FINANCIAL ACCOUNTING STANDARDS BOARD
SMALL BUSINESS ADVISORY COMMITTEE MEETING

May 11, 2004
FASB Offices
401 Merritt 7
Norwalk, CT

Agenda

9:00 a.m.	Informal gathering outside Boardroom for coffee
9:30 a.m.	Welcome and Introductions (George Batavick)
9:45 a.m.	Opening Remarks and Role of the Committee (Bob Herz)
10:00 a.m.	FASB Standard-setting Process and Current Board Agenda (George Batavick)
10:30 a.m.	Equity-Based Compensation (Mike Crooch)
12:00 p.m.	L U N C H
12:45 p.m.	Equity-Based Compensation, cont’d (Mike Crooch)
1:15 p.m.	Business Combinations (Mike Crooch)
1:45 p.m.	Current Accounting Environment (George Batavick)
2:45 p.m.	Closing Remarks (George Batavick)
3:00 p.m.	A D J O U R N M E N T

Meeting of the
Financial Accounting Standards Board
Small Business Advisory Committee
May 11, 2004

Small Business Advisory Committee Members Attending	Affiliation
Michael S. Cain	Frost National Bank
Daniel J. Donoghue	Piper Jaffray Inc.
Robert A. Dyson	Friedman Alpren & Green LLP
Mark Ellis	Michael C. Fina group of companies
Richard E. Forrestel, Jr.	Cold Spring Construction Company, Inc.
Joseph Graziano	Grant Thornton LLP
William G. Hall	William G. Hall & Company
Michael L. Hansen	Mid-States Construction Company and Eagle Metal Finishing, LLC
Gregory P. Hanson	Avanir Pharmaceuticals
Jane Hoffman	National Cooperative Business Association
W. Stephen Holmes	InterWest Partners
Francis C. Jumonville, Jr.	Airtrol, Inc.
Mauricio Kohn	Kohn Financial Consulting, L.L.C.
Steven C. Mayer	Human Genome Sciences, Inc.
Russell V. Meyers	Witt Mares Eggleston Smith, PLC
Darrel L. Posegate	Home Federal Bank
Charles L. Saeman	State Bank of Cross Plains
Edgar Anson Thrower	Contec, Inc.
Scott M. Waite	Patelco Credit Union
Grafton H. Willey, IV	Tofias PC
Deborah Anne Wilson	Utility Service Co., Inc.
Candace Wright	Postlethwaite & Netterville
Lark E. Wysham	Citizens Bank/Citizens Bancorp

Committee Members Not Attending	Affiliation
Joe Joseph	Putnam Investments

Others Attending

Financial Accounting Standards Board:

Robert H. Herz	Chairman
George J. Batavick	Member
G. Michael Crooch	Member
Gary S. Schieneman	Member
Leslie F. Seidman	Member
Edward W. Trott	Member

FASB Staff:

Suzanne Q. Bielstein	Director of Major Projects and Technical Activities
Lawrence W. Smith	Director of Technical Application & Implementation Activities
Ronald J. Bossio	Senior Project Manager
Michael W. Tovey	Practice Fellow
Lauren Belot	Postgraduate Technical Assistant

Others:

Greg Dean	Staff Director, Securities and Investment Subcommittee of the Senate Committee on Banking, Housing, and Urban Affairs
Greg Edwards	Principal, Accounting Standards, The Canadian Institute of Chartered Accountants
Gregory Fletcher	Assistant Chief Auditor, Public Company Accounting Oversight Board
Tia Jenkins	Senior Assistant, Division of Corporation Finance, Securities and Exchange Commission
James J. Leisenring	Member, International Standards Accounting Board
Jenifer Minke-Girard	Senior Associate Chief Accountant, Securities and Exchange Commission
Daniel Noll	Director Accounting Standards, American Institute of Certified Public Accountants
Richard J. Swift	Chairman, Financial Accounting Standards Advisory Council
Teresa S. Polley	Executive Director, Financial Accounting Standards Advisory Council

Please note: The following materials are provided to facilitate the audience's understanding of the topics to be discussed at this meeting of the Small Business Advisory Committee. These materials are presented for discussion purposes only; they are not intended to reflect the views of the FASB or its staff. Official positions of the FASB are determined only after extensive due process and deliberations.

Equity-Based Compensation
Small Business Advisory Committee Meeting
May 11, 2004

Background

On March 31, 2004, the Financial Accounting Standards Board (FASB) issued a proposed Statement, *Share-Based Payment*, that addresses the accounting for share-based payment transactions in which an enterprise receives employee services in exchange for (a) equity instruments of the enterprise or (b) liabilities that are based on the fair value of the enterprise’s equity instruments or that may be settled by the issuance of such equity instruments. The proposed Statement would eliminate the ability to account for share-based compensation transactions using APB Opinion No. 25, *Accounting for Stock Issued to Employees*, and generally would require instead that such transactions be accounted for using a fair-value-based method.

The proposed Statement would neither change the accounting in FASB Statement No. 123, *Accounting for Stock-Based Compensation*, for transactions in which an enterprise exchanges its equity instruments for services of parties other than employees nor change the accounting for employee stock ownership plans, which are subject to AICPA Statement of Position 93-6, *Employers’ Accounting for Employee Stock Ownership Plans*. The Board intends to reconsider the accounting for those transactions and plans in a later phase of its project on equity-based compensation. Attached, for your convenience, is the Summary from the proposed Statement.

Small Business Issuers

Some argue that the cost-benefit considerations that led the Board to propose certain accounting alternatives for nonpublic entities should apply equally to small business issuers, as defined by the Securities Act of 1933 and the Securities Exchange Act of 1934.

Questions for Committee Members

1. Do you believe that some or all of those alternatives should be extended to those public entities?

2. Recent studies have shown that only 3% of small businesses in the U.S. grant stock options as part of their employee compensation programs. Is this level of participation consistent with your experiences? Also, is any particular type of plan is more common among the 3%?

Nonpublic Entities

Consistent with its mission, when the Board developed this proposed Statement it evaluated whether it would fill a significant need and whether the costs imposed to apply this proposed Statement, as compared to other alternatives, would be justified in relation to the overall benefits of the resulting information. As part of that evaluation, the Board carefully considered the impact of this proposed Statement on nonpublic entities and made several decisions to mitigate the incremental costs those entities would incur in complying with its provisions. For example, the Board decided to permit those entities to elect to use either the fair-value-based method or the intrinsic value method (with final measurement of compensation cost at settlement date) of accounting for share-based compensation arrangements. Additionally, the Board selected transition provisions that it believes will minimize costs of transition (most nonpublic entities would use a prospective method of transition rather than the modified prospective method required for public entities). Moreover, the Board decided to extend the effective date of this proposed Statement for nonpublic entities to provide them additional time to study its requirements and plan for transition.

Questions for Committee Members

3. Do you agree with the Board's conclusions to allow an election of intrinsic value method for nonpublic entities? If not, why not?

4. Do you believe those decisions relating to transition and effective date are appropriate? If not, why not? Should other modifications of this proposed Statement's provisions be made for those entities?

Fair Value Measurement

Some respondents to the Invitation to Comment suggested that the FASB prescribe a single method of estimating expected volatility or even a uniform volatility assumption that would be used for all companies. Other respondents to the Invitation to Comment disagreed with such an approach. Additionally, some parties believe that historical volatility, which has been commonly used as the estimate of expected volatility under Statement 123 as originally issued, is often not an appropriate measure to use. The proposed Statement would require enterprises to make their best estimate of expected volatility (as well as other assumptions) by applying the guidance provided in the proposed Statement to their specific facts and circumstances. In that regard, the proposed Statement provides guidance on information other than historical volatility that should be used in estimating expected volatility, and explicitly notes that defaulting to historical volatility as the estimate of expected volatility without taking into consideration other available information is not appropriate.

In developing this proposed Statement, the Board acknowledged that there may be circumstances in which it is not possible to reasonably estimate the fair value of an equity instrument. In those cases, the Board decided to require that compensation cost be measured using an intrinsic value method with remeasurement through the settlement date.

Questions for Committee Members

5. If you believe the Board should require a specific method of estimating expected volatility, please explain the method you prefer.

6. Are there any specific concerns for small business issuers with regard to estimating volatility?

7. Do you agree that the intrinsic value method with remeasurement through the settlement date is the appropriate alternative accounting treatment when it is not possible to reasonably estimate the fair value? If not, what other alternative do you prefer, and why?

Employee Stock Purchase Plans

For the reasons described in the proposed Statement, that document establishes the principle that an employee stock purchase plan transaction is not compensatory if the employee is entitled to purchase shares on terms that are no more favorable than those available to all holders of the same class of the shares.

Question for Committee Members

8. Do you agree with that principle? If not, why not?

9. Do small businesses have employee stock purchase plans? What is the level of participation in those plans?

Disclosures

Because compensation cost would be recognized for share-based compensation transactions, the Board concluded that it was appropriate to reconsider and modify the information required to be disclosed for such transactions. The Board also decided to frame the disclosure requirements of this proposed Statement in terms of disclosure objectives. Those objectives are supplemented by related implementation guidance describing the minimum disclosures required to meet those objectives.

Questions for Committee Members

10. Do you believe that the disclosure objectives set forth in this proposed Statement are appropriate and complete? If not, what would you change and why?

11. Do you believe that the minimum required disclosures are sufficient to meet those disclosure objectives? If not, what additional disclosures should be required? Please provide an example of any additional disclosure you would suggest.

Transition

This proposed Statement would require the modified prospective method of transition for public companies and would not permit retrospective application.

Questions for Committee Members

12. Do you agree with the transition provisions of this proposed Statement? If not, why not?

13. Do you believe that entities should be permitted to elect retrospective application upon adoption of this proposed Statement? If so, why?

ATTACHMENT
Proposed Statement of Financial Accounting Standards

Share-Based Payment–an Amendment of FASB Statements No. 123 and 95

Summary

This proposed Statement addresses the accounting for transactions in which an enterprise exchanges its valuable equity instruments for employee services. It also addresses transactions in which an enterprise incurs liabilities that are based on the fair value of the enterprise's equity instruments or that may be settled by the issuance of those equity instruments in exchange for employee services. This proposed Statement does not change the accounting for similar transactions involving parties other than employees or the accounting for employee stock ownership plans, which are subject to AICPA Statement of Position 93-6, *Employers' Accounting for Employee Stock Ownership Plans;* the Board intends to reconsider the accounting for those transactions and plans in a later phase of its project on equity-based compensation.

The objective of the accounting required by FASB Statement No. 123, *Accounting for Stock-Based Compensation*,[*] as it would be amended by this proposed Statement, is to recognize in an entity's financial statements the cost of employee services received in exchange for valuable equity instruments issued, and liabilities incurred, to employees in share-based payment transactions. Key provisions of this proposed Statement are as follows:

a. For public entities, the cost of employee services received in exchange for equity instruments would be measured based on the grant-date fair value of those instruments (with limited exceptions). That cost would be recognized over the requisite service period (often the vesting period). Generally, no compensation cost would be recognized for equity instruments that do not vest.

b. For public entities, the cost of employee services received in exchange for liabilities would be measured initially at the fair value of liabilities and would be remeasured subsequently at each reporting date through settlement date. The pro rata change in fair value during the requisite service period would be recognized over that period, and the change in fair value after the requisite service period is complete would be recognized in the financial statements in the period of change.

c. The grant-date fair value of employee share options and similar instruments would be estimated using option-pricing models adjusted for the unique characteristics of those options and instruments (unless observable market prices for the same or similar options are available).

d. If an equity award is modified subsequent to the grant date, incremental compensation cost would be recognized in an amount equal to the excess of the fair value

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[*]Unless the text indicates otherwise, all references to Statement 123 in this summary are to that Statement as originally issued—that is, before the effects of this amendment.

of the modified award over the fair value of the original award immediately prior to the modification.

e. Employee share purchase plans would not be considered compensatory if the terms of those plans were no more favorable than those available to all holders of the same class of shares and substantially all eligible employees could participate on an equitable basis.

f. Excess tax benefits, as defined by this proposed Statement, would be recognized as an addition to paid-in capital. Cash retained as a result of those excess tax benefits would be presented in the statement of cash flows as financing cash inflows. The write-off of deferred tax assets relating to unrealized tax benefits associated with recognized compensation cost would be reported as income tax expense.

g. This proposed Statement allows nonpublic entities to elect to measure compensation cost of awards of equity share options and similar instruments at intrinsic value through the date of settlement. That election also would apply to awards of liability instruments. This proposed Statement also requires that public entities measure compensation cost of awards of equity share options and similar instruments at intrinsic value through the date of settlement if it is not reasonably possible to estimate their grant-date fair value.

h. The notes to financial statements of both public and nonpublic entities would disclose the information that users of financial information need to understand the nature of share-based payment transactions and the effects of those transactions on the financial statements.

Background

APB Opinion No. 25, *Accounting for Stock Issued to Employees*, was issued in 1972. Opinion 25 required that compensation cost for awards of share options be measured at their intrinsic value, which is the amount by which the fair value of an equity share exceeds the exercise price. Opinion 25 also established criteria for determining the date at which an award's intrinsic value should be measured; that criteria distinguished between awards whose terms are known (or fixed) at the date of grant and awards whose terms are not known (or variable) at the date of grant. Measuring fixed awards' intrinsic values at the date of grant generally resulted in little or no compensation cost being recognized for valuable equity instruments given to employees in exchange for their services. Additionally, distinguishing between fixed and variable awards was difficult in practice, which resulted in a large amount of specialized and complex accounting guidance.[†]

[†]That guidance was identified by the United States Securities and Exchange Commission (SEC) as an example of rules-based accounting standards (SEC, *Study Pursuant to Section 108(d) of the Sarbanes-Oxley Act of 2002 on the Adoption by the United States Financial Reporting System of a Principles-Based Accounting System*, March 25, 2003 [www.sec.gov]).

Statement 123 was issued in 1995 and was effective for share-based compensation transactions occurring in fiscal periods beginning after December 15, 1995. As originally issued, Statement 123 established a fair-value-based method of accounting for share-based compensation awarded to employees. The fair-value-based method of accounting requires that compensation cost for awards of share options be measured at their fair value on the date of grant. As opposed to the accounting under Opinion 25, the application of the fair-value-based method to fixed awards results in compensation cost being recognized when services are received in exchange for valuable equity instruments of the employer. Statement 123 established as preferable the fair-value-based method and encouraged, but did not require, entities to adopt it. The Board's decision at that time to permit entities to continue accounting for share-based compensation transactions using Opinion 25 was based on practical rather than conceptual considerations.

Reasons for Issuing This Proposed Statement

There are four principal reasons for issuing this proposed Statement:

a. **Addressing concerns of users and others.** Users of financial statements, including institutional and individual investors, as well as many other parties expressed to the FASB their concerns that using Opinion 25's intrinsic value method results in financial statements that do not faithfully represent the economic transactions affecting the issuer, namely, the receipt and consumption of employee services in exchange for valuable equity instruments. Financial statements that do not faithfully represent the economic transactions affecting an issuer can distort the reported financial condition and operations of that issuer and can lead to the inappropriate allocation of resources. Part of the FASB's mission is to improve standards of financial accounting for the benefit of users of financial information.

b. **Improving the comparability of reported financial information through the elimination of alternative accounting methods.** During the summer of 2002, a number of public companies announced their intention of voluntarily adopting Statement 123's fair-value-based method of accounting for share-based compensation transactions with employees. Since then, approximately 500 public companies have voluntarily adopted or announced their intention to adopt the fair-value-based method. Despite the many public companies that have voluntarily adopted the fair-value-based method of accounting, there remains a large number of companies that continue to use Opinion 25's intrinsic value method. The Board believes that similar economic transactions should be accounted for similarly (that is, share-based compensation transactions with employees should be accounted for using one method). Consistent with the conclusion in Statement 123, the Board believes such transactions should be accounted for using the fair-value-based method.

c. **Simplifying U.S. GAAP.** This proposed Statement would simplify the accounting for share-based payments. The Board believes that U.S. GAAP should be simplified whenever possible. Requiring the use of a single method of accounting for share-based payment would result in the elimination of Opinion 25's intrinsic value method and the many related detailed and form-driven rules.

d. **International convergence.** This proposed Statement would result in greater international comparability in the accounting for share-based payment. In February 2004, the International Accounting Standards Board (IASB), whose standards are followed by enterprises in many countries throughout the world, issued International Financial Reporting Standard (IFRS) 2, *Share-based Payment*. IFRS 2 requires that all enterprises recognize an expense for all employee services received (and consumed) in exchange for the enterprise's equity instruments. The IASB concluded that share-based compensation transactions should be accounted for using a fair-value-based method that is similar in most respects to the fair-value-based method established in this proposed Statement. Converging to a common set of high-quality financial accounting standards on an international basis for share-based payment transactions with employees improves the comparability of financial information around the world and simplifies the accounting for enterprises that report financial statements under both U.S. GAAP and international accounting standards.

The Board believes that this proposed Statement addresses users' and other parties' concerns by requiring enterprises to recognize an expense in the income statement for employee services received (and consumed) in exchange for the enterprises' equity instruments, thereby reflecting the consequences of the economic transaction in the financial statements. By requiring the fair-value-based method for all public companies, this proposed Statement would eliminate an alternative accounting method and the accounting guidance associated with that method; consequently, similar economic transactions would be accounted for similarly. Finally, requiring the use of Statement 123's fair-value-based method is convergent with IFRS 2.

Differences between This Proposed Statement and Current Practice

This proposed Statement would affect current practice in a number of ways, but chief among them is that it would eliminate the alternative to use Opinion 25's intrinsic value method of accounting that was provided in Statement 123 as originally issued. Under Opinion 25, issuing stock options to employees generally resulted in recognition of no compensation cost. This proposed Statement would require public companies to recognize the cost of employee services received in exchange for equity instruments, based on the grant-date fair value of those instruments (with limited exceptions).

This proposed Statement would affect current practice in other ways, including the measurement attribute for nonpublic entities, the pattern in which compensation cost would be recognized, the accounting for employee share purchase plans, and the accounting for income tax effects of share-based payment transactions. Paragraphs 6–15 of this proposed Statement summarize those as well as other differences.

How This Proposed Statement Would Improve Financial Reporting

This proposed Statement would require the recognition of compensation cost incurred as a result of receiving employee services in exchange for valuable equity instruments issued by the employer. Recognizing compensation cost in the financial statements improves the relevance and reliability of that financial information, helping users of financial information to understand better the economic transactions affecting an enterprise and to make better resource allocation decisions. Such information specifically will help users of financial statements understand the impact that share-based compensation arrangements have on an enterprise's financial condition and operations. This proposed Statement also would improve comparability by eliminating one of two different methods of accounting for share-based compensation transactions and would also thereby simplify existing U.S. GAAP. Eliminating different methods of accounting for the same transactions leads to improved comparability of financial statements because similar economic transactions are accounted for similarly.

How the Conclusions in This Proposed Statement Relate to the FASB's Conceptual Framework

FASB Concepts Statement No. 1, *Objectives of Financial Reporting by Business Enterprises,* states that financial reporting should provide information that is useful in making business and economic decisions. Recognizing compensation cost incurred as a result of receiving employee services in exchange for valuable equity instruments issued by the employer will help achieve that objective by providing information about the costs incurred by the employer to obtain employee services in the marketplace.

With respect to the notion of *comparability*, FASB Concepts Statement No. 2, *Qualitative Characteristics of Accounting Information,* states that information about an enterprise gains greatly in usefulness if it can be compared with similar information about other enterprises. Establishing the fair-value-based method of accounting as the required method will increase comparability because similar economic transactions will be accounted for similarly. That will improve the usefulness of financial information. Neutrality is another important characteristic of accounting information. Establishing that method also eliminates the accounting bias toward using employee share options for compensation, which results in accounting that is neutral for different forms of compensation.

Completeness is identified in Concepts Statement 2 as an essential element of representational faithfulness and relevance. Thus, to faithfully represent the total cost of employee services to the enterprise, compensation cost relating to valuable equity instruments issued by the employer to its employees in exchange for their services should be recognized in the employer's financial statements.

Concepts Statement 6 defines *assets* as probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events. Employee services cannot be stored and are received and used simultaneously. Those employee services are assets of an enterprise only momentarily—as the entity receives and uses them—although their use may create or add value to other assets of the enterprise. When an employer exchanges its valuable equity instruments for employee services, the receipt of those employee services creates an asset that should be either capitalized as part of another asset of the enterprise (as permitted by U.S. GAAP) or expensed when consumed.

Costs and Benefits

The mission of the FASB is to establish and improve standards of financial accounting and reporting for the guidance and education of the public, including preparers, auditors, and users of financial information. In fulfilling that mission, the Board endeavors to determine that a proposed standard will fill a significant need and that the costs imposed to meet that standard, as compared with other alternatives, are justified in relation to the overall benefits of the resulting information. The Board's consideration of each issue in a project includes the subjective weighing of the incremental improvement in financial reporting against the incremental cost of implementing the identified alternatives. At the end of that process, the Board considers the accounting provisions in the aggregate and assesses the related perceived costs on a qualitative basis.

Several procedures were conducted before the issuance of this proposed Statement to aid the Board in its assessment of the expected costs associated with implementing the required use of the fair-value-based accounting method. Those procedures included a field visit program, a survey of commercial software providers, and discussions with Option Valuation Group members, valuation experts, compensation consultants, and numerous other constituents. Based on the findings of those cost-benefit procedures, the Board concluded that this proposed Statement will sufficiently improve financial reporting to justify the costs it will impose. Paragraphs C40–C47 provide a discussion of the Board's cost-benefit assessment with respect to this proposed Statement.

The Effective Dates of This Proposed Statement

This proposed Statement would be applied to public entities prospectively for fiscal years beginning after December 15, 2004, as if all share-based compensation awards granted, modified, or settled after December 15, 1994, had been accounted for using the fair-value-based method of accounting. Nonpublic entities that had adopted the fair-value-based method of accounting for recognition or pro forma disclosures would use the same transition and effective date as public entities. All other nonpublic entities would apply this proposed Statement prospectively for fiscal years beginning after December 15, 2005.

Business Combinations–

Purchase Method Procedures (including Combinations between Mutual Enterprises) and Certain Issues Related to the Accounting for and Reporting of Noncontrolling (Minority) Interests

Small Business Advisory Committee Meeting

May 11, 2004

Background

In August 1996, the Board added to its agenda a project on business combinations. The Board's objective was to fundamentally reconsider the guidance in APB Opinions No. 16, *Business Combinations*, and No. 17, *Intangible Assets.* Later, the Board decided to conduct that project in two phases. The first phase would deal with the issue of accounting method—whether to continue to require the use of two basic methods of accounting (the purchase method and pooling-of-interests method). The second phase would deal with the details of procedures used in applying the purchase method. In June 2001, the Board concluded the first phase of that project with the issuance of FASB Statement No. 141, *Business Combinations*, and No. 142, *Goodwill and Other Intangible Assets*.

- Statement 141: Eliminated the pooling method and requires that all business combinations, as defined in the Statement, be accounted for by the purchase method.
- Statement 142: Addresses the accounting for goodwill and other intangible assets subsequent to their acquisition and addresses the accounting for intangible asset purchased outside a business combination.

The second phase of the project broadly reconsiders the current guidance on applying the purchase method of accounting that was not deliberated in developing Statement 141. During its deliberations on this project, the Board also has been considering issues related to:

- Accounting for and reporting of noncontrolling (minority) interests. Certain noncontrolling interest decisions reached affirm or modify tentative conclusions that the Board proposed and exposed for comment in its October 2000 Exposure Draft, *Accounting for Financial Instruments with Characteristics of Liabilities, Equity, or Both.*

- Accounting for combinations between mutual enterprises. Statement 141 included combinations between two or more mutual enterprises in its scope. However, that Statement provided a delayed effective date for these combinations, which allows Opinion 16 and related interpretative guidance (including, but not limited to, FASB Interpretations of Opinion 16 and AICPA Audit and Accounting Guides) to continue to be applied. After considering the issues raised about combinations between mutual enterprises, the Board concluded that combinations between mutual enterprises are economically similar to combinations between other business enterprises and that there is no need to issue separate application guidance for those business combinations. As a result, the Board decided to include the results of its deliberations and conclusions on combinations between mutual enterprises in the overall project on business combinations.

The Board expects that the result of this project will be the simultaneous issuance of (1) a Statement of Financial Accounting Standards that replaces Statement 141 (referred to as Statement 141(R)) so that all of the guidance on accounting for and reporting on an acquisition of a business are available in a single document and (2) a Statement of Financial Accounting Standards that replaces Accounting Research Bulletin No. 51 *Consolidated Financial Statements,* as amended by FASB Statement No. 94, *Consolidation of All Majority-Owned Subsidiaries.* That proposed Statement would carry forward all of the accounting and reporting requirements of ARB 51, as amended, without reconsideration but would add the requirements for the accounting for and reporting of noncontrolling interests in subsidiaries.[1]

The Board is partnering with the International Accounting Standards Board (IASB) on the issues related to the procedures for the acquisition of a business and the accounting for and reporting of noncontrolling interests. Additionally, the Board is conducting the deliberations related to the accounting for combinations between two or more mutual enterprises jointly with the Canadian Accounting Standards Board.

Area for Discussion—Measuring the Fair Value of the Business Acquired.

Underlying the proposed accounting for an acquisition of an entity is the Board's fundamental conclusion that an acquiring entity should recognize the business acquired at

[1] A separate part of the project is addressing acquisitions by not-for-profit organizations, including their acquisitions of for-profit businesses and not-for-profit hospitals, colleges and universities, charities, religious organizations, and the like.

its fair value at the acquisition date. Consistent with longstanding practice for exchange transactions, the fair value of the business acquired may be measured based on the fair value of the consideration given in exchange. Forms of consideration exchanged include cash, tangible or intangible assets, a business or a subsidiary of the acquiring entity, securities of the acquiring entity (common or preferred shares, options, warrants, or debt instruments), or promised future payments of the acquiring entity, including contingent payments. Some of these forms of consideration may have more apparent fair values than others.

Under proposed Statement 141(R), in situations in which there is an absence of a readily apparent fair value of the total consideration exchanged, the tentative decisions would still require the acquirer to apply the general principle—to measure the fair value of the business acquired at the acquisition date. This fundamental principle likely will result in more acquirers directly measuring the fair value of an acquired business than under the present procedures. For example, in an acquisition in which an acquiring entity obtains control of a business through a purchase of less than 100 percent of its ownership interests (say 20–80 percent), the consideration exchanged by the acquirer may not provide the best basis for measuring the fair value of the business acquired. In those circumstances in which the consideration exchanged does not provide the best basis, other valuation techniques should be used to determine the fair value of the business acquired under proposed Statement 141(R).

The use of other valuation techniques to estimate the fair value of the business acquired may be necessary for acquisitions in which (a) control of a business is achieved without a transfer of consideration, (b) control is obtained through a purchase of a less than 100 percent controlling ownership interest, or (c) the fair value of the total consideration transferred is determined not to be more clearly evident than the fair value of the business acquired. The latter circumstance would include, for example, a merger in which two private business enterprises or two mutual enterprises combine through an exchange of equity or member interests and the fair value of the business acquired is determined to be more clearly evident and, thus, more reliably measurable than the fair value of the equity or member interests transferred by the acquiring entity.

The Board agreed to provide broadly applicable guidance for determining the fair value of an acquired business in the absence of observable prices from transactions in active markets. Additionally, the Board decided to provide certain guidance specific to measuring the fair value of an acquired mutual enterprise, in particular, that benefits to members (for example, the distribution of member benefits in the form of reduced fees charged for goods or services) should be considered when measuring fair value. Both the broadly applicable and the mutual enterprise specific proposed guidance is provided in the attachment and will be included as application guidance of proposed Statement 141(R).

Questions for Committee Members

1. Have you participated in a business combination in which the fair value of the consideration exchanged was not readily apparent (for example, a merger of two private companies)? If yes, how did you determine the cost or fair value of the business acquired under Statement 141? Based on your experiences, do you have suggestions for those that may be required to perform these business valuations under proposed Statement 141(R)?

2. What guidance, *not* provided in Statements 141 and 142, might the Board add to assist in applying the provisions to combinations between mutual enterprises?

ATTACHMENT

Staff Draft of Proposed Guidance on Measuring the Fair Value of an Acquired Business as of February 18, 2004

Application of Paragraphs 18 and 21 [of the Proposed Standard] (Not Included)—Measuring the Fair Value of the Business Acquired

A35. Paragraph 18 requires that the business acquired be measured at fair value. Paragraph 21 adds that in an acquisition in which the acquiring entity purchases all of the ownership interest of the business acquired, the fair value of the consideration exchanged generally is more clearly evident than the fair value of the business acquired. Thus, in the absence of evidence to the contrary, the fair value of the consideration is to be used to determine the fair value of the business acquired. Clear examples include purchases of all of the equity interest in a business enterprise for cash or a promised payment of cash on a specified date. In those cases, the price for the business that the willing buyer and seller agreed upon is clearly evident and observable by all parties that have access to the terms and conditions of the combination. The fair values of other forms of consideration (for example, land, buildings, and other nonmonetary assets) generally are not as apparent as the fair value of cash or a promise of cash but, as noted in paragraph 21, their fair value may be more clearly evident than the fair value of the business acquired. Thus, absent evidence to the contrary, the fair value of that form of consideration transferred also is used as the best basis for determining the fair value of the business acquired.

A36. In some circumstances, however, the fair value of the business acquired may need to be estimated using other valuation techniques. Those circumstances include acquisitions in which (a) control of a business is achieved without a transfer of consideration (paragraph 5) or (b) the fair value of the total consideration transferred is determined not to be more clearly evident than the fair value of the business acquired. The latter circumstance would include, for example, a merger in which two private business enterprises or two mutual enterprises combine through an exchange of equity or member interests and the fair value of the business acquired is determined to be more clearly evident and, thus, more reliably measurable than the fair value of the equity or member interests transferred by the acquiring entity.

A37. In the circumstances noted in paragraph A36, active markets and observable prices generally do not exist for a business that is identical or similar to the business acquired; thus, consistent with Level 3 of the hierarchy, fair value should be estimated using multiple valuation techniques, as appropriate. The results of the multiple techniques applied would then be reconciled taking into consideration the reliability of the inputs used to estimate the fair value of the business acquired. For example, the market and income approaches are techniques that are most commonly used in the case of enterprise measurement. Thus, the techniques applied and reconciled might be the market approach and the income approach, or several variations of each based on the extent of the available data.

Market Approach

A38. In applying the market approach, the basic steps are (a) define and assess the available marketplace data (and adjust, if necessary) to derive valuation ratios and (b) apply the appropriate valuation ratios to the acquired business. As applied to business enterprises, the market approach is typically based on reference to prices of publicly traded equity of comparable businesses or by reference to other transactions involving comparable businesses for which the terms of business combinations are disclosed. Assessing comparability of the business acquired to these comparable businesses requires judgments about the commonality of different types of factors including, operational, market, financial, and nonfinancial. For example, factors might include products and services (operational factors); markets served, competitors, and position within the industry (market factors); capital structure and historic and forecasted financial performance (financial factors); and assessment of the depth of management, the expertise of personnel, and the maturity of the business (nonfinancial factors).

A39. Ideally, marketplace data are defined based on other entities within the same industry. Absent that information, one may define marketplace data based on economically similar businesses. Thus, there are various degrees of comparability between other businesses and the business acquired. In the event that there is not sufficient comparability between the operating metrics of the business acquired and those of the selected marketplace companies, it may be necessary to adjust the valuation ratios upward or downward based upon those differences to reflect the operating metrics of the business acquired.

Income Approach

A40. In applying an income approach, the basic steps involve estimating and measuring the value of future cash flows. As discussed in paragraph 24 of Statement 142:

> If a present value technique is used to measure fair value, estimates of future cash flows used in that technique shall be consistent with the objective of measuring fair value. Those cash flow estimates shall incorporate assumptions that marketplace participants would use in their estimates of fair value. If that information is not available without undue cost and effort, an entity may use its own assumptions. Those cash flow estimates shall be based on reasonable and supportable assumptions and shall consider all available evidence. The weight given to the evidence shall be commensurate with the extent to which the evidence can be verified objectively. If a range is estimated for the amounts or timing of possible cash flows, the likelihood of

possible outcomes shall be considered. Concepts Statement 7 discusses the essential elements of a present value measurement (paragraph 23), provides examples of circumstances in which an entity's cash flows might differ from the market cash flows (paragraph 32), and discusses the use of present value techniques in measuring the fair value of an asset or a liability (paragraphs 39–54 and 75–88).

Special Considerations in Applying the Market and Income Approaches to Mutual Enterprises

A41. As discussed in paragraph A36, when two mutual enterprises combine, the fair value of the business acquired may be more reliably measured than the fair value of member interests transferred by the acquiring entity. Mutual enterprises, while similar in many ways to other enterprises within the scope of this Statement, have some distinct differences that arise primarily from the dual nature of the members in their capacity as both customers and owners. Members of mutual enterprises generally expect to receive benefits for their membership. Those benefits are often in the form of reduced fees charged for goods and services. Accordingly, in addition to assessment of the future operations consistent with those of marketplace participants when estimating the fair value of any business acquired, when estimating the fair value of an acquired mutual enterprise, the assumptions that marketplace participants would make about future member benefits also must be considered.

Current Accounting Environment

Small Business Advisory Committee Meeting

May 11, 2004

Discussion

Over the past several years, business has experienced several significant accounting changes due to Statement 133 (and its amendments) on derivatives and hedging, Statement 146 on costs associated with exit or disposal activities, FIN 46 on variable-interest entities, and Statement 150 on certain financial instruments with characteristics of both liabilities and equity, among others. As new types of transactions or events are created in the business world or if information needs change, the FASB is asked to react to situations in which the accounting in unclear. Therefore, standards continue to expand and are becoming more complex. Currently, significant proposed changes are in the pipeline relating to recognition of stock-based compensation, business combinations, fair value measurement, and other matters.

The FASB is responsible for setting accounting standards consistent with its conceptual framework. It focuses on general purpose financial reporting that is used by the capital markets for making investment and lending decisions. The Board understands that its decisions about the accounting requirements, effective date, transition, and perhaps even the scope of a project can, and should, be made with an understanding of the environment in which those decisions must be implemented.

Over the years, the Board, based on cost/benefit judgments, has provided different measurement, presentation, disclosure, effective date and transition requirements for nonpublic companies in some standards. Recent examples are:

1. The current Exposure Draft on “Share-Based Payment” which lets nonpublic companies account for equity based compensation awards using either their fair value on grant date or intrinsic value on each reporting date until the options are exercised or otherwise settled.

2. Statement No. 132 "Employer's Disclosures about Pensions and Other Postretirement Benefits," which has reduced disclosure requirements for nonpublic companies and an extended effective date for certain disclosures.

With this in mind, please be prepared to discuss the following issues and questions.

Questions for Committee Members

1. For preparers, do you have access to adequate information and training to enable you to understand and implement new standards? If not, what additional information and training is needed and who should provide it?

2. For auditors, do you have adequate information and training to enable you to provide consistent advice to your clients and to audit compliance with newly issued accounting standards? If not, what additional information and training is needed and who should provide it?

3. Recently, some have suggested that the FASB should consider whether different accounting standards should apply to small nonpublic companies and whether differential accounting and disclosure requirements should apply to small public companies. The Board believes that the objective of financial reporting is to provide information that investors and other users of financial statements find useful in making business and economic decisions. In meeting that objective, however, the Board recognizes that the benefits of the information provided by an accounting standard must exceed the costs of providing that information.

    a. For users of financial statements:
        i. Do your financial information needs relating to small businesses or nonpublic companies differ from those relating to large businesses? If so, how and why?
        ii. Do you have the ability to obtain information directly from small businesses, thereby reducing the need for disclosure in notes to financial statements (or potentially changing the perceived need to recognize certain assets and liabilities in the financial statements themselves)? If so, which disclosures or accounting requirements could be reduced or eliminated?

    b. For users, preparers, and auditors of financial statements:
        i. Do you believe that certain existing accounting requirements are too complex and should not be required (or be simplified) for small businesses? If so, what are those accounting pronouncements and why are they difficult or costly to apply?
        ii. Do you believe that certain existing disclosure requirements should be eliminated because they do not provide information needed by

financial statements users? If so, what are those disclosure requirements?

iii. Would the existence of a differential reporting regime impose costs on your organization? For example, would significant costs be incurred to monitor development of differing sets of accounting standards, or to convert from one accounting regime to another in the event of an initial public offering or other event that requires compliance with SEC rules and regulations?

4. Is the current pace and level of change in accounting standards too rapid? If so, what pace would be appropriate and why?

5. What are the major initial and ongoing costs for small businesses associated with new accounting standards and in what instances do the costs of improved financial reporting standards exceed the benefits for users of small business financial statements?

6. Are there particular financial reporting issues impacting small businesses that you believe the FASB should be addressing? If so, what are those issues and why are they important?