

**FASB Small Business Advisory Committee
MINUTES OF MEETING
December 1, 2004**

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

Members Present

Michael Cain
Daniel Donoghue
Robert Dyson
Mark Ellis
Richard Forrestel, Jr.
Joe Joseph
William Hall
Gregory Hanson
Jane Hoffman
W. Stephen Holmes

Steven Mayer
Russell Meyers
Edward Nusbaum
Darrel Posegate
Charles Saeman
Edgar Anson Thrower
Grafton Willey, IV
Deborah Wilson
Candace Wright
Lark Wysham

Members Absent

Michael Hansen
Francis Jumonville, Jr.

Mauricio Kohn
Scott Waite

Others Attending

Financial Accounting Standards Board:
Robert Herz, Chairman
George Batavick, Member
Katherine Schipper, Member
Gary Schieneman, Member
Edward Trott, Member

FASB Staff:
Halsey Bullen, Senior Project Manager
Ronald Bossio, Senior Project Manager
Niall Campbell, Project Manager
Brooke Richards, Project Manager
Josh Gagon, Postgraduate Technical Assistant

Others:

Gregory Scates, Associate Chief Auditor, PCAOB
Jenifer Minke-Girard, Senior Associate Chief Accountant, SEC
Daniel Noll, Director of Accounting Standards, AICPA
Teresa Polley, Executive Director, FASAC

Welcome and Introductions

Mr. Batavick called the meeting to order at 9:05 a.m. and welcomed members of the Committee to the second Small Business Advisory Committee (SBAC) meeting. He stated that he believes the initial SBAC meeting in May was a big success and he hopes the SBAC would build on that success at this meeting. He noted that since the last SBAC meeting, there have been many positive developments with regard to the FASB working with the SBAC. First and foremost is the fact that under the leadership and initiative of Committee member Andy Thrower, an Agenda Committee was formed. Mr. Batavick thanked Mr. Thrower and other members of the Agenda Committee for taking that initiative. Also, since the formation of the SBAC, the FASB has called upon members of the SBAC to obtain input from the small business community on various aspects of projects that the FASB is currently working on. Lastly, SBAC members responded to a survey on the top priorities for the FASB. That input will be helpful to the FASB in making future agenda decisions.

Report of the FASB Chairman

Mr. Herz thanked members of the SBAC for their participation and input into the FASB process. He then reported on the following strategic and technical matters:

- The current reporting environment, including the demands of Section 404 of the Sarbanes-Oxley Act of 2003. The Board has extended the comment periods of certain proposals and delayed the effective dates of certain final standards in response to the current demands on entities with respect to Section 404. Also, while the Board is committed to moving toward principles-based standards, in the current environment some constituents seem to prefer more rules-based guidance.
- The SEC report required under Sarbanes-Oxley on off-balance-sheet activities. The Board anticipates that the report, when issued, may have standard-setting implications for the FASB.
- With respect to technical projects, the Board's progress on the fair value measurement project and the uncertain tax position project, the recent issuance of a final Statement on inventory costs, the expected issuance of a final Statement on nonmonetary exchanges, two proposed FASB Staff Positions on the tax effects of the American Jobs Creation Act of 2004, progress on the project to codify existing GAAP, and the planned issuance of an Exposure Draft on purchase method procedures.
- With respect to international activities, the October joint meeting with the International Accounting Standards Board (IASB). The FASB and the IASB have added a new joint project to improve the conceptual framework and create a single framework for both Boards. The FASB is monitoring the IASB's project on small and medium-sized entities (SMEs). On that subject, the FASB looks forward to the

AICPA's report on its recent survey on whether general-purpose GAAP financial statements of privately held entities meet the needs of users of those statements.

Mr. Herz opened the discussion to questions from SBAC members. Mr. Batavick added that if SBAC members had questions from the earlier staff update (held before the meeting started) on FIN 46(R), *Consolidation of Variable Interest Entities*, and EITF Issue 03-1, "The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments," they should feel free to ask those questions as well.

A Committee member expressed the view that people simply do not understand FIN 46(R). He stated that the proposed FASB Staff Position (FSP) on FIN 46(R) only adds to the complexity. Another member agreed with those comments and stated that in many cases for small companies, FIN 46(R) leads to less useful information in the financial statements. Some members agreed that FIN 46(R) may be useful for companies with many variable interest entities, but that for some small businesses, FIN 46(R) may be less useful.

Mr. Herz stated that FIN 46(R) was an attempt to move away from a "bright line" that was very rules-based to a more principles-based standard based on risk and reward. He noted that the move to a more principles-based standard may not be working as well as the FASB had wished because many constituents are reticent to apply judgment or economic and finance principles and still ask for "bright lines." Mr. Trott noted that the FASB issues standards for general-purpose financial statements that provide relevant information for outside investors. If the financial statements are issued for a different purpose, entities have more flexibility to use an other comprehensive basis of accounting (OCBOA).

A Committee member stated that there has been a dramatic shift by auditors to increased conservatism coupled with increased concern about independence. He stated that auditors are reluctant to answer technical questions without consulting their national offices. In addition, auditors are reluctant to advise management on how to appropriately account for transactions due to concerns about independence. As a result, audit fees have increased substantially. Another Committee member stated that audit firms have become more conservative in response to the current environment and the Public Company Accounting Oversight Board (PCAOB) and SEC.

Conceptual Framework

Mr. Bullen provided an introduction to the Board's new conceptual framework project and background about the existing framework. He stated that the conceptual framework is a coherent system of interrelated objectives and fundamentals that prescribes the nature, function, and limitations of financial reporting. The conceptual framework is intended to facilitate the provision of evenhanded, neutral financial and related information that is consistent across multiple years and changing Boards.

Mr. Bullen noted that the standard-setting process and the standard setter are the primary beneficiaries of the conceptual framework. The conceptual framework provides a language in which accountants and standard setters can communicate. The standard-setting process also benefits because the standards that are issued are more internally consistent.

Mr. Bullen stated that the conceptual framework first establishes the objectives of financial reporting. The most important objective of financial reporting is to provide information that is useful in investment, credit, and similar decisions being made by external parties who generally lack the authority to prescribe the information they want. The conceptual framework does not distinguish between large and small companies or privately held or public companies.

Mr. Bullen stated that the conceptual framework then defines the elements of financial statements, beginning with the definitions of assets and liabilities. All other definitions flow from the basic definitions of assets and liabilities.

Mr. Bullen noted that the Board continues to find the framework useful in making decisions in its current agenda projects. However, because the framework has not kept up with changing times and changing business practices, it needs updating and refining. Additionally, some parts of the framework that originally were planned have not been completed, even though the need for conceptual guidance in those areas continues to be evidenced in the Board's agenda projects. The IASB has similar difficulties with its framework. Thus, both the FASB and the IASB have decided to add a project to their agendas to improve the conceptual framework.

Mr. Trott stated that another reason for adding the conceptual framework project to the agenda is that the framework can be useful to constituents in their communications with the Board on agenda projects. The FASB and IASB plan to publish two initial communications documents to explain the purpose and importance of the framework, why the Boards wish to converge their existing frameworks, and why those frameworks are in need of improvements. Those documents will be targeted to different audiences in the hope of achieving a greater level of understanding among various constituents of the conceptual framework.

A Committee member asked how the Board will address existing standards that will be inconsistent with the revised conceptual framework. Mr. Trott stated that the new conceptual framework likely would be applied prospectively to new standards and then would be applied to existing pronouncements as they are revised or replaced.

A Committee member introduced his views on the objectives of financial reporting. That Committee member presented the following proposed objectives of financial reporting:

- (i). To provide information that is useful in investment, credit, economic, and other decisions being made by both external [and internal] parties who would normally seek such information.

- (ii). To ensure that such information is timely, accurate, reliable, and relevant to such decisions.
- (iii). To present the information in a fair,¹ uniform, and comparable manner [across the industry being represented].

¹ Alternative words: neutral, evenhanded.

The Committee member stated that from those objectives, he can evaluate the impact of transactions as it relates to the objectives.

One Committee member stated that the key is that the information must be timely. He stated that if information in financial statements becomes dated or is not timely, those financial statements become less reliable and relevant.

Mr. Schieneman noted that the proposed objectives refer to information rather than financial statements. Mr. Herz asked whether that information should be financial information only or whether nonfinancial measures, such as customer satisfaction, also should be included. A Committee member stated that the FASB should be concerned with financial information only.

Committee members generally supported the Board's project to improve the conceptual framework. One member stated that the Board should be cautious about being too quick to modify the current framework. He analogized changing the conceptual framework to changing the Constitution of the United States and cautioned the Board not to rush to change the conceptual framework as it now stands; otherwise, the framework may lose its credibility.

Another Committee member noted that there are business entities, for example, cooperatives, that do not have an investor focus. She stated that this type of entity does not have a primary purpose of drawing cash out of the entity. She encouraged the Board to be mindful of other types of business structures as it progresses in the conceptual framework project.

Ms. Schipper stated that it would be helpful to her as a Board member to obtain further SBAC member input on the following questions concerning the objectives of financial reporting as presented above vis-à-vis the FASB's objectives as stated in the conceptual framework:

1. With regard to the first objective, the current FASB conceptual framework is based on the view that financial reporting is to be useful for resource allocation decisions; however, the first objective above seems to allow for decisions that are economic in nature, but are not necessarily resource allocation decisions. For example, the IRS would like to have information to make economic decisions that involve the collection of taxes. As another example, the Board has been told that the Federal Reserve and certain other federal regulatory agencies would like to have financial reporting that is useful for the decisions that involve the setting of interest rates and macro-economic policy. Do members of the Committee believe that financial

reporting should be responsive to those and other constituencies who make economic decisions, or should financial reporting continue to be focused on resource allocation decisions?

2. Items (ii) and (iii) above could be construed as ways of defining the word useful—that is, once one agrees that the objective is to provide decision-useful information, then these other two items are not objectives; they are actually ways to make the notion of usefulness operational. Do Committee members have that in mind—that items (ii) and (iii) represent what it means for information to be useful? If not, can Committee members explain how (ii) and (iii) relate to (i)?
3. Item (ii) above uses the word timely. One SBAC member used the word timeliness to describe how long it takes after the reporting date for a report to be issued. Do Committee members agree that another meaning of timeliness is that the information in the financial statements is current as of the reporting date (as opposed to historical, referring to some other reporting date), regardless of when the financial statements are issued? Do Committee members prefer one meaning over the other and, if so, why?
4. Do Committee members believe that there is a construct called accurate that is different from reliable, and if so, what is the difference?
5. Do Committee members believe that the word uniform is something different from comparable, and if so, what is the difference?
6. Do Committee members agree that there should be industry-specific accounting—that is, the nature of the accounting for the transaction should depend on the type of firm engaging in the transaction? In considering this question, Committee members are invited to consider situations in which manufacturing or retailing firms establish consumer finance lines of business.

Ms. Schipper suggested that following the meeting, Committee members may wish to respond in writing to some or all of the questions.

Costs and Benefits

Mr. Bossio stated that since the Board began setting standards in the 1970s, its constituents have asked and continue to ask two fundamental questions about costs and benefits. Those questions are:

- How do Board members assess and weigh the potential benefits and costs of a proposed change to accounting and reporting standards?
- What procedures does the FASB use to assist Board members in assessing whether the expected benefits justify the anticipated costs?

Mr. Bossio stated that FASB Concepts Statement No. 2, *Qualitative Characteristics of Accounting Information*, notes the following about costs and benefits:

- To be useful, accounting information must attain some minimum level of both relevance and reliability, but beyond those minimum levels, sometimes users of financial information may gain by sacrificing some degree of relevance for added reliability or some degree of reliability for added relevance.
- A standard-setting body has to do its best to meet the needs of society as a whole when it promulgates a standard that sacrifices one of those qualities for the other; and it must also be aware constantly of the calculus of costs and benefits.
- The Board cannot cease to be concerned about the cost-effectiveness of its standards. To do so would be a dereliction of its duty and a disservice to its constituents.

Mr. Bossio noted that the second point states that costs and benefits must be assessed on the basis of society as a whole, not simply how a single entity will be affected by the change in accounting rules. He stated that the Board uses a qualitative analysis, *not* quantitative analysis, to assess whether a proposed standard will sufficiently improve financial reporting to justify the costs it will impose on the financial reporting system as a whole.

Mr. Bossio stated that performing a qualitative analysis of the costs and benefits entails several activities, including participating in field visits and discussing potential costs with the User Advisory Council, FASAC, the SBAC, and other preparers and users throughout an ongoing project. Mr. Bossio also noted that the FASB will look to academic research that may help Board members understand some of the costs associated with implementing a new standard or requirement.

Mr. Schieneman stated that the FASB receives considerable input on the costs of new standards. He stated that in determining the costs associated with new standards, entities are implementing the proposed standard hypothetically to see what additional costs will be incurred. He stated that the area the Board has difficulty in assessing is the benefit side of the equation. He noted that as a first step, users can determine whether there is a need for certain financial information. He noted that the Board created the User Advisory Council to provide a forum to obtain that type of information. He encouraged the users on the SBAC to consider how they are affected by the Board's activities and to provide input to the Board.

Ms. Schipper stated that when she thinks about the benefits of new standards, she thinks of them vis-à-vis the conceptual framework. She stated that she often focuses on completeness, neutrality, and comparability. Completeness would imply that items that meet the definitions of assets or liabilities are recorded as assets or liabilities. She noted that comparability and neutrality are impaired by treatment alternatives. She stated that treatment alternatives carry another cost with them, and that is the cost of maintaining the treatment alternative. When one treatment alternative is viewed as favorable to another alternative, then the favorable treatment alternative provides an "accounting subsidy." The existence of treatment alternatives is extremely costly to the system and to maintain the system.

A Committee member stated that the Board also must consider the cost of unintended consequences of a standard.

Ms. Schipper stated that to help avoid unintended consequences, the Board must have specific details of problematic transactions or business arrangements so that the Board can respond before a final standard is issued.

A Committee member stated that another cost is that fewer people can understand the standards. As a result, preparers are less informed and question the benefits of the new standard.

Mr. Herz stated that a question that has been debated is whether accounting standards should be molded to fit supply side, that is, preparer and auditor, constraints. He stated that while the Board always must carefully consider the ability of preparers and auditors to properly implement new standards, if financial statements are considered a product, then that product should be customer- or user-oriented. He stated that financial reporting has been supply-side oriented and that perhaps that should be changed with more of a focus on the user.

A Committee member stated that it may be beneficial for the FASB to begin using something similar to the FOG index when assessing the readability and understandability of its standards. He stated that all standards should be tested for ease of understanding, complexity, timeliness, and exceptions. Mr. Batavick agreed and noted that the FASB does have an initiative to simplify the writing of its standards.

A Committee member asked what members of the SBAC can do to be more proactive in helping the FASB understand some of the costs and benefits of new standards for small businesses.

Board members asked that SBAC members consider the following:

- Are there distinguishing characteristics of small businesses that should be considered during the Board's analysis of costs and benefits of issuing standards? If so, what are they?
- Should the perspectives and needs of different users of financial information be considered? If so, how?
- Are there different ownership characteristics and capital structures that should be considered?
- Should the Board consider another cost of standard setting to be the costs of small businesses to develop the expertise to deal with a new standard? If so, would smaller entities benefit from longer comment periods and longer implementation periods?

A Committee member stated that delaying implementation periods for small businesses would be very helpful to allow those entities to see how others are applying the standard and to have more time to gain an understanding of the standard. In addition, she stated

that she hopes the SEC will consider changing the definition of small business issuers because the current limit of 500 shareholders and \$10 million in total assets is too low. She added that small businesses with limited accounting personnel may not have the time and resources to respond to Exposure Drafts and often rely on representative organizations, such as the American Bankers Association, to respond to FASB requests for comment. She noted that the Board should consider those responses to represent her voice as well, even if she does not personally respond to the issue.

Liabilities and Equity Project

Ms. Schipper stated that the first phase of this project led to FASB Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*, which provides guidance for three types of freestanding financial instruments with characteristics of both liabilities and equity. She stated that in the second phase, the Board has two objectives:

1. To improve the accounting by issuers for instruments that contain characteristics of equity and either or both liabilities and assets.
2. To amend and improve the definitions and discussions of liabilities and equity, and perhaps assets, in FASB Concepts Statement No. 6, *Elements of Financial Statements*.

In achieving both objectives the Board will identify opportunities for convergence with the IASB.

Ms. Schipper stated that the meeting materials contain three tentative definitions and four classification decisions based on those definitions. The materials also contain several ways of illustrating the application of those classification decisions. Ms. Schipper then described in detail those definitions, the Board's tentative decisions on classification, and the reasoning supporting the Board's tentative decisions.

In response to a question about how convertible preferred stock would be treated under the new definitions and approach, Ms. Schipper stated that if no settlement obligation exists, the preferred stock would be classified as equity.

Mr. Trott stated that this project is a good example of the need to revisit the conceptual framework. He stated that many of the instruments used currently probably did not exist when the conceptual framework was developed. Therefore, there is a need to review the conceptual framework and possibly change the definitions of assets and liabilities to more accurately reflect the current business environment.

A Committee member asked whether the Board has drafted revised definitions for liabilities. Ms. Schipper stated that the Board has reviewed draft language but is in the process of determining what should be included in the Concepts Statements and what should be included as guidance in a standard.

A Committee member asked about the classification of subordinated interests for which a direct ownership relationship exists, such as limited partnership interests. Ms. Schipper stated that under the ownership-relationship settlement approach, if a direct ownership relationship exists, the limited partnership interest would be classified as equity, even if there is a settlement obligation.

Another Committee member asked whether the Board considered any governance attributes, such as voting rights, when defining ownership. Ms. Schipper stated that the Board did consider governance attributes when defining ownership; however, the Board decided that voting, per se, is not a necessary characteristic of an ownership interest. The Board decided to define ownership relationship in terms of subordination and pay-off structure—not decision rights.

A Committee member asked how stock appreciation rights (SARs) would be classified under the tentative decisions. Ms. Schipper stated that SARs would establish an indirect ownership relationship and if there is a choice of settlement forms, that is, the issuer could settle in shares or in cash, the instrument would be classified as a liability. If, however, there is no choice of settlement and the instrument can be settled only with shares, then it would qualify as equity because the SAR is an indirect ownership relationship instrument whose settlement would establish a direct ownership relationship.

In response to a question about the expected timing for issuance of a document, Ms. Richards stated that the project has reached its first milestone, which was to address single component instruments. The next step is to address compound instruments. She stated that timing is uncertain but that a due process document that may be in the form of a Preliminary Views may be issued near the end of 2005.

Equity-Based Compensation

Mr. Campbell described the following changes that have been made to the Exposure Draft on equity-based compensation that affect nonpublic and small business entities:

1. Measurement of equity awards issued by nonpublic entities
2. Measurement of liability awards issued by nonpublic entities
3. Effective date and transition for public entities that are small business issuers
4. Effective date and transition for nonpublic entities.

Mr. Campbell stated that the Board proposed in the Exposure Draft that a nonpublic entity choose whether to account for its equity share options based on either their fair value at the grant date or their intrinsic value, remeasured at each reporting date until settlement. He stated that the Board has decided that a nonpublic entity should measure equity awards using the same method as a public entity unless it is not practicable for a nonpublic entity to make a reasonable estimate of the expected volatility of its own share price. In that case, a nonpublic entity would use the historical volatility of an appropriate industry sector index as an assumption in an option pricing model.

Mr. Campbell stated that the Board initially proposed that nonpublic entities be allowed to make a policy decision whether to measure liabilities incurred under share-based payment arrangements with employees at fair value or intrinsic value. The Board has decided to retain this policy for a nonpublic entity's liability awards. In addition, the Board has decided that a nonpublic entity that makes a policy choice to measure its liability awards at fair value should be permitted to do so using a calculated value if it is not practicable to make a reasonable estimate of the expected volatility of its own share price.

Mr. Campbell stated that the Board has decided that public entities that are small business issuers would be required to apply the final Statement for interim or annual periods beginning after December 15, 2005, using the same transition provisions that apply to other public entities. The Board also has decided to permit all entities that had adopted the FASB Statement No. 123, *Accounting for Stock-Based Compensation*, fair-value-based method of accounting for either recognition or pro forma disclosures to use a modified retrospective transition method using their existing Statement 123 fair-value-based cost information.

Mr. Campbell stated that the Board has decided that *all* nonpublic entities would be required to apply the final Statement for fiscal years beginning after December 15, 2005. Nonpublic entities that had adopted the Statement 123 fair-value-based method of accounting for either recognition or pro forma disclosures would use the same transition provisions as public entities.

A Committee member asked whether the final Statement would allow for new measurement models that may be developed in the future. Mr. Batavick stated that the final standard will allow for other models that are acceptable and reasonable based on the objectives set out in the standards. Mr. Herz stated that any new model would have to be generally accepted and follow sound finance theory.

A Committee member expressed concerns about implementing the Board's proposed measurement model, particularly developing the assumptions for expected volatility and employee behavior. He questioned how those assumptions would be audited. He noted that a group of high-tech companies had presented an alternative measurement model to the Board that the Board ultimately rejected. He stated that the alternative measurement model proposed using a beta-adjusted index volatility measurement that would be easily verified and easily audited.

Ms. Schipper stated that she believes that the proposed beta-adjusted index volatility model results in a measurement that is not representationally faithful. She stated that an index volatility reflects the effects of diversification—the broader the index, the greater the effect of diversification. She noted that a call option that is issued by a specific entity derives its value from the total return volatility of that entity, and not systematic volatility, which is what is reflected in an index. For almost any share in an index, the index volatility will be smaller than the true volatility that is driving the fair value of the option and, therefore, results in a measurement that is not representationally faithful.

A Committee member from the auditing profession noted that the Board addressed many issues in its redeliberations and while the final standard may not be perfect, the Board has done a good job in addressing areas of concern.

Results of SBAC Survey

Ms. Polley summarized the results of the survey that was sent to SBAC members, noting that the Board asked for input on three main issues. The survey first asked SBAC members to identify the five most important issues that the Board should address currently. The five issues appearing most often in SBAC responses were differential accounting standards, codification and simplification, fair value, revenue recognition, and business combinations.

The survey also asked for SBAC members' views on areas in which accounting issues may arise in the future. Ms. Polley reported that SBAC members had diverse responses, including derivatives, fair value, cash flow reporting, revenue recognition, consolidations, and lease accounting.

The third area of the survey focused on differential accounting standards for certain entities. Ms. Polley noted that SBAC members overwhelmingly favored differential standards but differed on the types of entities that should be eligible to apply those standards. Some believe that the determining factor should be whether the entity is publicly or privately held. Others believe that differential standards should apply based on an entity's capital structure. Still others believe the determining factor should be an entity's size. Some Committee members believe that alternative standards should differ only in terms of required disclosures. Others believe that differences should extend to recognition and measurement.

Mr. Batavick stated that the Board is monitoring the IASB project on SMEs. He noted that the IASB is in the process of analyzing comments received on its discussion paper on accounting standards for SMEs. He stated that the Board also will study the results of the AICPA survey on the usefulness of general-purpose GAAP financial statements of privately held entities.

Mr. Noll stated that the AICPA hopes to issue a document with the results of its survey in the December-January time frame.

Mr. Herz stated that the results of the IASB's SME project and the AICPA survey would be an important topic of discussion for a special SBAC meeting or for the next scheduled SBAC meeting.

Mr. Batavick asked SBAC members whether differential accounting would present any audit problems.

One Committee member stated that if the differences were limited to disclosures, the differences should not present a significant problem. He stated that from an accounting and auditing viewpoint, he would prefer that differences be limited to narrow areas.

A Committee member stated that people buy brands. The FASB is the brand, and small businesses need the FASB to support and move forward with differential accounting standards. Another Committee member expressed the concern that if the FASB does not address this issue for small businesses, another group would be formed to promulgate small business accounting standards and that the creation of such a group would not be beneficial to any of the Board's constituents.

Closing Remarks and Adjournment

Mr. Batavick asked members if they would like to discuss any other issues. Members of the SBAC asked for a brief update on the status of Congressional action on equity-based compensation.

Mr. Herz noted that the House had passed a bill earlier in the year but that the Senate had not taken action on a similar bill. He noted that the Board continues to monitor activity in Washington DC. A Committee member stated that SBAC members can provide support to the Board by contacting their representatives and encouraging them to leave accounting standard setting to the FASB.

Mr. Batavick thanked all meeting participants and encouraged members to provide input on how to improve future meetings. He adjourned the meeting at 3:00 p.m.