

**FASB Small Business Advisory Committee
MINUTES OF MEETING
June 22, 2005**

The FASB Small Business Advisory Committee met at the FASB offices in Norwalk, Connecticut.

Members Present

Michael S. Cain	Russell V. Meyers
Robert A. Dyson	Darrel L. Posegate
Mark Ellis	Charles L. Saeman
Richard E. Forrestel, Jr.	Leonard Steinberg
William G. Hall	E. Anson Thrower
Gregory P. Hanson	Scott M. Waite
Jane A. Hoffman	Grafton H. Willey, IV
W. Stephen Holmes	Deborah A. Wilson
Steven C. Mayer	Candace Wright

Members Absent

Daniel J. Donoghue	Mauricio Kohn
Joe Joseph	Edward E. Nusbaum
Francis C. Jumonville, Jr.	Lark E. Wysham

Others Attending

Financial Accounting Standards Board:

Robert H. Herz	Chairman
George J. Batavick	Member
G. Michael Crooch	Member
Katherine Schipper	Member
Leslie F. Seidman	Member
Edward W. Trott	Member
Donald M. Young	Member

FASB Staff:

Suzanne Q. Bielstein	Director of Major Projects and Technical Activities
Halsey G. Bullen	Senior Project Manager
Russell G. Golden	Senior Technical Advisor
Lawrence W. Smith	Director of Technical Application & Implementation Activities
Jennifer L. Sullivan	Project Manager
J. Ryan Bergstrom	Postgraduate Technical Assistant

Others:

Gregory Fletcher	Assistant Chief Auditor, Public Company Accounting Oversight Board
Joseph Graziano	Partner in Charge—Accounting Principles, Grant Thornton LLP
Daniel Noll	Director Accounting Standards, American Institute of Certified Public Accountants
Teresa Polley	Executive Director, Financial Accounting Standards Advisory Council
Scott A. Taub	Deputy Chief Accountant, Securities and Exchange Commission

Welcome and Introductions

Mr. Batavick called the meeting to order at 9:04 a.m. and welcomed members of the Committee to the third Small Business Advisory Committee (SBAC) meeting. Mr. Batavick thanked the members of the Agenda Committee for their help in developing the agenda for today's meeting.

Report of the FASB Chairman

Mr. Herz reported on the following strategic and technical matters:

- The recent issuance of FASB Statement No. 154, *Accounting Changes and Error Corrections*, FASB Interpretation No. 47, *Accounting for Conditional Asset Retirement Obligations*, FASB Staff Position FAS 19-1, "Accounting for Suspended Well Costs," and the FASB Exposure Draft, *The Hierarchy of Generally Accepted Accounting Principles*.
- The expected issuance of three Exposure Drafts on projects related to FASB Statement No. 141, *Business Combinations*, including one each on purchase method procedures and noncontrolling interests in June 2005, and one on not-for-profit organizations late in 2005.
- The expected issuance of three Exposure Drafts in August 2005 on projects related to FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, including one on hybrid instruments, one on servicing rights, and one on qualifying special-purpose entities and isolation of transferred assets.
- The expected issuance of an Exposure Draft of a proposed Interpretation on uncertain tax positions later this summer.
- The expected posting to the FASB website of a milestone draft on the liabilities and equity project, which considers simple instruments. Deliberations on the second milestone, which considers compound instruments, are set to begin in June 2005.

- The expected issuance of a final Statement on fair value measurement in the third quarter of 2005.
- The addition of two projects to the Board's agenda, one on disclosures for derivatives and one on defining insurance risk transfer for insurers and insureds.
- The main topics discussed at the semiannual joint meeting of the FASB and IASB in April, including the joint project on the conceptual framework, the joint project on performance reporting, and the Boards' overall convergence strategy.

Mr. Herz reported that in conjunction with the AICPA's private company reporting initiative, a small working group had been formed including George Batavick, Ed Trott, and Russell Golden from the FASB as well as several staff members from the AICPA to work on private company reporting issues. Mr. Batavick described two other related initiatives:

- The IASB's project on small and medium-sized entities (SMEs). In this effort, the IASB is attempting to identify what constitutes an SME, with the determination being made based on whether an entity has "public responsibility." Entities deemed to have public responsibility will have to comply with full International Financial Reporting Standards (IFRS); those that do not may be granted some exceptions under IFRS. The project is in an early stage.
- The SEC's Advisory Committee on Smaller Public Companies. The SEC created this committee to address several issues affecting smaller public companies, including whether accounting and disclosure requirements should differ for small business issuers. Mr. Batavick noted that in early discussions, the Accounting Subcommittee had concluded that recognition principles should not change for small business issuers but that measurement and transition guidance are areas that could be considered for differences.

Mr. Batavick added that there is a perception among private companies that the tightening of auditor independence rules for public companies has affected private companies' relationships with their auditors. Smaller private companies may rely more heavily on their auditors for advice when implementing new accounting standards, but some believe that the auditor may no longer provide that advice because of independence rules. He asked Mr. Fletcher from the PCAOB to comment.

Mr. Fletcher stated that Auditing Standard No. 2, "An Audit of Internal Control over Financial Reporting Performed in Conjunction with an Audit of Financial Statements," was written as a risk-based standard that allows for a top-down and principles-based approach and that its independence requirements do not preclude consultations between auditors and their clients. The PCAOB is aware of the independence issue. However, it believes that constituents are misinterpreting the requirements of Auditing Standard No. 2 and Section 404 of the Sarbanes Oxley Act. He noted that the PCAOB recently issued a policy statement that clarified the independence guidance for auditors in Auditing Standard No. 2. The PCAOB staff also issued a Q&A document addressing the same issues. Mr. Fletcher clarified that auditors were never prohibited from providing advice

on the implementation of new accounting standards. He added that it is not possible for the PCAOB to define every possible situation for what an auditor may or may not do, but he noted that it is clear that the current guidance prevents an auditor from actually performing the accounting for an audit client. Mr. Fletcher suggested that in the event that such help is needed, the client should seek the guidance from another accounting firm rather than from the auditor.

Report of the SEC

Mr. Taub reported on the following matters:

- The SEC's Advisory Committee on Smaller Public Companies and its four subcommittees continue to address issues affecting small business issuers. The internal control subcommittee likely will recommend time extensions and possibly lower scope requirements for the internal control reporting for certain entities. The Committee also is considering a change to the definition of a small business issuer.
- The SEC published its *Report and Recommendations Pursuant to Section 401(c) of the Sarbanes-Oxley Act of 2002 On Arrangements with Off-Balance Sheet Implications, Special Purpose Entities, and Transparency of Filings by Issuers*. Mr. Taub summarized some of the recommendations in the report, including that the FASB should continue or begin (as applicable) work on consolidations, pensions, leases, fair value for all financial instruments, and a disclosure framework. Mr. Taub encouraged SBAC members to read the report.

Private Company Financial Reporting

Mr. Ellis, an SBAC member and also a member of the AICPA Private Company Financial Reporting Task Force, explained that the purpose of the task force is to consider whether the general-purpose financial statements of private companies prepared in accordance with GAAP meet the financial reporting needs of constituents who use them.

Mr. Ellis reported that in February 2005, the task force issued its conclusions, summarized as follows:

- General-purpose financial statements of private companies prepared in accordance with GAAP have moderately high to high value to the constituents who use them, especially with respect to the characteristics of consistency and comparability.
- GAAP for private companies should be developed based on concepts and accounting that are appropriate for the distinctly different needs of constituents of private company financial reporting.
- The current approach to providing exceptions and other bases of accounting is not the best response to private company financial reporting needs.

- Fundamental changes should be made in the current GAAP standards-setting process to ensure that the financial reporting needs of private company constituents are met.

The Task Force recommended that a cooperative effort that includes representatives of the key constituents of private company financial reporting be undertaken to:

- Determine who should establish private company GAAP.
- Identify how to best effect fundamental change in the GAAP standards-setting process to ensure that the financial reporting needs of private company constituents are met.
- Develop and oversee the implementation process on a timely basis.

A Committee member asked for Board members' views on the survey and its results.

Mr. Herz stated that meeting the needs of users of financial statements is a key goal of the Board. He noted that one of the significant findings is that survey respondents place a high value on GAAP financial statements. Although some respondents believe certain areas of GAAP are less relevant for private companies, Mr. Herz stated that he questions whether public companies might have responded in the same way for certain areas of GAAP. He noted the conceptual framework already allows for differences in situations for which the user needs, capital structure, and the cost-benefit equation may be different. Mr. Herz added that the survey results have provided a welcome focus on the reporting needs of private companies and their constituents, as have the Board's creation of the SBAC and other recent activities.

Mr. Trott stated that in setting GAAP for general-purpose financial statements, the premise is that the user of the financial information does not have direct access to management nor can the user compel certain information from management. He noted that the survey points out that different accounting for an entity is appropriate only when differences exist in the entity's structure such that users have different information needs. He noted that if this is the case, then the ability to meet these different user needs is captured in the conceptual framework. The issue then becomes how to determine which attributes of a nonpublic company result in different user needs. The approach of determining the user's needs then becomes the anchor to ensure that definitions for assets, liabilities, balance sheets, income statements, etc., do not evolve to mean different things to different user groups and GAAP maintains its consistency.

Committee members expressed the following views:

- The survey failed to ask the most important question: "Why do users of private company financial statements have different needs?" The SBAC, the FASB, the AICPA, or some other group should identify and compile a list of those differences; only when those differences are identified and evaluated can a discussion begin about the applicability of certain standards to private companies.

- The FASB should be the only standard setter and should use one set of concept statements that are understandable to the average preparer and user. Adding another standard setter to the process would only degrade and complicate GAAP.
- Lenders to small businesses believe that consistency in reporting is a very important aspect of GAAP financial statements. Another valuable aspect is the independent audit as well as the timeliness of the financial statements. Complexity in accounting standards slows down the process, resulting in less relevant information. The complexity of accounting rules must be balanced with the ability of a company to prepare timely, consistent financial statements.
- Most very small private companies are extensions of a single individual, and the financial information that would be useful to users in this case would include all of the individual's personal assets and liabilities as well as the business financial information. Consequently, the nature of the entity becomes very important because the access to capital in such an instance can be very limited. The lives of such small companies may be only a few years. Thus, from a user's standpoint, cash flow becomes one of the most important items; the further GAAP takes a preparer from a cash basis, the more difficult it becomes to tell what a small company's cash flows are. Another issue is that smaller companies often lack the expertise to prepare true GAAP financial statements.
- The AICPA study states that 99.7 percent of incorporated businesses in the United States are private. For users, GAAP is very important for consistent financial statements, but for many small businesses, users review the principal's net worth, tax returns, and personal guarantees when making loan decisions in addition to reviewing financial statements. As companies grow, users rely more heavily on GAAP financial statements and less on the personal information.
- Before moving forward on different standards, the codification project should be completed. Regardless of the GAAP being used, it needs to be in one place; then, decisions can be made on the need for different requirements for private companies. The codification of all GAAP will help solve one of the biggest issues that small business and private companies face, which is the complexity of GAAP.
- The terms *small company* and *private company* often are used interchangeably; however, they are not necessary interchangeable. There is a big difference between a very large private company and a very small public company.
- There is a perception that the FASB is moving toward fair value, which is very difficult for private companies and which, in turn, will result in the need for more and more exceptions from GAAP and result in less consistency and comparability.
- In the past, if a standard is not applicable to private companies or small businesses, those entities have been excluded from the scope of the Statement. The issue is that small companies often enter into the same, complex transactions that larger companies enter into, such as derivatives. It would not be practicable to write an

entirely new set of standards for small businesses that are entering into the same transactions as larger businesses.

Mr. Trott stated that the FASB does not set standards from a public company versus private company perspective; rather, the FASB primarily addresses accounting for certain transactions or economic phenomena. No line limits one group or the other from certain transactions or economic phenomena. He noted that his primary concern as a Board member is that a final standard results in transparent and consistent accounting for the same or similar transactions and economic phenomena.

Financial Performance Reporting

Ms. Sullivan summarized the decisions made at the joint FASB-IASB meeting in April and noted that the Board's goal is to issue an Exposure Draft of those decisions in the fourth quarter of 2005. Ms. Sullivan then summarized the discussion at the June 14, 2005, Joint International Group (JIG) meeting that focused on the meaning of net income and approaches to aggregation or categorization of information in a statement of earnings and comprehensive income.

Committee members expressed differing views on the aggregation or classification of information within the statement of earnings and comprehensive income. Many supported an operating-nonoperating approach. Others supported an operating-financing-investing approach. Still others expressed support for a recurring-nonrecurring approach or a realized-unrealized approach.

Mr. Batavick asked whether requiring a single statement of earnings and comprehensive income would create any problems.

Committee members generally did not oppose a single statement approach. One member did not object, provided the operating-nonoperating approach is used.

Ms. Schipper asked for input on how the Board should define operating activities versus nonoperating activities.

Committee members expressed the following views:

- Operating activities are a normalized, sustainable, or representative income number.
- Operating activities are the activities that management can influence or has control over.
- Operations are sales and cost of sales.
- Operating activities represent the consumption of resources of the entity.

With regard to consistency in reporting across entities, some Committee members expressed the view that the Board should define clearly the activities that belong in one classification versus another. Others believe that consistency across an industry is

sufficient. Still others believe that management should have the flexibility to decide how to classify its activities.

The Conceptual Framework

Mr. Bullen stated that the FASB and IASB began deliberations on the joint conceptual framework project by considering the objectives of financial reporting and the qualitative characteristics of accounting information. He noted that at the joint meeting in April, the Boards discussed (1) the financial information needs of users and (2) the relative importance of decision usefulness and accountability or stewardship. The FASB and IASB reached the following tentative conclusions about the needs of users of financial reports:

- Financial reports should be prepared from the entity's perspective and should aim to provide information to a wide range of users, rather than focusing on the information needs of existing common shareholders only. The framework should identify the primary users as present and potential investors and creditors (and their advisers).
- The overriding objective of financial reporting is to provide information about the entity that is useful to the external users who lack the power to prescribe the information they require and must therefore rely on the information provided by an entity's management.

Mr. Bullen noted that the main questions are who are the users of financial statements and whether GAAP financial statements are meeting the needs of those users. He clarified that this project addresses the needs of those who use general-purpose financial statements as the primary source of information about an entity, not those who are in a position to compel management to provide additional information.

Committee members expressed the following views:

- Owners and lenders are the primary users of financial information of private companies; owners value the GAAP financial statements because they are audited and therefore serve as a verification that the financial information is being prepared correctly.
- Private companies do not widely distribute an entire set of GAAP financial statements to creditors and other users; rather, they provide only the data needed by the particular user.
- The users of public company financial statements can be very different from users of private company financial statements. Thus, the ability of users to obtain information from management can differ greatly from public to private companies.

Mr. Trott then raised the question of how the ability to access information from management affects the private company financial reporting issue.

Mr. Taub stated that perhaps there is not a need to create a second set of accounting standards for private companies; rather, private companies can produce statements that deviate from GAAP with an explanation describing why the deviation is a better representation than that which GAAP would provide. He noted that if lenders want something other than GAAP financials, they can always ask for the information they need and the preparer can prepare the information and explain in the footnotes the departure from GAAP. He stated that it would be easier for each lender to decide what information he or she wants as opposed to creating an entirely new set of GAAP.

Mr. Noll stated that the AICPA's research shows that GAAP exceptions are used and widely accepted by lenders and other creditors of small businesses but that constituents believe GAAP could be more useful in certain instances relating to small businesses. He stated that if one believes that GAAP needs to be improved for small businesses, then there is a disconnect to simply conclude that GAAP exceptions are the answer. He noted that if there are too many GAAP exceptions, then the line in the audit report that states that the financial statements are presented in conformity with GAAP will no longer be true.

Mr. Bullen introduced the second issue for discussion, the relative roles of decision usefulness and the stewardship or accountability of management. In the Boards' existing frameworks, the overriding objective of financial reporting is to provide information to assist users in making economic decisions. The objective of providing information to help users to assess the stewardship or accountability of management is a subset of the decision-usefulness objective. Mr. Bullen asked the Committee whether stewardship should be an objective on a par with usefulness in investment and credit decisions or, as the Boards have concluded, whether it should be a subsidiary of the overriding decision-usefulness objective.

Committee members expressed the following views:

- Stewardship should be on a par with decision usefulness because a lender wants to know that the money loaned to a company is being used for the purpose for which it was borrowed and not to simply enrich the life of the borrower. Likewise, investors want to know that the money they have put into a company is being used effectively by management.
- Placing stewardship below decision usefulness as an objective of financial reporting is counter to the internal control environment that exists post Sarbanes Oxley.
- Stewardship should be discussed on a broad level in the conceptual framework project.

Codification and Retrieval Project

Mr. Smith stated that the Board's long-term goal is to create a single, authoritative codification of U.S. GAAP. The objective of the codification project is to integrate and topically organize all relevant accounting guidance issued by the U.S. standard setters

(FASB, AICPA, EITF, and SEC). The Board will issue the codification draft to constituents for an extended verification period. The objective of the verification process is to ensure that the codification accurately reflects existing U.S. GAAP. Once the Board addresses constituent comments, the codification will become the single authoritative source of U.S. GAAP and will supersede all existing standards.

Mr. Smith noted that the project is a reorganization of the accounting literature into a topical structure that resembles the *Current Text* topics—it is not a rewrite of the literature. The codification project is not an attempt to simplify GAAP or change GAAP.

Mr. Smith noted that the codification will contain the text of all relevant U.S. GAAP literature issued by the FASB, APB, AICPA, EITF, and SEC. However, the codification will segregate the SEC content so that it will not interfere with the needs of private companies. He noted that, ultimately, the FASB may develop functionality within the electronic retrieval system that will allow users to exclude SEC content from their user interface.

In response to questions, Mr. Smith added that the codification software will include a simple word search. He noted that the authoritative AICPA literature would be included in the codification but that nonauthoritative guidance such as Issues Papers would not. Appendices and EITF consensuses will be included. Each standard's basis for conclusions will be archived. Parts of the basis may be elevated to authoritative status.

Mr. Trott stated that once the project reaches a critical mass, portions will be released for review. However, when the entire project is complete, the codification will become GAAP all at once.

Other Issues and Closing Remarks

Mr. Batavick noted that time was still available and he returned to the topic of private company financial reporting. He asked Committee members for input on changes needed in the standard-setting process to ensure that the financial reporting needs of private company constituents are met.

Committee members expressed the following views:

- The FASB should consider the costs of training to implement new accounting guidance in its cost-benefit analysis of any new standards.
- The Notice for Recipients in Exposure Drafts could include specific questions seeking input on private company issues. Questions also could be asked during the course of the project, rather than at the Exposure Draft stage.
- A subcommittee of the SBAC could be created to write comment letters to represent the private company viewpoint.

- An FASB staff member should be dedicated to obtaining private company input. Perhaps the Board could explore a private company fellowship program similar to the practice and industry fellow program.
- Given that each member of the SBAC was nominated by a sponsoring organization, each member has a responsibility to ensure that a member of his or her sponsoring organization writes a comment letter on new proposals.

Mr. Batavick thanked the Committee members for their input and participation. He adjourned the meeting at 3:00 p.m.