of income/expense items would not need to be categorized as other comprehensive income and the mechanism of recycling would not be necessary
- Accommodation permitting recycling to be granted in the interim
 - Boards will reconsider the standards that give rise to OCI items (and recycling) separately, not as part of this project

Tentative Views: Other Comprehensive Income

Differing views on interim presentation:

- **FASB**
 - OCI items *other than foreign currency translation adjustments* will be classified on the statement of comprehensive income consistent with the classification of the asset or liability that gives rise to those items
 - OCI items should continue to be recycled, as required by other standards, within the functional category in which the OCI item was initially recognized
- **IASB**
 - Has not reached a consensus on how to present OCI items in the statement of comprehensive income

Tentative Views: Statement of Cash Flows

- The following information should be presented:
 - FASB: Require use of the direct method to present operating cash flows
 - IASB: Permit use of the indirect method to present operating cash flows
 - Disclose operating cash flows under the method not used in statement
 - Provide information about noncash activities

Tentative Views: Statement of Cash Flows

- Eliminate the notion of cash equivalents
 - Decision also applies to statement of financial position
- Present information on changes in cash only
 - Currently exploring whether amounts of cash receipts and payments related to items previously classified as cash equivalents would be permitted to be presented net in the statement of cash flows

Tentative Views: Statement of Changes in Equity

- Include details of the change in the beginning and ending balance of each component of equity
 - Accumulated other comprehensive income would be presented in the aggregate
 - The details for each other comprehensive income item would be presented in the notes
 - Proceeds from capital transactions should be presented in the aggregate

Tentative Views: Liquidity Information

- Presentation on face of statement of financial position will vary by entity type
 - Non-financial institutions will be required to classify assets and liabilities into short- and long-term categories
 - Financial institutions will not be required to classify assets and liabilities into short- and long-term categories
- Financial institutions will be required to present detailed maturity information in the notes for contractual assets and liabilities with maturities < 12 months
- All entities would present details of maturities for contractual long-term assets and liabilities

Tentative Views: Footnotes Relating to Financial Statements as a Whole

- Footnote describing measurement attributes used in each balance sheet line item
- Footnote reporting measurement uncertainties relating to each balance sheet line item
- Footnote to help distinguish between various changes in assets and liabilities
 - Will separately identify changes relating to cash, accruals, fair values and other remeasurements
 - Will help achieve line-item cohesiveness across statements
 - Boards will consider the characteristics of persistence and measurement subjectivity in determining what information should be presented separately in the reconciliation
- Footnote on segment disclosures
 - Reconciles to balances reported on face of financial statements

Next Steps: FSP Project Phase B

- Remaining issues to be deliberated:
 - Totals and subtotals
- Recasting exercise
 - To understand implementation issues better, we will ask a few companies to recast their statements this summer using the proposed format and report on any issues found
 - Sample financial statements prepared consistent with these proposals can be found in March 2007 FASAC materials on FASB website
- Initial discussion document expected to be issued in the 4th quarter of 2007
 - Preliminary Views (FASB)
 - Discussion Paper (IASB)

Liabilities and equity project – objectives

- To develop a comprehensive standard of accounting and reporting for financial instruments with characteristics of equity, of liabilities, or both
 - Such a standard will improve financial reporting by providing a more complete and representational depiction of those financial instruments in the statement of financial position
- To further converge with accounting standards developed by the IASB by conducting the project under a “modified joint approach”
- FASB expects to issue preliminary views document this year; IASB will supply “wrap-around” cover and issue it to its constituents for public comment

Liabilities and equity project

- Scope: Financial (and certain non-financial) instruments that have characteristics of liabilities, assets, and equity
- Basic Approaches
 - Ownership
 - Ownership/settlement
 - Reassessed expected outcomes
- FASB preliminary views document will indicate that the current Board unanimously supports the ownership approach
 - This support is partially due to the complexity of other approaches, not just a preference for the approach itself
 - Two Board members are not completely comfortable with the requirement in ownership approach that all liabilities instruments in scope of the standard will be fair valued through income

Classifying operating liabilities, financing liabilities, and equity

How should items be classified?

Accounts Payable

Notes Payable

Pension Liability

Straight Debt

Convertible Debt (settled in cash, shares, or both) ?

Mandatorily Redeemable Shares ?

Share Based Payments (Options, Warrants) ?

Minority Interests

Preferred Equity ?

Common Equity

Approach 1: Ownership

Equity includes present direct owners of an entity

- Current shareholders
- Shares mandatorily redeemable at fair value

Liabilities include all other instruments

- “Future” shareholders
- Options
- Warrants
- Perpetual preferred stock
- Instruments with fixed payoffs

Approach 1: Ownership

Characteristics:

- Less emphasis on solvency
 - Footnote disclosure may be necessary to fully understand the liquidity requirements of many instruments (cash vs. share settlement)
- Requires limited separation of instruments
- EPS is simplified as dilution is included in income
 - e.g., employee stock option expense reflects change in share price in income

Approach 2: Ownership-settlement

Equity includes present direct owners of an entity AND certain instruments settled with shares

- Current shareholders
- Minority interest holders
- Perpetual preferred stock
- Options
- Warrants

Liabilities include all other instruments

- Instruments settled in cash

Note: Instruments with both equity and non-equity outcomes are separated into equity and liability components. e.g., debt convertible into fixed number of shares

Approach 2: Ownership-settlement

Characteristics:

- Relies on the form of settlement (cash vs. shares) to classify certain instruments
 - e.g., a cash SAR is a liability whereas a stock option is equity
- Requires the separation of many instruments
- Classification of stock options is consistent with 123(R)

Approach 3: Reassessed expected outcomes

Equity includes present direct owners and AND any payoff that is linked to a direct ownership instrument

- Current shareholders
- Shares mandatorily redeemable at fair value

Liabilities include all other instruments

- Perpetual preferred stock
- Instruments with fixed payoffs

Note: Instruments that have potential for either an equity or a non-equity outcome (e.g., debt convertible into fixed number of shares) and all options and forwards are separated into equity and nonequity components

Approach 3: Reassessed expected outcomes

Characteristics:

- Based on probabilities of outcomes
- Has the same impact on comprehensive income as the ownership approach
- Requires the most separation of the three approaches (most notably options and forwards)

Implications for financial statements

Assume the following instruments were issued on 1/1/05:

Straight Debt – 5 year, 3% coupon, 8% market interest, face value \$1,000 for \$800

Convertible Debt – 5 year, 3% coupon, convertible into 25 shares at \$40, issued for \$1,000

Share Settled Employee Stock Option – Issued 2 year option to purchase 100 shares for \$35, issued for \$515 (paid in services)

Cash Settled Option – Issued 2 year warrant to purchase 100 shares for \$35, issued for \$515 (paid in cash)

Share price on: 1/1/05 = \$32

 12/31/05 = \$36

 12/31/06 = \$48

Implications for balance sheet

Under Proposed FSP Approach

	Ownership			Ownership-Settlement		
	01/01/05	12/31/05	12/31/06	01/01/05	12/31/05	12/31/06
Net Business Assets and Liabilities	20,000	21,485	23,985	20,000	21,485	23,985
Financing Assets and Liabilities:						
Straight Debt	800	864	933	800	864	933
Convertible Debt	1,000	1,100	1,250	800	864	933
Options - Cash Settled	515	535	1,300	515	535	1,300
Options - Share Settled	515	535	1,300	0	0	0
Net Financing Assets and Liabilities	2,830	3,034	4,783	2,115	2,263	3,166
Equity						
Convertible Debt - Conversion Option	0	0	0	200	200	200
Options - Share Settled	0	0	0	515	515	515
Common Shares	10,000	10,000	10,000	10,000	10,000	10,000
Retained Earnings	7,170	8,451	9,202	7,170	8,507	10,104
Total Equity	17,170	18,451	19,202	17,885	19,222	20,819

Ownership approach reports higher liabilities and lower equity than ownership-settlement approach

Implications for income statement

	Onwership		Ownership-Settlement	
	12/31/05	12/31/06	12/31/05	12/31/06
Business:				
Operating Income before Option Expense	2,000	2,500	2,000	2,500
Stock Option Expense	(535)	(765)	(515)	0
Business Income	1,465	1,735	1,485	2,500
Financing Expense				
Straight Debt	(64)	(69)	(64)	(69)
Convertible Debt	(100)	(150)	(64)	(69)
Options - Cash Settled	(20)	(765)	(20)	(765)
Net Financing Expense	(184)	(984)	(148)	(903)
Comprehensive Income	1,281	751	1,337	1,597

Ownership approach reports higher business and financing expenses than ownership-settlement approach due to higher liabilities, which are marked to fair value through earnings

Why a Project on Revenue Recognition?

- No comprehensive standard on revenue recognition
 - Lack of broad conceptual guidance
 - Existing guidance is voluminous (200+ pieces), ad hoc, industry specific, and often (seemingly) inconsistent
- Existing guidance is not applied easily to multiple element arrangements (MEA's)
 - Revenue for delivered products is delayed when remaining deliverables cannot be measured reliably.
 - IFRS contain no explicit guidance on MEA's
- Revenue recognition is a primary cause of financial statement restatements in the U.S.—sometimes because of fraud and sometimes because of misapplication of accounting guidance

Revenue Recognition Project: Objectives

- Eliminate inconsistencies in the existing guidance on revenues in FASB Concepts Statements
- Provide conceptual guidance that would be useful in addressing revenue recognition issues that may arise in the future
- Eliminate inconsistencies in existing authoritative literature and accepted practices
- Fill voids in revenue recognition guidance that have developed over time
- Establish a single, comprehensive standard on revenue recognition

Revenue Recognition: Key Principles

- Revenue arises from changes in assets and liabilities arising from contracts with customers.
 - Some board members interpret this to mean that revenue arises upon satisfaction of a performance obligation to a customer
 - Other board members think that revenue arises upon the creation or enhancement of an asset for which a committed customer exists
- Not overridden by tests based on the notions of realization and completion of an earnings process

Revenue Recognition: Key Principles

- A performance obligation is a promise to deliver an economic benefit to the customer
- Economic benefit transfers to the customer when the customer receives a current right to an existing economic resource
- Indicators that such an economic resource is separable from the contract as a whole include:
 - It is sold separately or as an optional extra by any vendor in the customer's reference market
 - The customer could resell it separately in that reference market.
- For contracts that contains separable performance obligations, each performance obligation is revenue generating

Revenue Recognition: Current Plans

- Boards want to issue a due process document in 2007
 - Communicating preliminary views if reached, discussion of alternatives otherwise
- To develop proposals two advisor teams formed composed of board members from FASB/IASB
 - Fair value (FV) team
 - Allocated customer consideration (CC) team
- Each model will be developed to the same depth using the same examples
- Once models are developed the full Boards will deliberate and provide preliminary views
- If the answers were easy, this project would have been completed a long time ago

Fair Value Model

- At initial measurement,
 - All rights and obligations measured at fair value
 - If the fair value of the promised consideration from the customer is greater than sum of the fair values of remaining performance obligations, residual revenue is recognized at contract formation
- After initial measurement, outstanding obligations are remeasured at fair value on each reporting date.
 - In essence, benefits delivered to a customer are measured at their fair value on the day they are delivered, and reported as revenue
 - Changes in lay-off price result in contract gains and losses
 - When obligation is finally satisfied, revenue can be higher or lower than actual consideration received from customer

Customer Consideration Model

- At initial measurement, customer consideration is allocated to obligations
 - Obligations measured at selling price
 - Vendor's own selling price
 - Competitor's selling price for same item
 - Layoff price of obligation if measurable at Level 1 fair value
 - Vendor's own assumptions about costs, margins, risks
 - Difference between consideration and sum of selling prices is allocated based on selling prices to those items not measured at Level 1 fair value
 - No residual revenue at contract formation
- After initial measurement, outstanding obligations are **NOT** remeasured, unless the contract becomes onerous
 - When obligation is finally satisfied, revenue is equal to actual consideration received from customer
 - Obligations do not faithfully reflect the lay-off price on the measurement date
 - The accounting after initial measurement seems simpler

Leasing Project: Overall Objectives

- To comprehensively reconsider the guidance in FASB Statement No. 13, together with its subsequent amendments and interpretations
- To ensure that investors and other users of financial statements are provided useful, transparent, and complete information about leasing transactions in the financial statements
 - “Capitalize all-or-nothing” approach in current literature may not communicate the resources and obligations arising from leases
 - Analysts routinely capitalize operating leases
 - The SEC staff formally recommended improvements to lease accounting as part of its June 2005 report to Congress on off-balance sheet arrangements

Criticisms of Current Leasing Standards

- Current standards are heavily rules based with bright-line tests.
- Companies can structure transactions to achieve desired accounting outcomes that may not faithfully represent the underlying economics.
- Off-balance sheet financing can distort comparability among companies.

Project Timeline

- Added to agenda July 19, 2006 as joint project with IASB
- Staff research and formation of a joint international working group (2006)
- Board deliberations (2007-2008)
- Preliminary views document issued for public comment (2008)
- Exposure draft for public comment (2009)
- *Initially the project will consider the accounting by both the lessee and the lessor*

General Project Issues

- Can the Boards develop a new accounting model for leases that is “simple”?
- Does the accounting by lessees and lessors need to be symmetrical?
- Consideration of tax issues
- Initial scope should be transactions accounted for under current lease accounting literature:
 - Statement 13
 - EITF 01-8
 - IFRS 17
 - IFRIC 4
- Before publishing a Preliminary Views document, will consider whether to (1) extend the scope of the project to other arrangements that convey similar rights or (2) make scope exceptions for short-term or immaterial leases

Tentative Decisions: Identification of Assets/Liabilities

- The Board analyzed the rights and obligations arising under a simple lease contract and evaluated which of those rights and obligations met the definitions of assets and liabilities in the existing Conceptual Framework
- Asset/Liabilities of Lessor:
 - Receivable from Lessee (Asset)
 - Residual Interest in Leased Item (Asset)
- Asset/Liabilities of Lessee:
 - Right to Use Leased Item (Asset)
 - Obligation to Pay Rentals (Liability)

Tentative Decisions: Leasing Model

- Conceptual framework analysis suggests that lease represents sharing by lessor and lessee of the right to use the leased asset over its useful life
 - Forms basis of “right to use” model currently being considered by Boards
- Issues pertaining to measurement, presentation, derecognition, and recognition have only begun to be considered and could affect preliminary conclusions

Additional Issues to Address

For Lessee

- More complex leases:
 - Rights and obligations arising from options to renew or terminate the lease
 - Residual value guarantees and similar arrangements
 - Contingent and variable rentals
 - Sale and leasebacks
- Disclosures by lessees
- Recognition (when), measurement (at what value), and presentation (gross vs. net) on the financial statements

For Lessor

- Recognition of revenue
- Should there be leveraged leases?
- Disclosures by lessors
- Residual value insurance
- Symmetry with lessee accounting

FASB Only Projects

- Pensions and other postretirement benefits
- Derivatives and hedging
- Transfer of financial assets: revision of SFAS 140

Statement 158

Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans

- Recognizes net overfunded or underfunded status in balance sheet. FV of plan assets minus:
 - Pension = Projected Benefit Obligation (PBO)
 - OPEB = Accumulated Postretirement Benefit Obligation (APBO)
- Recognizes an asset for overfunded plans and a separate liability for underfunded plans
- Requires change in when plan assets and benefit obligations are measured
 - Measurement date changed to date of the sponsoring employer's financial statements
 - No change in how plan assets and benefit obligations are measured

Statement 158

Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans

- No change in basic approach for measuring annual net benefit cost
- Recognize previously unrecognized items:
 - Gains and losses and prior service costs in other comprehensive income (OCI)
 - Net transition assets or obligations in accumulated other comprehensive income (AOCI)
- Effective dates:
 - Recognition of Funding Status:
 - Public Companies — as of the end of the fiscal year ending after December 15, 2006
 - Nonpublic Companies — as of the end of the fiscal year ending after June 15, 2007
 - Change in Measurement Date:
 - All entities, fiscal years ending after December 15, 2008

Statement 158

Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans

Issues to consider:

- A. The recording of funding status has significant deferred tax effects. If the status is a liability, a deferred tax asset will be recorded and the need for a valuation allowance must be evaluated
- B. Book value per share will be significantly changed. Compensation and buyout contracts and other arrangements that are based on book value per share should be reconsidered

Postretirement benefits project

- Phase 2: Comprehensive reconsideration of postretirement benefit accounting, including but not limited to
 - Measurement of obligations
 - Obligations are (very) long lived and measurement is based on complex assumptions
 - Should the long-lived nature of the obligations affect the accounting treatment?
 - Should financial reporting standards provide additional guidance on those assumptions?
 - Recognition and display of cost components
 - Earnings versus Other Comprehensive Income
 - Immediate recognition versus deferred recognition of certain gains and losses
 - Possible consolidation of postretirement benefit trusts by the plan sponsor

Observation: Phase 2 is expected to be a joint project with the International Accounting Standards Board

Derivatives and hedging project

- Statement 133 provides special accounting for hedging activities because of differences in the way hedging instruments and hedged items are recognized and measured
- Since the effective date of Statement 133, the FASB has been asked to address numerous issues on many aspects of hedge accounting
- As a result, at the January 31, 2007 meeting, the Board directed the staff to research issues causing difficulties in the application of hedge accounting
- Conclusion: Statement 133 is broken
 - It is difficult to apply (even by the well intended) and users find the reported results difficult to understand
 - It is poster child for complexity in our current accounting model
 - It is time to pursue developing a model that is easier to apply and more transparent to investors

Derivatives and hedging project

- At the May 23, 2007 meeting, the Board decided to add a project to its agenda to address the accounting for derivatives and hedging activities
- The objectives of this project are as follows:
 - Resolve practice issues that have arisen under Statement 133
 - Simplify accounting for hedging activities
 - Improve the financial reporting for hedging activities, making the accounting model and associated disclosures easier to understand for users of financial statements
 - Limit differences in the accounting for derivative instruments and hedging activities

Derivatives and hedging project

- At the May 23, 2007 meeting, the staff also presented three possible approaches to accounting for hedging activities to the Board
- The Board instructed the staff to only develop the fair-value approach at the current time
- The fair value approach generally would eliminate by-risk hedging, requiring
 - For fair value hedges that the fair value of the full hedging instrument and full hedged item be recognized in income in the current period
 - For cash flow hedges that the effective (ineffective) portion of the hedge would be recognized in other comprehensive income (earnings). Recycling out of OCI would occur as before
- In addition, the fair value approach would eliminate the need to assess effectiveness
 - Eliminating the need for methods that assume no ineffectiveness, i.e., the shortcut and critical term match methods.
- The approach also would limit the situations where issuers would need to document the hedging relationship

Transfers of financial assets- revisions to Statement 140

- Statement 140 is
 - Extremely complicated
 - Overly reliant on
 - Lawyers decisions
 - Difficult to implement notions such as basic servicing and passive activities of a QSPE
- Investors typically undo the accounting by putting the transferred assets back on the books of the transferor
- The Board has twice tried to “fix” the standard without success
 - Efforts undertaken were primarily patches to the existing complicated framework

Transfers of financial assets- revisions to Statement 140

- At its May 30, 2007, the Board decided to explore a bolder approach to addressing financial asset derecognition problems by authorizing the staff to explore an accounting model that
 - Removes the qualifying special-purpose entity (QSPE) concept from FASB Statement 140
 - Considers eliminating the other derecognition criteria from the statement
 - Replaces those criterion with a new linked-presentation model as a solution to the issues in Statement 140
- The linked presentation model would
 - Significantly limit the types of financial assets qualifying for derecognition
 - Increase the number of transactions accounted for as collateralized borrowings
 - Permit net presentation on the face of the balance sheet of the transferred asset and related liability when the proceeds of the asset would be used to settle the liability

Closing remarks

- Thanks for your attention!!
- For an electronic copy of these slides please contact me by email at tjlinsmeier@fasb.org
- Final questions on presentation or on other items on FASB agenda?

Fair value measures—Relevance

- Intent of using the fair value measurement attribute in financial reporting is to increase the relevance of reported numbers
 - Fair value is the only measurement attribute for certain items, including certain derivatives
 - *Example:* Interest rate swap
 - Fair value is the most relevant attribute for (many) incomplete exchange transactions
 - *Example:* Marketable securities
 - Fair value measurement is based on current economic conditions, including current information about the dispersion of possible outcomes
 - Aggregates and summarizes more information
 - Timely (relative to awaiting the ultimate settlement)

Fair value measures—Relevance

- The alternatives to fair value do not necessarily provide more relevant measures
- One alternative: Allocations of transaction amounts
 - Example: EITF 00-21 (revenue recognition)
 - Observations:
 - Allocations require their own estimations (which may be based on fair values). Those estimations may require extensive judgment.
 - Allocations of transaction amounts are not necessarily more reliable than fair value measures
- Another alternative: Wait until the economic changes which drive fair values appear as realizations of income or expense
 - Example: reduce fixed asset carrying value to fair value versus wait until the asset produces less income
 - Observation: this approach does not produce timely information

Fair value measures—Reliability

- Claim: Fair value measurement in the absence of observed prices introduces an intolerable amount of measurement error
 - What is the actual reliability of fair value measures?
 - Sometimes very reliable when based on observed prices
 - How reliable are fair value measures compared to other reported numbers that are based on estimates and judgments?
 - Examples of fair value estimates that are believed to be highly reliable include interest rate swaps and the LOCOM measures of servicing rights
 - What are the causes of unreliable measures?

Use of Estimates Generally in Financial Reports

- Financial reporting issues:
 - SEC requirement to discuss critical accounting policies
 - Requiring difficult, complex or subjective judgments/estimates
 - Number of items to be estimated may be large
 - Time period covered may be extensive
 - Important to the portrayal of results

Lucent's 2005 annual report lists the following "more important" estimates and assumptions that affect financial condition and results of operations

- Revenue recognition
- Pension and postretirement benefits
- Income taxes
- Legal contingencies
- Intangible assets
- Receivables and customer financing
- Inventories
- Restructuring
- Warranties

What causes unreliable fair value outcomes?

- (Honest) forecasting errors and errors of judgment
- Error from models (including assumptions and simplifications)
- Lack of expertise (a function of education; are you ready?)
- Management induced error ("earnings management")

Question to consider: Are these considerations different between fair value estimates and other estimates?

Is conservatism the solution to management-induced error?

From APB Statement 4: conservatism is induced by a general preference that measurement errors be in the direction of understating net assets and income (a unidirectional bias in reported numbers)

Observations:

- Is biased reporting the *low cost* solution to a governance problem?
 - An alternative: Could lenders protect themselves by writing conservative contracts, without requiring biased reporting that potentially affects decision usefulness for equity investors?
 - Also could system shift management's incentives by reducing benefits (or increasing cost) of introducing error?
- Conservatism in accrual/deferral model primarily introduced through impairments
 - However, impairments often are discretionary
 - Fair value remeasurements in down markets may result in more conservative accounting by requiring writedowns

Derivatives disclosure project

- SFAS also 133 has been criticized by constituents for lacking transparent disclosures
- Sources of criticism include:
 - November 2004 Fitch Ratings Report
 - Berkshire Hathaway's 2002 Annual Report
 - Numerous published articles
- Board issued an exposure draft on proposed disclosures in December 2006
- The comment period has ended and the Board is now redeliberating with intent to issue a final standard this year

Derivatives disclosure project

Disclosure objectives

- Derivatives disclosures should provide:
 1. An understanding of how and why an entity uses derivatives
 2. An understanding of how derivatives and related hedged items are accounted for
 3. How derivative instruments affect an entity's financial position, results of operations, and cash flows

Observation: Disclosures relating to first two objectives already required of public registrants by SEC in FRR 48

Derivatives disclosure project – initial proposals

The ED proposed:

- Modifying the requirements of paragraph 44 of Statement 133 to include a discussion of objectives and strategies for using derivative instruments by, at a minimum, the instrument's primary underlying risk that the reporting entity is intending to modify (for example, interest rate, credit, foreign exchange rate, or overall price).
- Requiring disclosure in tabular format by primary underlying risk, accounting designation, and purpose of (1) the notional amounts and fair values of derivative instruments, (2) the location and fair values of derivative instruments and related gains and losses reported in the balance sheet and income statement, and (3) the location and amount of gains and losses reported in the income statement on hedged items designated and qualifying in hedging relationships. Disclosure of instances in which derivative instruments contain leverage factors also would be required.

Derivatives disclosure project – initial proposals

The ED also proposed:

- Requiring disclosure of (1) the existence and nature of contingent features in derivative instruments (for example, payment acceleration clauses), (2) the aggregate fair value amount of derivative instruments that contain those features, and (3) the aggregate fair value amount of assets that would be required to be posted as collateral or transferred in accordance with the provisions associated with the triggering of the contingent features.
- Requiring disclosure of counterparty credit risk in derivative instruments. Disclosure of the aggregate fair value of derivative instruments in asset positions on both a gross basis and net of collateral posted by the counterparty also would be required.
- Requiring cross-referencing to other footnotes in which derivative-related information is disclosed.

Derivatives disclosure project – next steps

At its May 2007 meeting, the Board to redeliberate on the following issues raised by respondents.

- Project objectives and scope—whether to limit the scope of the project to derivative instruments and hedged items in designated and qualifying hedging relationships (as proposed)
- Tabular disclosure—level of disaggregation
- Notional amounts and leverage factors disclosures—whether notional amounts provide useful information
- Contingent features disclosures—definition
- Operational and system constraints
- Frequency of disclosures—annual versus interim periods
- Effective date—whether to delay the effective date to allow for operational and systems changes.