

**FASB Small Business Advisory Committee
MINUTES OF MEETING
December 8, 2006**

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

Members Present

P. Glenn Bradley
Gary M. Cademartori
Michael S. Cain
Robert A. Dyson
Mark Ellis
Richard E. Forrestel, Jr.
Richard H. Gesseck
William G. Hall
Gregory P. Hanson
W. Stephen Holmes
Edward E. Nusbaum

Neal A. Petrovich
Darrel L. Posegate
Richard L. Reed
Charles L. Saeman
Leonard Steinberg
Troy D. Templeton
E. Anson Thrower
Grafton H. Willey, IV
Deborah A. Wilson
Candace Wright

Members Absent

A. Donald Janezic
Mauricio Kohn

Scott M. Waite

Others Attending

Financial Accounting Standards Board:

Robert H. Herz
George J. Batavick
G. Michael Crooch
Thomas J. Linsmeier
Edward W. Trott
Donald M. Young

Chairman
Member
Member
Member
Member
Member

FASB Staff:

Ann E. Benson
Suzanne Q. Bielstein

Postgraduate Technical Assistant
Director of Major Projects and Technical
Activities

Jill M. Carnrick
Paul H. Glotzer
Kimberly R. Petrone
Stefanie A. Tamulis
Troy P. Van Beek

Assistant Project Manager
Project Manager
Senior Project Manager
Project Manager
Postgraduate Technical Assistant

Others:

Gregory Fletcher	Assistant Chief Auditor, Public Company Accounting Oversight Board
Ian P. N. Hague	Principal, Canadian Accounting Standards Board
Conrad W. Hewitt	Chief Accountant, Securities and Exchange Commission
Daniel Noll	Director, Accounting Standards, American Institute of Certified Public Accountants
Teresa S. Polley	Executive Director, FASB Advisory Groups, Financial Accounting Standards Advisory Council

Introductory Remarks

1. Mr. Batavick called the meeting to order at 9:00 a.m. and welcomed SBAC members and guests to the meeting. He thanked the members of the Agenda Committee for their help in developing the agenda.

Report of the FASB Chairman

2. Mr. Herz reported on the following strategic and technical matters:
 - a. The recent issuance of FASB Statements No. 157, *Fair Value Measurements*, and No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans*, and FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes*.
 - b. The issuance of two Exposure Drafts, *Not-for-Profit Organizations: Mergers and Acquisitions* and *Not-for-profit Organizations: Goodwill and Other Intangible Assets Acquired in a Merger or Acquisition*, in September 2006.
 - c. The status of the lease accounting project. In July 2006, the FASB added to its agenda a project to comprehensively reconsider the existing accounting for leases. The project is a joint project with the International Accounting Standards Board (IASB). In December, the Boards announced members of an advisory committee to identify issues related to lease accounting. The first meeting of the advisory committee will occur during the first quarter of 2007.
 - d. The status of the project on postretirement benefit obligations including pensions. The staff will commence Phase 2 of the project in 2007, during which the staff will look at postretirement benefit issues related to the income statement, balance sheet, and multiemployer plans.
 - e. The status of the project to amend FASB Statement 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*.

Discussion continues to center on isolation criteria and how to define permitted activities of a qualifying special-purpose entity.

- f. The status of Phase 1 of the fair value option project. The Board currently is redeliberating the Exposure Draft, *The Fair Value Option for Financial Assets and Financial Liabilities*. The Board plans to issue a final document in early 2007.
- g. The status of the derivatives disclosure project. The Board issued an Exposure Draft, *Disclosures about Derivative Instruments and Hedging Activities*, on December 8, 2006.
- h. The status of the joint FASB-IASB revenue recognition project. The Boards have formed two working groups to analyze and compare two potential recognition models, the customer consideration model and the fair value model.
- i. The private company financial reporting joint initiative with the AICPA. A private company financial reporting committee will be formed to make recommendations to the FASB on potential differences in existing and future standards for public and private company reporting. Differences will be based on user needs and cost-benefit considerations. Mr. Herz announced that Judith O'Dell will chair the newly formed committee, which will have 12 members—4 practitioners, 4 preparers, and 4 users of private company financial statements.
- j. The status of XBRL. In September 2006, the SEC announced it will update the EDGAR system and support the development of the U.S. GAAP reporting taxonomies. Over the next six to nine months, there will be a significant effort by the FAF to update those taxonomies.

Report from the SEC

3. Mr. Hewitt reported on the following matters:

- a. The management guidance project, which focuses on the efficient and effective evaluation of an internal control system. The SEC received 154 comment letters. Among other input, the Commission staff considered the recommendations of the Advisory Committee on Smaller Public Companies. The Commission will have an open hearing on the topic on December 13, 2006.
- b. The Commission is considering extending the time until certain public companies are required to implement the internal control reporting requirements. For example, non-accelerated filers (those with less than \$75 million in worldwide market capitalization) with a calendar year-end would be required to provide management's assessment of internal control over financial reporting by 2007 but would not have to have an audit of that assessment until 2008.

- c. Progress on revisions to Auditing Standard No. 2. The Commission is working with the PCAOB on the revisions of Auditing Standard No. 2, which ultimately will require SEC approval.
- d. Progress on the “roadmap,” which outlines steps that must be taken to remove reconciliation requirements for entities that report under international financial reporting standards and are listed in the U.S. markets. The Commission staff currently is examining IFRS filings and noting areas of difference.
- e. The SEC approval of the PCAOB budget for 2007.
- f. The issue of complexity and principles-based standards. In 2007, the SEC will work with the FASB and others to address complexity in the financial reporting system. One aspect of complexity is the issue of principles-based accounting standards.
- g. The status of XBRL. The SEC has allocated approximately \$5.5 million to further develop the U.S. taxonomies. In response to a question, Mr. Hewitt noted that costs for companies to implement XBRL have been reported to be fairly low. He stated that as more public companies adopt XBRL, the market may put pressure on private companies to adopt XBRL.

Report from the PCAOB

- 4. Mr. Fletcher reported on the following matters:
 - a. The SEC approval of the PCAOB budget for 2007. The PCAOB plans to increase its staff to approximately 519 people by the end of 2007.
 - b. The issuance by the PCAOB staff of a series of questions and answers to assist auditors in the audit of stock option grants pursuant to FASB Statement No. 123(R), *Accounting for Stock-Based Compensation*, and SEC Staff Accounting Bulletin No. 107.
 - c. The October meeting with the PCAOB’s Standing Advisory Group to obtain advice on its current standard-setting priorities and certain matters related to its strategic plan.
 - d. PCAOB consideration at an upcoming meeting of whether to expose for public comment a new auditing standard that might supersede Auditing Standard No. 2.
 - e. Internal control implementation guidance for small public company audits. Under PCAOB oversight, a group of auditors that has performed audits of internal control over financial reporting of small accelerated filers will develop guidance on auditing internal control over financial reporting for small public companies.

5. In response to a question about efficiency, Mr. Fletcher stated that in the 2006 inspection cycle, PCAOB inspectors have focused on whether the accounting firms have performed audits of internal control over financial reporting in an efficient manner. A press release on the PCAOB's web site describes that approach.
6. A Committee member stated that Section 404 of the Sarbanes-Oxley Act has begun to affect not-for-profit entities. Specifically, lenders are beginning to require not-for-profit entities to have internal control audits before extending capital.

Conceptual Framework

7. Mr. Batavick stated that the FASB conceptual framework project is a joint project with the IASB. The Boards currently are working on the elements phase of the project, specifically the asset definition. The Boards have not yet addressed measurement and recognition of an asset; rather, they are focusing only on identifying assets that may qualify for measurement and recognition.
8. Mr. Hague stated that the Boards hope to overcome problematic areas in existing asset definitions, as well as to achieve convergence. He referred members to the discussion materials for the meeting, which include the current IASB and FASB asset definitions and the proposed working definition of an asset.
9. Mr. Hague asked SBAC members to comment on whether the proposed definition is clear and understandable and appropriately captures the things that ought to be considered assets. Furthermore, does it overcome the weaknesses in the existing definitions without introducing other weaknesses?
10. Committee members expressed the following views:
 - a. *Privileged access* should not replace *control* in the proposed definition. *Control* seems to be more of a defined concept, whereas *privileged access* is a broad concept that may be difficult to apply in practice.
 - b. Measurement and the definition of an asset should be addressed simultaneously.
 - c. The proposed working definition of an asset is clearer and more understandable than the current definition.
 - d. Expenses can be present economic resources, yet expenses are not assets. The concept of *future economic benefits* should be included in the asset definition. The change from focusing on future benefits to focusing on current resources will require companies to look at a list of expenditures to determine whether they qualify as present economic resources.
 - e. If the proposed working definition allows entities to capitalize assets that must be expensed under the current asset definition, that could cause comparability problems.

- f. The Boards will need to consider whether the proposed asset definition is operational for a not-for-profit entity.
11. Mr. Batavick noted that the Boards decided at the beginning of the conceptual framework project to focus on for-profit entities first, and subsequently address whether to consider differences for not-for-profit entities. Mr. Hague added that while not-for-profit entities are not in the forefront of the Boards' current deliberations, outside monitors are providing the staff with helpful input which the staff is considering in its development of the issues.
12. Committee members asked for clarification on the application of the definition to items such as a life insurance policy and a maintenance contract.
13. Mr. Trott stated that for a life insurance policy, the insured's asset as of the date of purchase is the right to the promise by the insurer to stand ready to pay an amount upon the death of the policyholder. For a maintenance contract in which one party promises to pay and another party promises to render services, both parties have assets. One asset is the right to receive payment. The other asset is the right to receive services. Each party also has a liability—one to make a payment, the other to deliver services.
14. Mr. Trott stated that the proposed definition would not eliminate the need to consider the substance of a transaction over its form. He noted that the Boards are testing the proposed definition on a variety of examples to determine whether it is easier to identify assets under the proposed definition than under the current definition.
15. Mr. Batavick stated that the conceptual framework project will not affect current accounting without standards-level changes. Rather, the new conceptual framework has implications for standard setting.

Financial Statement Presentation

16. Mr. Young stated that the financial statement presentation project is aiming to realign the financial reporting model so that a user can separately identify and evaluate an entity's value-creating activities (business) and the funding of that value creation (financing).
17. Ms. Petrone added that the financial statement presentation project is a joint project with the IASB and is progressing as a comprehensive review of the presentation of the financial statements as a whole. The Boards plan to issue a discussion document in mid-2007 with their preliminary views to provide constituents the opportunity to comment on the principles related to financial statement presentation before the Boards develop an Exposure Draft of a proposed Statement. Two of the key working principles driving the Boards' decisions are that the financial statements should (a) present a cohesive financial picture of an entity and (b) separate an entity's financing activities from its business activities. Further, financing activities would be separated into transactions with owners in their capacity as owners and all other financing activities.

18. Ms. Petrone stated that under those key working principles, each of the financial statements would have a business section, which would be further classified into operating and investing categories; a financing section, which would be further classified into financing asset, financing liability, and equity categories; a discontinued operations section; and an income tax section. Ms. Petrone noted that assets and liabilities would be classified in one of those sections or categories on the statement of financial position based on how an entity manages its business. Changes in those assets and liabilities would be classified consistently in the statement of comprehensive income and the statement of cash flows.
19. Ms. Petrone asked for Committee member input on the proposed financial statement working format and whether it would lead to improved financial reporting.
20. Committee members expressed the following views:
 - a. While a public entity's investors may find separation of an entity's business and financing activities useful, that presentation may not be as useful for users of private company financial statements.
 - b. The Board will need to address significant cost-benefit issues as the project progresses, specifically in the context of small businesses. Financial ratios used for analysis will need to be reworked, manuals and computer programs will need to be rewritten, loan agreements will need to be revisited, and more detailed financial analysis will be needed to cope with the new presentation format. It is unlikely that the large cost burden incurred to comply with the new presentation format will yield any definable benefits. The proposed format may be helpful in analyzing large conglomerates, but would not be helpful in analyzing small nonpublic entities.
 - c. Many small business owners evaluate an entity's performance during a period based on net income, a metric that would no longer be presented under the proposed working format.
 - d. Specifically for small businesses, the Board must understand and consider the credit granting process of asset-based lenders to determine whether the proposed presentation format would meet the needs of those users. Asset-based lenders are sometimes the most significant lender that a small business relies on.
 - e. The categorization approach introduces management discretion that is subject to change over time. A mechanism should be implemented to track changes in asset and liability classification over time.
 - f. To cope with the fact that management's discretion for classifying items can change over time, the Board should consider implementing restrictions that would add rigor to the overall eyes-of-management approach.

- g. The ability of management to use judgment in preparing the financial statements may offset some of the costs that will be incurred in the transition to the new format.
- h. The proposed change only affects the presentation of information—if consistency in presentation can be achieved across entities, the financial statement presentation project will result in a significant improvement in financial reporting.
- i. The proposed format will be useful and understandable to small business owners—separating the operating activities from all other activities will be helpful in communicating financial performance and position.
- j. The proposed presentation format is a vast improvement over the current financial reporting model and will benefit users and preparers of both public and private entity financial statements. However, the cost borne by small businesses to cope with the new format will be disproportionately high.
- k. It is not clear what items, other than cash, would be classified as financing assets. The capital requirements of an entity change with the business cycle, and therefore the concept of excess capital to describe what would be classified as a financing asset is not useful.
- l. When soliciting views of constituents, the Board also should consider licensing agencies as a financial statement user group.

Evaluating Materiality

21. Mr. Glotzer stated that later this month, the Board will consider the issuance of a document to clarify whether the requirements of SEC Staff Accounting Bulletin No. 108, *Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements*, should apply to private companies. SAB 108 addresses the following three elements:
- a. Quantification of financial statement misstatements for evaluating materiality
 - b. Cumulative-effect adjustment rather than restatement of prior periods upon initial application if an entity meets certain criteria
 - c. Disclosure.
22. Mr. Glotzer stated that some constituents believe that the FASB should not address the quantification of financial statement misstatements for the purposes of evaluating materiality because (a) a definition of materiality already exists in FASB Concepts Statement No. 2, *Qualitative Characteristics of Accounting Information*, (b) a materiality evaluation should be left to the judgment of preparers and auditors, and (c) the evaluation of materiality requires more consideration than solely quantitative guidelines.

23. Mr. Glotzer noted, however, that some constituents want the FASB to address the quantification of financial statement misstatements for the purposes of evaluating materiality because doing so (a) would make preparers (as well as auditors) responsible for the concept of materiality and (b) could bring the guidance into U.S. GAAP through the overall codification process.
24. Mr. Glotzer stated that another alternative would be for the FASB not to address SAB 108 in its entirety; that is, the FASB would not address the quantification of materiality but would allow an exception to FASB Statement No. 154, *Accounting Changes and Error Correction*, for entities that are not SEC registrants. This alternative would allow non-SEC registrants to make a one-time correction without restatement similar to that provided to SEC registrants in SAB 108. This alternative would preclude any diversity in practice that would result from SEC registrants having such an exception and non-SEC registrants not having that same exception.
25. Mr. Trott described an accumulating sales cut-off error as an example to illustrate the “rollover approach” and the “iron curtain approach” in quantifying financial statement misstatements for the purpose of evaluating materiality. Mr. Trott stated that the question for the Committee is whether the FASB should issue guidance similar to that issued in SAB 108 that would be applicable to nonpublic and not-for-profit entities.
26. Committee members expressed the following views:
- a. In small businesses it is not uncommon for all errors, material or immaterial, to be corrected at the end of each year. It would be improbable for errors to accumulate over several reporting periods. Because the accumulation of errors is not a significant issue for small nonpublic entities, guidance on this issue would not be the best use of FASB resources.
 - b. Prior-period errors exist frequently in small businesses and a one-time exception from Statement 154 to make a cumulative-effect adjustment (rather than a restatement) to correct those prior-period errors would be an effective way for an entity to correct any previous errors without being forced to restate. This also would preclude diversity in practice between SEC registrants and non-SEC registrants.

Liabilities and Equity

27. Mr. Linsmeier described the Board’s approach to addressing this project with the IASB, referred to as the modified joint approach. He noted that the Board plans to issue a Preliminary Views that explains the alternatives considered by the FASB, their perceived advantages and disadvantages, and the Board’s preference among those alternatives. He noted the possibility that none of the three approaches described in the Preliminary Views will have support from a majority of FASB members. He asked Committee members for their views on issuing a Preliminary

Views under those circumstances. He also asked for Committee input on the content of the three alternative approaches being considered by the Board.

28. Ms. Carnrick briefly described the three approaches that the Board is considering, referred to as the ownership approach, the ownership-settlement approach, and the reassessed expected outcomes (REO) approach.

29. Committee members expressed the following views:

- a. The question of whether an instrument should be classified as a liability or as equity is an issue that is frequently encountered in practice and guidance in this area is necessary.
- b. The existence of contingent features complicates the classification of instruments with those features. The approach that would not allow management's discretion to enter into the consideration of how to classify an instrument would be the best alternative. That is, the Board should aim for a narrow view of equity.
- c. Although the difference between settling an instrument in stock and settling an instrument in cash may not always be a substantive feature for public entities (for example, a public entity with a very liquid market), those settlement alternatives are certainly substantive for small and nonpublic entities.
- d. The contingent claims modeling technique under the REO approach has an additional cost burden, especially for small businesses that may not have the necessary level of expertise for such modeling. The REO approach adds more complexity to an already complex area of accounting.
- e. Mandatorily redeemable stock that is redeemable for other than a fixed price should continue to be accounted for as equity under any of the approaches.
- f. The Preliminary Views should include examples that illustrate the differences between the three methods.
- g. Issuing the Preliminary Views with the three approaches, possibly without a majority of Board support for a single alternative, would be acceptable and would likely result in receiving the most constructive comments in the comment phase.

Business Combinations

30. Mr. Crooch described the progress on the business combinations project. He noted that the Board is in the process of redeliberating certain issues and that one particularly contentious issue is the accounting for preacquisition contingencies. He stated that under the Exposure Draft, *Business Combinations*—a replacement of FASB Statement No. 141 (BC ED), an acquirer would initially recognize a contingency at fair value and would remeasure that contingency at fair value up to the

settlement date with any changes being recognized in income each reporting period. Mr. Crooch stated that respondents to the BC ED strongly opposed that proposal, stating that, in some cases, they were unsure how to determine (a) when a contingency meets the definition of an asset or liability and, if so, (b) how to value that contingency.

31. Ms. Tamulis stated that the Board will consider the following alternatives for addressing the uncertainty of whether an asset or liability exists (element uncertainty):

- a. Require recognition of all contingencies that meet the definition of an asset or liability and do not provide guidance for determining when the asset or liability definition is met (as proposed in the BC ED)
- b. Require recognition of all contractual contingencies
- c. Require recognition of all contingencies that are legally enforceable.

32. Committee members expressed the following views:

- a. At a minimum, all preacquisition contingencies should be disclosed; recognition is a more difficult question.
- b. An acquiring entity considers both recorded and unrecorded liabilities in determining the purchase price, which indicates that unrecorded contingent liabilities do exist and probably should be recognized at the time of the purchase.
- c. The Boards should pursue a principles-based approach for the recognition of contingencies such that the facts and circumstances of each acquisition can be considered without the constraint of meeting a percentage threshold level.
- d. An acquiring entity should recognize all contractual contingent assets and liabilities and noncontractual contingent assets and liabilities above a certain threshold. Recognition of noncontractual assets and liabilities adds to the level of uncertainty.
- e. The fair value recognition of contingencies appears to be the conceptually correct answer.
- f. One Committee member stated that the recognition threshold for contingent assets should be the same as the threshold for contingent liabilities, while another Committee member stated that contingent assets should have a more rigorous recognition threshold.
- g. Contingent consideration should be disclosed in the financial statements; however, contingent consideration, in most cases, should not be measured at the

acquisition date at fair value and subsequently remeasured to fair value at each reporting period.

Other Current Issues and Adjournment

33. Mr. Batavick opened the discussion to Committee members for comments or questions on other issues.
34. A Committee member requested that a concise summary of Committee meetings and meeting materials be created so that Committee members can distribute those materials to and solicit input from their constituencies. That Committee member agreed to provide Mr. Batavick and Ms. Polley with further details on the type of information that would be helpful.
35. A Committee member requested more time between the date when the meeting materials are distributed and the meeting so that members can obtain input from their constituencies.
36. A Committee member asked for an update on the codification project. Mr. Herz stated that the codification is tentatively on schedule to be issued for an extended verification period at the end of 2007. At that time, the Board would solicit and consider comments on the draft throughout 2008 with the plan to issue the codification as authoritative GAAP in 2009 or 2010. Mr. Herz stated that future standard-setting activities would be amendments to the codification.
37. A Committee member asked the Board to consider issuing guidance for a circumstance in which a point-of-sale arrangement between a customer and a supplier is replaced with a consignment arrangement, with the consignment arrangement being treated retroactively.
38. A Committee member noted that the outcome of the Board's project on transfers of financial assets (a proposed amendment of Statement 140), including the permitted activities of a qualifying special-purpose entity, will have a significant impact on the banking industry.
39. Mr. Batavick noted that Mr. Nusbaum's term on the SBAC would end as of December 31. He thanked Mr. Nusbaum for his valuable contributions to the Committee.
40. Mr. Batavick thanked the Committee members and observers for their input and participation. He adjourned the meeting at 2:30 p.m.