Financial Accounting Standards Board

PCAOB – SAG 7/15/10 Meeting
Convergence and Change

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Disclaimer

The views expressed in this presentation are my own and do not represent positions of the Financial Accounting Standards Board.

Positions of the FASB are arrived at only after extensive due process and deliberation.

Overall Goal of FASB in Pursuing Convergence

Improved, high-quality, converged standards developed through rigorous due process

Priorities:

1. *Maintain independent process*
2. *Improve financial reporting in US*
3. *Reach consistent answers with IFRS*

Improve *and* Converge

- FASB and IASB working since 2002 to improve and converge U.S. GAAP and IFRS.
- Memorandum of Understanding (MoU)
  - *Identified 9 major accounting areas needing improvement in both U.S. GAAP and IFRS*
  - *Completed Business Combinations project in 2007 by issuing FAS 141(R) and 160, and IFRS 3*
  - *Remainder of projects still ongoing (slide 8)*
- My view: we would be working on these projects even without convergence agenda

Drivers of Timing

- Financial Crisis underscored importance of global convergence of standards.
- G-20 has called for FASB/ IASB to "redouble their efforts" to complete MoU projects by June 2011.
- SEC monitoring progress on MoU projects before making decision about IFRS for U.S. public companies.

Drivers for Timing

- The June 2011 date also is being driven by the IASB because of:
  - *Countries, including Brazil, Canada, India, and Korea, that have announced plans or intentions to adopt IFRS for their listed companies on or around 2011 or 2012*
  - *Desire for a "stable platform" for them to change*
  - *Terms ending for IASB chair Sir David Tweedie and several other IASB board members by 2011.*

Current Status of Deliberations & Implications

- **Volume and timing of MOU projects**
  - ***Challenges ability of constituents to provide quality input to due process***
    - **Reactions from CFA Institute, FEI, ITAC and others: high quality improvement is primary, speed is secondary.**
  - ***Challenges preparers' ability to implement final standards and users' ability to analyze new financial information and formats***

June 2 Joint Statement

- **The IASB and the FASB are in the process of developing a modified strategy to**:
  - *Prioritize the issues most in need of improvement and convergence.*
  - *Stagger the publication of Exposure Drafts and related consultations (such as round tables) to enable effective stakeholder participation.*
  - *Limit the number of significant or complex Exposure Drafts issued in any one quarter to 4.*
  - *Issue a separate exposure document seeking input about effective dates and transition methods.*

June 2 Joint Statement

- The modified strategy retains the target completion date of June 2011 for many of the projects.
- The target completion dates for a few projects will extend into the second half of 2011.
- Timing subject to change based on the nature and extent of comments received.
- SEC has said this modification in timing will not adversely affect their ability to make a decision in 2011 about IFRS in the U.S.

Still committed to convergence; phasing helps ensure quality process and product

FASB/IASB Project Target Dates*

Project	Exposure Draft	Comments Due
Financial Instruments	May 2010	9/30
Reporting OCI	May 2010	9/30
Fair Value Measurement	June 2010	8/15
Revenue Recognition	June 2010	10/22
Insurance	Summer 2010	TBD
Leases	Summer 2010	TBD
Consolidations	Deciding on strategy	
Financial Statement Presentation	Early 2011	TBD
Financial Instruments with Characteristics of Equity	Early 2011(?)	TBD

*Subject to change

Caution about Timing

- This intense level of standard setting is still unprecedented
  - *FASB has issued, at most, 4 major standards in one year; IASB has issued 9 major standards in its 9-year history.*
- Boards don't agree on some key issues
  - *Financial Instruments (cost vs. FV on long-term investments and most liabilities)*
  - *Leases (lessor accounting)*
  - *Insurance (DAC and risk margin)*
- All timing is subject to consideration of public commentary

Convergence: One Final Key Point

- If FASB/IASB achieve convergence on <u>all</u> of these major projects
  - *U.S. GAAP and IFRS will <u>not</u> be completely converged.*
    - Point raised in February 2010 SEC statement
    - E.g., LIFO inventory, R&D, component depreciation etc. etc. etc.
  - *Part of SEC consideration: how important are these differences and what is the best way to deal with them*

Selected MoU Projects

Financial Instruments

- Problems:
  - *Complexities and inconsistencies within and between U.S. GAAP and IFRS, on:*
    - Accounting for debt instruments
    - Impairment
    - Hedge accounting
  - *In U.S., different impairment approaches for debt securities and loans especially problematic*
  - *Strongly held views about fair value, especially for illiquid instruments.*

Financial Instruments

- **Proposed Solution:**
  - *Fair value balance sheet for most financial instruments (including loans and deposits)*
    - Exceptions (cost): short-term trade receivables and payables; debt when the entity does not have significant financial assets
    - Narrowing of Equity Method (to strategic investments)
  - *Change in fair value goes to net income unless related asset/liability qualifies for OCI*
    - Must be held long-term for collection of cash flows
    - Must not have embedded derivatives
    - Derivatives and equity securities do not qualify for OCI

Financial Instruments

- **Proposed Solution (cont'd):**
  - *For FV-OCI items, cost is shown, and impairment is based on collectability of cash flows, not FV*
    - Elimination of probable threshold
  - *Credit losses to net income, not OCI*
  - *Yields are calculated net of the allowance, not based on contractual terms*
  - *Equity is presented before and after FV-OCI adjustment*
  - *Simplified criteria to qualify for hedge accounting, elimination of shortcut method, no redesignating effective hedges.*

Financial Instruments

- **Companies Affected:**
  - *All; greater effect on financial institutions.*
- **Challenges to Convergence:**
  - *IASB currently has reached different conclusions in their proposed model, highlighted in table on following slide. (Classification and measurement decisions finalized in IFRS 9)*
  - *Mixed, strongly held, views among worldwide investors and regulators on the use of FV information for loans, deposits, etc.*

Financial Instruments

Area	FASB	IASB
Main Classification Categories (including Liabilities)	• Fair value through net income • Fair value through other comprehensive income (FV-OCI)	• Fair value through net income • Amortized cost
Credit Impairment	• Based on past events and existing conditions and their implications for the collectability of the financial asset • Recognized in net income	• Impairment recognized based on expected credit losses over the life of the financial asset • Recognized in net income
Hedge Accounting	• Bifurcation by risk allowed for financial items • Qualitative assessments required at inception (quantitative may be necessary) • Reasonably effective threshold	• Currently deliberating issues with a plan to issue and exposure draft in the second half of 2010

Next Steps

- Comments Due 9/30/10
- Investor Survey on website
- Field visits with companies and investors
- Roundtable after Comment Period
- Redeliberate with IASB; try to converge
- Will also address balance sheet netting; try to finalize at the same time as broader project

Fair Value Measurement

- Problem:
  - *US GAAP and IFRS definitions not yet converged; FASB issued Statement 157 in 2006*
    - The IASB exposed Statement 157 with some fairly minor proposed modifications
    - Both FASB and IASB have since issued additional guidance in this area in response to Financial Crisis.
- Proposed Solution:
  - *One global definition of fair value and disclosures about fair value.*

Fair Value Measurement

- Companies Affected:
  - *All, especially financial institutions*
- Key points:
  - *No significant differences regarding how to measure fair value, yet many changes to ASC 820 to conform words*
  - *Major changes to ASC 820 (157)*
    - Eliminate “highest and best use” concept for financial instruments
    - Clarification of blockage factor
    - Exception to FV for financial instruments managed as a portfolio
    - Sensitivity type disclosure for uncertainty for level three measurements

Next Steps

- Comments due 8/15/2010
- Plan to finalize in 2011

Single Statement of Comprehensive Income

- Resurrected as part of Financial Instruments (for FASB) and Pensions (for IASB) (compromise; some wanted FV-NI for everything)
- However, because other items are reported in OCI (pensions, FX); expose separately
- OCI would be presented under Net Income, totaling to Comprehensive Income
- EPS still based on Net Income only
- US prevalent practice is to present Statement of Comprehensive Income in Statement of Changes in Stockholder's Equity; not allowed in IFRS

Next Steps

- Comments due 9/30/10
- Redeliberate and finalize in 4Q 2010

Revenue Recognition

- **Problems:**
  - *U.S. GAAP: 200+ standards (now codified), inconsistent, developed piecemeal*
  - *IFRS: very broad, limited guidance. (Anecdotally rely on U.S. GAAP for implementation guidance)*
- **Proposed Solution:**
  - *Common principle for all industries, based on transfer of control of benefits and satisfaction of promises to customers*

Revenue Recognition

- **Key points:**
  - *Revenue is recognized as control of benefits is transferred to customer and promises are fulfilled. Will change pattern for some arrangements.*
  - *Multi-element contracts are separated into portions based on estimated selling prices*
  - *Credit risk is initially factored into measurement of revenue rather than as a hurdle for revenue recognition*
  - *Contract costs must be expensed, unless they meet certain conditions*

Next Steps

- Comments due October 22.
- More field visits, specific industry outreach
- Roundtables, webcasts
- Plan to finalize in 2011; effective date not yet determined

Leases

- Problems:
  - *Off-balance sheet presentation of leased assets and related financing.*
  - *Bright-line distinction between on- and off-balance sheet, leading to structuring opportunities.*
- Proposed Solution:
  - *Lessees: Obligations recognized on balance sheet, with a corresponding asset. Interest expense on debt; amortization of right-to-use asset*

Leases

- **Proposed Solution (cont'd):**
  - ***Lessor: Record lease receivable; still debating whether credit should be to the leased asset ("derecognition approach") or a deferred revenue account ("performance obligation approach")***
- **Companies Affected:**
  - ***All; key industries affected include retailers, banks (branch offices), big equipment lessees (such as airlines and hospitals).***

Leases

- **Challenges to Convergence:**
  - ***Differences between the Boards on approach to lessor accounting:***
    - **FASB (majority): Credit to "performance obligation"; recognize revenue over lease term.**
    - **IASB (majority): Credit to leased asset; recognize gain up-front.**
  - ***New pattern of income/expense recognition from capitalizing all leases (interest and amortization, instead of rent expense/income).***

Next Steps

- Board meetings to resolve remaining issues
- Exposure draft this summer
- Roundtables, field visits, discussions with investors
- Plan to finalize in 2011.

Consolidations

- FASB issued 167 in 2009
  - *Addressed consolidation of VIEs*
- IASB issued ED in 2008
  - *Addresses both VIEs and Voting Interests*
- Objective: One consolidation model

Consolidations

- Progress to date
  - *Control based consolidation model*
  - *Major challenge is designing a control based consolidation model for traditional voting interest entities*
- Three potential models
  - *“Ability to”*
  - *“Ability with evidence”*
  - *Majority vote or contractual control (today’s model under US GAAP*

Consolidations

- FASB to hold roundtables to address IASB’s proposed model (ability to view)
- Decision to be made on how to proceed

Issues for Auditors

- Principles versus rules
  - *Revenue recognition will eliminate 200+ pieces of specific guidance*
  - *Several documents provide "disclosure objectives" with provision that if objectives are not met through specific requirements that supplemental disclosures should be provided*
  - *Consolidations could do away with 50.1% assessment*

More Judgment Required

- Financial Instruments
  - *Business model – no tainting*
  - *Expanded use of fair value*
  - *Core Deposits*
  - *Amortized cost exception for liabilities*
  - *No probable threshold for impairment*
  - *Cash collections in excess of interest accrual*
  - *Assessment of hedge effectiveness*

More Judgment Required

- Fair Value
  - *Sensitivity disclosures*
  - *Netting of financial instruments*
- Revenue Recognition
  - *When to combine/separate contracts*
  - *Determining the transaction price*
  - *Allocation of transaction price to performance obligations*
  - *Assessing satisfaction of performance obligations*

More Judgment Required

- Leases
  - *Lease Term*
    - Options to renew/cancel
  - *Contingent rents*
  - *Separating payments for services from lease payments*
- Consolidation
  - *Assessing who had control/power*
  - *Varies depending on model*

More Judgment Required

- Insurance
  - *Too many to list*
- Financial Statement Presentation
  - *(Indirect) Direct Cash Flow method*

Conclusions

Questions?