SMALL BUSINESS ADVISORY COMMITTEE
June 21, 2006 - - - - 9:00 A.M.
FASB Offices - - - - Norwalk, Connecticut

Agenda

1. Introductory Remarks (Mr. Batavick)	
2. Report of the FASB Chairman (Mr. Herz)	Mr. Herz will comment on Board activities not otherwise on the meeting agenda. (Attachment A)
3. Report from the SEC (Mr. Taub)	Mr. Taub will comment on accounting and related matters at the SEC.
4. Report from the PCAOB (Mr. Scates)	Mr. Scates will comment on Public Company Accounting Oversight Board matters.
5. Private Company Financial Reporting (Messrs. Batavick and Golden)	Committee members will discuss the Invitation to Comment, *Enhancing the Financial Accounting and Reporting Standard-Setting Process for Private Companies*. (Attachment B)
B R E A K	
6. Conceptual Framework (Messrs. Crooch and McBeth)	Committee members will discuss the measurement phase of this joint project with the IASB. (Attachment C)
7. Insurance Risk Transfer (Messrs. Crooch and Cropsey)	Committee members will discuss the Invitation to Comment, *Bifurcation of Insurance and Reinsurance Contracts for Financial Reporting*. (Attachment D)
L U N C H	
8. Financial Statement Presentation (Mr. Young and Ms. Petrone)	Committee members will discuss how certain of the working principles might be applied in categorization and display of financial statements. (Attachment E)
9. Lease Accounting (Ms. Zeyher)	The Committee will discuss issues the Board should consider in a potential project on lease accounting. (Attachment F)
10. Other Current Issues and Closing Remarks (Mr. Batavick)	Committee members will discuss any new issues that may require the Board's attention.
A D J O U R N M E N T	

SBAC MEETING
JUNE 21, 2006
FASB CHAIRMAN'S REPORT

- **TECHNICAL ACTIVITIES**
- **UPDATES ON:**
  - **SEC SMALL BUSINESS ADVISORY COMMITTEE**
  - **PRIVATE COMPANY REPORTING INITIATIVE**
  - **NOT-FOR-PROFIT INITIATIVE**
  - **CODIFICATION**

PRIVATE COMPANY FINANCIAL REPORTING

Small Business Advisory Committee
June 21, 2006

Background

The Financial Accounting Standards Board (FASB) and the American Institute of Certified Public Accountants (AICPA) have issued an Invitation to Comment, *Enhancing the Financial Accounting and Reporting Standard-Setting Process for Private Companies*, that describes a proposal intended to improve the financial reporting process for private company constituents. That Invitation to Comment (ITC) is attached separately.

The FASB and the AICPA are committed to exploring ways to enhance the value, transparency, and cost effectiveness of financial reporting for private companies. The proposal further reflects the mission of the FASB as the standard setter in the United States to establish and improve standards of financial accounting and reporting for both public and private companies.

Specifically, the proposal seeks constituent feedback on proposed enhancements to the FASB's standard-setting procedure that would determine whether the FASB Board should consider differences in accounting standards for private companies within generally accepted accounting principles (GAAP).

Summary of Proposed Changes

Paragraphs 16 to 29 of the ITC contain the joint proposal for enhancing the accounting standard-setting process. The proposal covers two broad areas:

- Enhancements to the FASB standard-setting process to ensure that the financial reporting needs of constituents of private companies are adequately addressed.
- The creation of a new committee whose mission is to provide recommendations that will help the FASB Board determine whether there should be differences in prospective and existing accounting standards for private companies.

Questions for Committee Members

We ask that SBAC members read the attached ITC and be prepared to discuss the following questions included in the "Issues for Respondents" section of the ITC:

1. Do you believe the proposal contained in paragraphs 16-29 will improve the accounting standard-setting process for private companies?

2. Specific to paragraphs 16-29, do you believe that the proposed changes will help ensure that the financial reporting needs of constituents of private companies are met?

3. The FASB and the AICPA believe that any differences in generally accepted accounting principles for private companies should be based on financial statement user needs and cost-benefit considerations. Do you agree?

4. The FASB and AICPA believe that members of the proposed committee (except the chair) should not be compensated beyond a reasonable reimbursement of expenses. Do you agree?

5. The FASB and the AICPA believe the committee should set its own agenda and priorities. Do you agree?

CONCEPTUAL FRAMEWORK PROJECT
Measurement Phase Plan

Small Business Advisory Committee
June 2006

INTRODUCTION

At the April joint meeting of the IASB and FASB, the Boards generally approved a plan for the measurement phase of the joint conceptual framework (CF) project. This paper explains the CF project team's goal for the measurement phase, summarizes the plan, takes a closer look at the measurement phase's first milestone, and discusses the interaction of the CF project and the Board's standard-setting activities during the measurement phase of the CF project.

GOAL OF THE MEASUREMENT PHASE

The Boards' current frameworks are nearly void of conceptual guidance on accounting measurement, providing only short lists of measurement bases used in the current mixed-attribute accounting model. The CF staff views the goal of the measurement phase of the CF project as filling that void by defining the various measurement bases, describing their strengths and weaknesses, and providing a conceptual foundation for determining where the measurement bases can provide the most useful information for various decision makers.

That goal is broad. It does not focus on any particular measurement basis. It is true that there are some who think fair value is the only relevant measurement basis. It is also true that the Board has studied fair value as part of its standard-setting activities and concluded that fair value is the most relevant measurement basis for financial instruments. (See attached Appendix for a summary of current projects related to measuring financial instruments at fair value.) However, the Board has not reached a similar conclusion in the broader context of all assets and liabilities.

The selection of an appropriate measurement basis is now and always will be done on a standard-by-standard basis. Whatever the Board concludes, the goal of the measurement phase of the CF project is to construct a measurement framework and guidance that will enhance the quality of the Board's decisions.

MEASUREMENT PHASE PLAN

The CF staff has defined three milestones or parts for the measurement phase, each with several issues to address. The first milestone focuses on measurement bases. Its purpose is to carefully identify, define, and describe measurement bases that are either currently used or proposed, as a foundation for the rest of the measurement phase. This milestone is currently under way and is expected to be completed by mid-2007. The purpose of the second milestone is to evaluate those measurement bases using a set of criteria that includes, but is not necessarily limited to, the qualitative characteristics of decision-useful information discussed in the initial phase of the CF project. The primary task of the third milestone is to derive conceptual conclusions from the results of the first two milestones and address practical issues of using the measurement bases. In addition, any miscellaneous measurement issues not addressed in the first two milestones will be discussed in the final milestone.

MEASUREMENT BASES

Measurement debates traditionally have been characterized in terms of historical cost versus current value and more recently as historical cost versus fair value. The staff thinks there are at least two reasons that such debates have never produced a consensus. The first reason is oversimplification; the second is miscommunication.

By oversimplification the staff means that historical cost and current value are not single measurement bases, but rather two families of measurement bases. The historical cost family includes original transaction price, original entry value, accumulated cost, allocated cost, amortized cost, and combinations of accumulated, allocated, and amortized costs. The properties of these historical cost variants, including the time dimension(s) to which they relate and the subjectivity or objectivity of their inputs, may affect the extent to which they satisfy the qualitative characteristics of decision-useful information in various settings. Therefore, understanding the nature and properties of those variants in the first part of the measurement phase is a precursor to evaluating historical cost variants in the second part of the phase.

Likewise, current value is not one measurement basis, but many, including current cash equivalent, replacement cost, reproduction cost, deprival value, entry value, exit value, at least two versions of fair value, net realizable value, and value in use. As is the case with historical cost variants, current value variants do not share all the same properties, may not stand up to evaluation by the qualitative characteristics in the same manner, and may not be equally suited for providing useful information in all settings.

By miscommunication, the CF staff means that some measurement bases have been given more than one label, and some labels have been used to refer to more than one measurement basis. For example, there are some who use the labels *net realizable value* and *exit value* (fair value less cost to sell) interchangeably. At the same time, the CF staff's early research has identified three different uses of the label *net realizable value,* two of which are not substitutes for *exit value.* The staff believes that confusion is created when measurement bases have more than one label, which may lead those who use the labels to think they agree or disagree with others' ideas when in fact they do not.

The CF staff thinks that taking the time to clearly define, describe, and understand the various historical cost and current value variants and to select one label for each variant may improve the quality of the measurement phase deliberations and the completed conceptual framework.

STANDARD SETTING DURING THE MEASUREMENT PHASE

Many constituents have asked questions about the relationship between the measurement phase of the CF project and standard setting, in terms of current projects that have important measurement implications as well as current standards that do not harmonize with the current frameworks. The CF staff thinks it is important to remember that the purpose of the CF project differs from the purpose of any standard-setting project. While the CF establishes broad concepts and ideals, individual standards projects are relatively narrower in scope and must address practical considerations, such as costs versus benefits. Also, the CF project is independent of any standard-setting project, although CF project activities may inform standard-setting projects and *vice versa.*

From its inception, the Board had to make decisions about measurement in its standards without the help of a framework. After work was completed on the original CF, the Board had the qualitative characteristics as a decision aid, but no substantive measurement guidance. Nevertheless, the Board continued to set standards and do the best it could.

During the measurement phase of the CF project, the Board will continue to work on standards as it has in the past, making decisions and exposing those decisions for comment. The staff believes that as the measurement phase progresses and improves, the Board’s decisions will be grounded in improved guidance. Once the CF project is finished, it will guide the Board in new standards projects.

QUESTIONS FOR COMMITTEE MEMBERS

1. Do Committee members have any questions, comments, or observations about the measurement phase of the CF project and the staff's plan for that phase?

2. The paper identified two measurement base families. The historical cost family includes: original transaction price, original entry value, accumulated cost, allocated cost, amortized cost, and combinations of accumulated, allocated, and amortized costs. The current value family includes: current cash equivalent, replacement cost, reproduction cost, deprival value, entry value, exit value, fair value, net realizable value and value in use.

   a. Do Committee members believe that there are measurement base families other than historical cost and current value? If so, please describe.

   b. Do Committee members believe that there are measurement bases not listed above? If so, please describe.

Summary of Current Projects Related to Measuring Financial Instruments at Fair Value

Attachment C on the measurement phase plan of the conceptual framework project describes a void in the existing conceptual framework—robust measurement concepts—and the steps the FASB and the IASB are taking to fill that void. Those steps include identifying and defining measurement bases and determining when use of those bases might provide decision-useful financial information.

That paper also explains that the void in the existing framework does not mean that the Board has not been thinking about measurement concepts and their application. Quite the contrary.

- At the conceptual level, the FASB considered how present value should be used for financial reporting, an effort that led to FASB Concepts Statement No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements*.

- At the standards level, the Board has comprehensively considered measurement issues in the specific context of financial instruments. It concluded in 1998 that the relevant measurement of financial instruments is fair value, a decision that has been affirmed several times.

The Board's conclusion about the relevance of fair value for financial instruments did not immediately result in a requirement to apply fair value to all financial instruments, however. Rather, changes in the accounting for financial instrument standards occurred following the tradition and past practice of bringing about incremental change over time.

The purpose of this paper is to explain the Boards' future plans for improving the existing standards of financial reporting for financial instruments and the role fair value might play in those improvements.

In October 2005, the FASB and the IASB agreed upon a long-term objective of requiring all financial instruments to be measured at fair value with realized and unrealized gains and losses recognized in the period in which they occur. Most members of both Boards have concluded that fair value is the most relevant measurement attribute for financial instruments. Some of those reasons are as follows:

- Fair value incorporates the current market assessment of the future, including the amount, timing, and uncertainty of future cash flows attributable to a financial instrument. Fair value information provides a benchmark measurement that users of financial statements may adjust to reflect their own expectations.

- Fair value reflects the collective assumptions and expectations of market participants rather than entity specific assumptions and expectations.

- Changes in fair values reflect the effects of changes in market conditions when they occur. Therefore, they reflect the effects of management decisions to buy, sell, incur, extinguish, or hold financial assets or financial liabilities on a timely basis

- Volatility in reported financial performance arising from changes in fair values of financial instruments reflects market volatility.

The Boards do not expect to be in a position to require fair value measurement of all financial instruments for several years. Among the issues that the Boards must resolve prior to requiring full fair value include: (1) which items should be subject to the requirement, (2) how to estimate fair value for financial instruments that are not traded in active markets, and (3) what information to present about past changes in fair value and exposures to future changes in market factors. The Boards are currently working toward resolving some of these issues and have a number of projects related to the objective of fair value measurement. Some of those projects are as follows:

1. Fair Value Measurements—The FASB expects to issue a final Statement on determining fair values in 2006. The IASB added this topic to its agenda in September 2005. The IASB expects to issue the FASB's final Statement on determining fair values as an IASB Exposure Draft together with an Invitation to Comment.

2. Fair Value Option—The IASB included in IAS 39 (as revised in December 2003) an option permitting an entity to designate at initial recognition any financial instrument to be remeasured at fair value, with changes in fair value included in profit or loss. The IASB included this option to simplify the application of IAS 39. In response to concerns raised by some constituents (particularly prudential supervisors of banks, securities companies, and insurers) that the option might be used

inappropriately, the IASB issued an amendment to IAS 39. That amendment imposed eligibility criteria that must be met before an entity can elect to apply the option. The IASB believes that the fair value option will enable constituents to become more familiar with using fair value as a measurement attribute for financial instruments. The FASB has an active project on its agenda to establish a fair value option. On June 19, the Board will hold a roundtable discussion with respondents to its January 25, 2006 Exposure Draft, *The Fair Value Option for Financial Assets and Financial Liabilities*. The Board expects to begin redeliberations on the Exposure Draft in July and issue a final Statement in the fourth quarter of 2006.

3. Presentation and Display of Changes in Fair Values of Financial Instruments and Scope Issues—The IASB and FASB have a joint research project to consider: (a) what information should be presented or disclosed about changes in fair values of financial instruments, (b) the definition of financial assets and financial liabilities, and (c) other scope issues such as which items other than financial instruments should be accounted for in the same manner as financial instruments.

4. Financial Statement Presentation—The IASB and FASB have a joint project to establish standards for presentation of information in financial statements to enhance the decision-usefulness of that information. The Boards believe that this project will assist in determining how fair values, and the changes in fair values, of financial instruments will be displayed.

In addition, the Boards also will consider issuing a financial instruments due process document by December 31, 2007 that will:

a. Describe the major issues in current accounting standards and practice related to financial instruments

b. Describe the Boards' long-term objectives with regard to accounting for financial instruments and the reasons that the Boards established those objectives

c. Present preliminary views on any individual issues on which a majority of the members of either Board have agreed, tentative conclusions supported by a significant minority of members of the Boards, and any other results of the Boards' deliberations that would aid constituents in preparing responses to the questions in the document

d. Ask constituents for their opinions about the issues and possible alternative resolutions that may have been identified, and to request suggestions from constituents about possible ways to achieve the Boards' long-term objectives with the least cost and disruption in practice

e. Demonstrate to constituents the interaction between the issues related to the long-term objectives for financial instruments and other projects the Boards are undertaking (such as the financial statement presentation project).

ATTACHMENT D

INVITATION TO COMMENT

Bifurcation of Insurance and Reinsurance Contracts Financial Reporting

Applies to Policyholders, Insurers, and Reinsurers

Small Business Advisory Committee
June 2006

OVERVIEW

On May 26, 2006, the FASB issued an Invitation to Comment, *Bifurcation of Insurance and Reinsurance Contracts for Financial Reporting,* (ITC) to gather input from the buyers and sellers of insurance and reinsurance contracts and the users of their financial statements about the possible bifurcation of those contracts. Bifurcation would divide some or all of these contracts into the following components for financial reporting purposes:

a. Components that transfer significant insurance risk and are accounted for as *insurance*—for policyholders (including noninsurance, insurance and reinsurance entities), that means premiums are expensed during the contract period and the occurrence of an insured event generates an insurance recovery that is recorded as a gain in the income statement.
b. Financing components that are accounted for as *deposits*—for policyholders, that means premiums paid are recorded as an asset by the policyholder and the recovery from an insured event is a reduction to the deposit with no income statement benefit.

The accounting by insurers (including reinsurers) is usually symmetrical to the policyholder accounting.

Of particular concern to the FASB is the depiction in the policyholder's financial statements of insurance contracts that transfer only limited insurance risk. These finite risk contracts often have both significant insurance components and significant financing components; but, in current practice, they typically are

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accounted for in their entirety as insurance contracts. Accounting for an entire contract as either insurance or financing—sometimes referred to as a pass-fail paradigm in the ITC—also places significant pressure on determining the minimum level of risk transfer that satisfies the significant risk transfer condition required for insurance contract accounting. An alternative to accounting for an entire contract as either insurance or financing would be to bifurcate that contract into insurance and financing components.

The threshold question is whether bifurcation would improve financial reporting by providing users of financial statements with better information about the economic substance of insurance arrangements than the information provided by the current accounting for these arrangements.

The ITC was issued as part of the risk transfer project and requests information about:

a. A working definition of insurance contract and insurance risk
b. Whether insurance and reinsurance contracts should be bifurcated into insurance and deposit components
c. If so, which insurance and reinsurance contracts would be bifurcated
d. If so, how would insurance and reinsurance contracts be bifurcated.

The ITC has been distributed separately to SBAC members in advance of this meeting. Comments on the ITC are due August 24, 2006 (a 90-day comment period). The ITC is a staff document that is intended to be a neutral discussion document. It does not address the accounting for the separate insurance components or deposit components nor is it intended to change current practice for accounting for insurance contracts. However, the issues addressed in the ITC could affect all entities that buy insurance (that is, all policyholders), all insurers, and all kinds and forms of insurance and reinsurance contracts.

BACKGROUND

The press has reported alleged abuses of the accounting for certain insurance (including reinsurance) contracts, often referred to as finite risk insurance contracts. Because finite risk insurance contracts typically contain terms or features that limit the amount of insurance risk transferred, those contracts also often include significant financing components. The extent to which insurance and reinsurance contracts transfer insurance risk and qualify for insurance accounting has been a significant financial reporting issue in recent restatements by several major insurance companies and at least one noninsurance company.

Assertions have been made that the reported misstatements were largely due to misapplication of the existing accounting guidance for risk transfer rather than to any inadequacy of that guidance. The contention is that the current principles-based guidance relies on judgment and that differences in judgment made in good faith should be expected and tolerated.

In April 2005, the Board added a project to its agenda to clarify the risk transfer conditions in FASB Statement No. 113, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts*. Those are the criteria used to determine whether a **reinsurance contract** (reinsurance is insurance for insurers) transfers significant insurance risk. Even if it has a significant financing component, a reinsurance contract that is determined to transfer significant insurance risk often is accounted for in its entirety as an insurance contract.

Statement 113 addresses only reinsurance contracts and there is no comparable risk transfer guidance for **insurance contracts**—although the Statement 113 guidance is sometimes analogized to in evaluating the transfer of insurance risk in insurance contracts. The lack of risk transfer guidance for insurance contracts is one of the Board's concerns in this project. In addition to addressing this concern and investigating bifurcation, the project is also exploring definitions for an insurance contract and related terms, revised wording for the Statement 113 risk transfer criteria, and enhanced display and disclosure requirements.

CURRENT ACCOUNTING FOR INSURANCE CONTRACTS

Insurance is the *indemnification* of a policyholder by an insurer against a loss or liability covered by an insurance contract. The notion of indemnification—that is, reimbursement for a loss—is included in paragraph 44 of FASB Statement No. 5, *Accounting for Contingencies*, and is central to U.S. GAAP (referred to as GAAP in the ITC and this summary) accounting for all insurance contracts. The pooling or spreading of risks is an important function of insurance companies—the pooling of risks and premiums from a large number of policyholders to pay the claims of the small number of those policyholders who suffer an insured loss. For example, for many individual insurance contracts such as personal auto or homeowners, neither the policyholder nor the insurer expects any claims during the contract term—the contract provides protection if an insured event occurs. On the other hand, the insurer expects claim losses on a portfolio of such contracts.

WORKING DEFINITIONS

The FASB has decided to use the definition of insurance contract in Appendix A of International Financial Reporting Standard (IFRS) 4, *Insurance Contracts*, as a working definition for the risk transfer project. That definition states:

> A contract under which one party (the insurer) accepts significant insurance risk from another party (the policyholder) by agreeing to compensate the policyholder if a specified uncertain future event (the insured event) adversely affects the policyholder. [Emphasis omitted.]

This definition is consistent with the ideas in paragraph 44 of Statement 5.

The IFRS 4 definition of insurance contract depends on a definition of significant *insurance risk*. Although IFRS 4 includes a definition of insurance risk, the ITC uses the GAAP definition of insurance risk in paragraph 121 of Statement 113:

> The risk arising from uncertainties about both (a) the ultimate amount of net cash flows from premiums, commissions, claims, and claim settlement expenses paid under a contract (often referred to as underwriting risk) and (b) the timing of the receipt and payment of those cash flows (often referred to as timing risk). Actual or imputed investment returns are not an element of insurance risk. Insurance risk is fortuitous—the possibility of adverse events occurring is outside the control of the insured.

Consistent with this definition, GAAP requires that an insurance or reinsurance contract transfer both underwriting risk and timing risk. Paragraph 9 of Statement 113 states that, for most property and liability insurance contracts, the transfer of significant insurance risk requires a greater than remote possibility of a significant variation in both the amount and the timing of payments by the reinsurer. Statement 113 also requires that, for reinsurance of both property and liability and life and health insurance contracts to qualify as transferring significant insurance risk, it be reasonably possible that the reinsurer incur a significant loss on the contract.

Although no commonly accepted definition exists for finite risk insurance or reinsurance contracts, they are often described as including features that limit the amount of insurance risk (both underwriting and timing) transferred from the policyholder to the insurer with the policyholder retaining a significant portion of that risk. Contract terms and features that can limit the transfer of insurance risk include the following:

a. Terms that result in the premium paid by the policyholder plus anticipated investment income earned by the insurer on that premium approximately equaling the reimbursements (including claim recoveries and any contract adjustments) expected by the policyholder from the insurer
b. Adjustable features that result in profit- and loss-sharing arrangements between the policyholder and the insurer

Contracts with such features are often determined to transfer significant insurance risk and, therefore, still qualify for insurance accounting in their entirety.

IF BIFURCATION, WHICH CONTRACTS?

If a bifurcation approach is adopted, the ITC suggests a sequential analysis applying four possible screens for determining which contracts should be bifurcated. The first three screens would sort identified contracts into four groups—those that:

a. Fail to meet the definition of insurance contract
b. Have negligible noninsurance features
c. Fail the Statement 113 risk-transfer guidance
d. Remain and could be subject to bifurcation.

The fourth screen would eliminate from bifurcation those remaining contracts with the presence or absence of specified contract terms or features. For example, the final screen might take a narrow approach and identify for bifurcation only those contracts that are determined to have significant financing components (in addition to significant insurance components). Alternatively, a broad approach might require bifurcation for all the remaining insurance contracts—that is, those contracts not exempted by the first three screens. The flow chart in Appendix A illustrates the steps in this analysis. Two approaches to the fourth screen—a narrow approach focusing on finite risk contracts (Approach A) and a broad approach including all remaining contracts not otherwise screened out (Approach B)—are discussed in the ITC (paragraphs 62–69).

IF BIFURCATION, WHAT METHOD?

If a bifurcation approach is adopted and the population of contracts subject to bifurcation is identified, an appropriate bifurcation method would need to be selected. Three methods are discussed in the ITC. The *expected payout method* views a portion of the insurance premium as a prepayment of claim payments by the insured. That portion of the contract could be accounted for as simply financing those payments. The *proportional method*—an effectiveness method—is based on the notion that a mathematical measure of the risk retained by the policyholder could be applied to a contract's cash flows to determine the financing component of the insurance contract. Finally, the *cash flow yield* *method* is based on the notion that the insurance contract's cash flows could be divided into cash flows that provide a return equivalent to the interest rate on a loan and cash flows that produce a yield in excess of the interest rate on a loan. The cash flow elements related to the interest rate on a loan would be accounted for as a financing and the remainder as insurance. Each of these methods would require significant research to assess feasibility and operationality.

Mathematical models using historical data often would be needed to bifurcate insurance and reinsurance contracts. Concern has been expressed that the available data for insurance exposures are not sufficient to develop the necessary model parameters and, therefore, that results based on those models will not be reliable.

CONVERGENCE

The International Accounting Standards Board currently has an insurance contracts project on its agenda. Phase I of that project resulted in the issuance of IFRS 4 in March 2004. However, IFRS 4 simply grandfathered most national accounting guidance for insurance and reinsurance contracts and left the development of that contract accounting guidance to Phase II. IFRS 4 also does not address accounting for insurance contracts by noninsurance entity policyholders. The insurance contracts project is now in phase II and policyholder accounting is not likely to be reviewed until later in that phase.

Although the FASB is not currently participating in the IASB's phase II project, the IASB and FASB have agreed to approach that project on the modified joint approach. Under that approach, the IASB will issue for public comment a Discussion Paper containing its tentative decisions on the accounting for insurance contracts. The FASB plans to seek input from its constituents on the IASB's preliminary views by issuing an Invitation to Comment containing the IASB Discussion Paper. The feedback received on that Invitation to Comment will be used by the FASB in deciding whether to add to its agenda a joint project with the IASB to develop a comprehensive standard on accounting for insurance contracts. As of April 1, 2006, the IASB Discussion Paper is scheduled to be issued in the fourth quarter of 2006. An FASB Invitation to Comment would be issued after its release. The FASB has not yet decided on the timing of that publication.

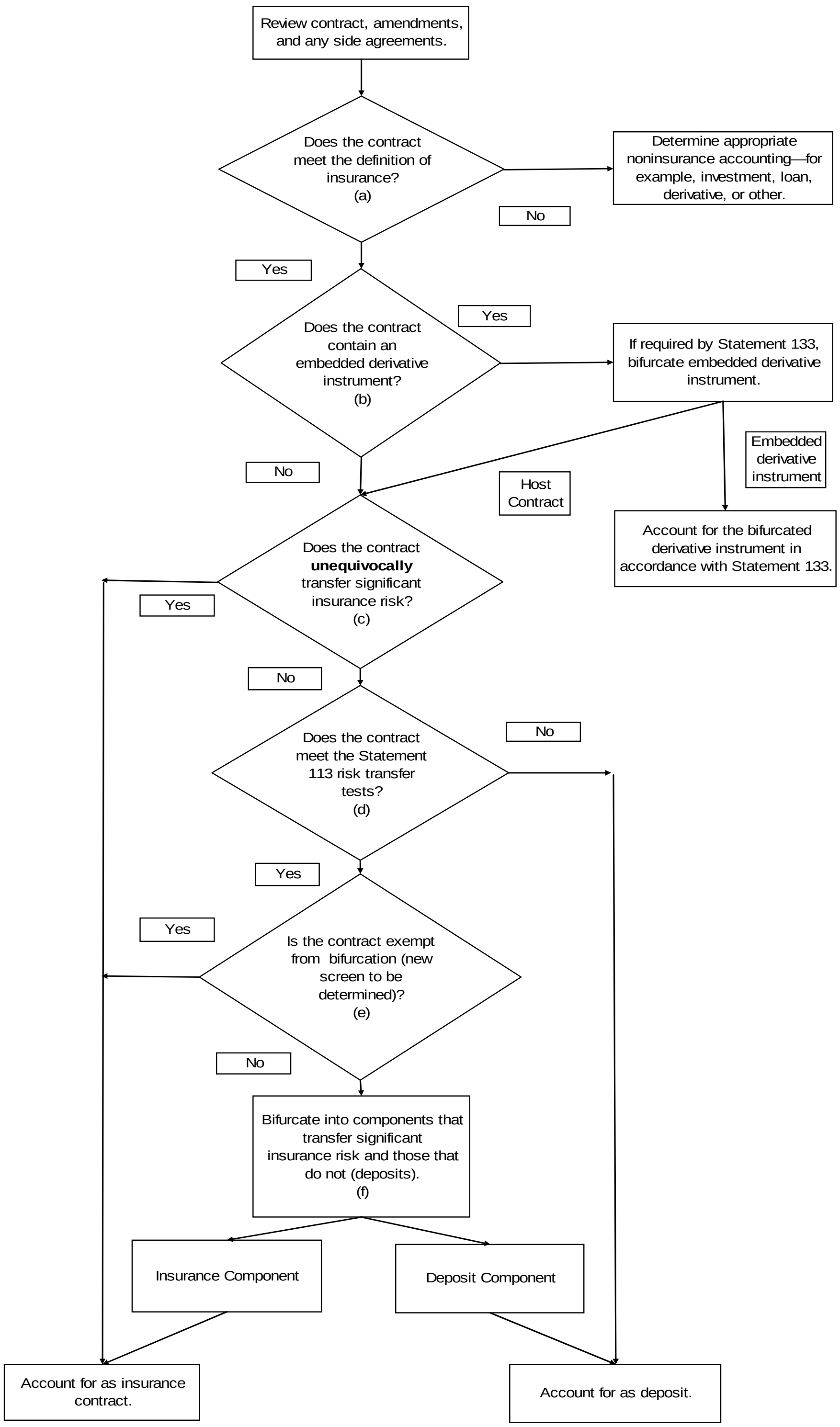
QUESTION FOR COMMITTEE MEMBERS

The following question is presented for discussion:

> Does classifying an entire contract as insurance or bifurcating that contract into insurance and deposit components provide more understandable and decision-useful information? Why? Which approach more faithfully represents the economic substance of the contract? Why?

APPENDIX A

Risk Transfer and Bifurcation Testing



Note: The letters in parenthesis refer to descriptions in paragraph 56 of the Invitation to Comment.

ATTACHMENT E

FINANCIAL STATEMENT PRESENTATION

SMALL BUSINESS ADVISORY COMMITTEE
June 2006

INTRODUCTION

The financial statement presentation project (formerly financial performance reporting project) is a joint project with the IASB. The project is being conducted in three phases.

- Phase A addresses what constitutes a complete set of financial statements and requirements to present comparative information. The Boards have completed their initial deliberations on the issues in Phase A (refer to the FASB website, www.fasb.org, for information about decisions made).

- Phase B addresses the fundamental issues of presentation of information on the face of the financial statements; the Boards are currently deliberating issues in this Phase.

- Phase C will address presentation and display of interim financial information in U.S. GAAP and will reconsider the requirements in IAS 34, *Interim Financial Reporting.* Work on Phase C topics will commence during the latter portion of Phase B.

At the June SBAC meeting, the Board would like to discuss Phase B issues that it will deliberate in mid-July.

SCOPE AND OBJECTIVE OF PROJECT

In April 2006, the FASB (and the IASB) affirmed the scope and objective of this joint project and agreed to change the title of the project to more fully describe the project's scope. In brief, the project will address the organization and presentation of financial information on the face of each financial statement that is included in a complete set of financial statements. The project will not include a comprehensive review of the notes to the financial statements. The resulting standard will apply to all business entities; however, the Board will consider whether there should be different presentation provisions for financial institutions.

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The Boards agreed that the project was undertaken to establish a common, high-quality standard for presentation of information in the financial statements, including the classification and display of line items and the aggregation of line items into subtotals and totals. The objective of that standard would be to present information in the individual financial statements (and among the financial statements) in ways that improve the ability of investors, creditors, and other financial statement users to:

1. Understand an entity's present and past financial position.
2. Understand the past operating, financing, and other activities that caused an entity's financial position to change and the components of those changes.
3. Use financial statement information (along with information from other sources) to assess the amounts, timing, and uncertainty of an entity's future cash flows.

PHASE B: WORKING PRINCIPLES

In April the Boards also agreed to the following working principles that will be the basis for their decisions on this project. (The Boards expect that the working principles will be revised and further developed as the project progresses.)

Financial statements should present information in a manner that:

1. Portrays a cohesive financial picture of an entity.
2. Allows for comparability over time.
3. Allows for comparability across entities.
4. Helps a user assess the liquidity of an entity's assets and liabilities (nearness to cash or time to conversion to cash).
5. Separates an entity's financing activities from its operating and other activities and further separates financing activities into transactions with owners in their capacity as owners and all other financing activities.
6. Helps a user understand:
    a. The measurement attributes used to measure assets and liabilities.
    b. The relative dispersion of the measurements of individual assets and liabilities.

c. What causes a change in reported amounts of individual assets and liabilities (such as transactions or remeasurements).

7. Disaggregates items into groups that respond similarly to changes in the same economic condition, and presents subtotals and totals where appropriate.

Application of the Working Principles

In May, the staff held working sessions with two small groups of FASB and IASB Board member advisors to discuss application of the working principles and possible ways information could be categorized and displayed in the financial statements. The balance of this paper describes some of those possibilities; it does not address all of the working principles.

Similar categories on the financial statements

The first working principle states that *financial statements should present information in a manner that portrays a cohesive financial picture of an entity*. That working principle implies that the financial statements should be presented in a way that interrelationships between financial statements are easily understood—in other words, any relationship between items on different financial statements (such as the income statement and the cash flow statement) should be clear. Application of this working principle should result in a set of financial statements that are as complementary as possible.

The fifth working principle states that *financial statements should present information in a manner that separates an entity's financing activities from its operating and other activities and further separates financing activities into transactions with owners in their capacity as owners and all other financing activities.* Combining the first and fifth working principle could result in each of the financial statements having a financing and an operating category. The following exhibit (Exhibit 1) illustrates at a very high level what each of the financial statements (except the statement of changes in equity) might look like. For illustrative purposes, the exhibit presumes that the financing category is defined and items that do not meet that definition are reported together in a single, residual operating category. If the Boards pursue this categorization scheme, they will need to address how the financing category should be defined (not an easy task) and whether more than two categories are needed. Shading and **bold**/***italic*** font are used to highlight the relationship between the financial statements.

Exhibit 1

Statement of Earnings and Comprehensive Income

	2005	**2004**	**2003**
Operating profit	165	150	130
Financing expenses	**30**	**30**	**30**
Profit/loss	***135***	***120***	***100***

Statement of Cash flows

	2005	**2004**	**2003**
Operating cash flow	150	140	130
Debt financing cash flow	**30**	**30**	**30**
Equity financing cash flow	***75***	***70***	***65***
Change in cash	45	40	35

Statement of Financial Position

	2005	**2004**	**2003**
Operating assets and liabilities	600	550	500
	600	550	500
Financing liabilities (debt)	**300**	**300**	**300**
Equity	***300***	***250***	***200***
	600	550	500

As illustrated above, assets and liabilities would no longer be grouped using a current/noncurrent categorization scheme; rather, operating assets **and** liabilities would be shown in the same section, while financing liabilities would be in a separate section as would equity items. Because the third working principle states that *financial statements should present information in a manner that helps a user assess the liquidity of an entity's assets and liabilities,* assets and liabilities might be presented in order of liquidity within each category.

Questions for Committee Members

1. If you are a user of financial statements, would a categorization scheme similar to the one illustrated in Exhibit 1 make analysis of the financial statements easier? If yes, why? If no, why not and what alternative presentation would you suggest?

2. If you are a preparer of financial statements, would a categorization scheme similar to the one illustrated in Exhibit 1 facilitate the communication between management and investors—that is, would it help you better explain your business and financial picture to investors? What costs (except for initial transition costs) do you envision this categorization scheme would add to your current financial statement preparation costs?

3. If you are a user of financial statements, if, as part of this categorization scheme, assets and liabilities were presented in order of liquidity within each category, would that meet your needs for financial analysis or would you lose information that is currently available on the statement of financial position?

4. A similar categorization scheme in the complete set of financial statements is being pursued with the goal of providing users with a better understanding of the relationship between items on the various financial statements. Does the illustrated categorization scheme appear to be moving in the right direction? If not, what other categorization or presentation scheme would you suggest?

Disaggregation of information

The seventh working principle states that *items should be disaggregated into groups that respond similarly to changes in the same economic condition, and present subtotals and totals where appropriate.* Numerous disaggregation schemes were discussed at the working sessions, including presentation by function or nature, differentiating between fixed and variable costs, and presenting items on either a gross or net basis. While not all of those disaggregate schemes follow from the working principle, presentation of information based on function or nature does.

Most entities typically present expenses by function rather than by nature. However, the CFA Institute's Centre for Financial Market Integrity October 2005 draft paper, *A Comprehensive Business Reporting Model*, recommends that individual line items be reported based on the nature of the items rather than the function for which they are used. Reporting information based on its nature would aggregate "like" expenses such as depreciation, material costs, transportation costs, employee benefits, and advertising costs; it would not allocate those expenses to the various functions of the entity (such as cost of sales). An example of each disaggregation scheme can be found below (Exhibit 2).

Exhibit 2

Presentation by Function

Revenue	X
Cost of sales	(X)
Gross profit	*X*
Other income	X
Distribution costs	(X)
Administrative expenses	(X)
Other expenses	(X)
Profit	**X**

Presentation by Nature

Revenue		X
Other income		X
Changes in inventories of finished goods and work in progress	X	
Raw materials and consumables used	X	
Employee benefits costs	X	
Depreciation and amortization expense	X	
Other expenses	X	
Total expenses		*(X)*
Profit		**X**

Those who support reporting individual line items by nature note that it is important to understand the forces at work that can increase or decrease the value of an entity or impact its future profitability. When information is reported based on the function for which a resource is consumed, unlike items are aggregated which results in information loss, and that loss is said to reduce predictive power and analytical value.

However, others will argue that reporting information based on function provides useful information about the allocation of resources to the various activities (functions) of an entity, thus allowing users to understand and predict the relationship between revenues and other expenses.

For users of financial statements to forecast future earnings, they need to have information grouped in such a way that they can apply their assumption about a future economic event (that will impact earnings) to only those items in the financial statements that would be impacted by that event. For example, cost information relating to raw material, labor, transportation, and distribution generally is grouped into a single line item (cost of sales or COS). While that grouping has some value in determining if the revenue generated from the sale of the items covers the cost, the grouping has little value to an investor or creditor in estimating what COS will be in the future.

To estimate the future amount of COS, an investor needs to understand the components that make up COS because those components are affected by things in different ways. For example, labor costs may be affected by the number of employees and the cost of living, but transportation costs may be affected by the price of gas or oil or even a railroad strike. If the financial statements include a break-down of costs of sales, an investor will no longer have to guess how assumptions about the number of employees or the price of gas affect certain expenses.

Questions for Committee Members

5. How important is the reporting format (nature or function) to communicating an entity's financial picture? Should one format be required or should entities be permitted to use the format that best presents their financial picture?

6. If you believe income statement items should be required to be presented by **function**, what information, if any, should be reported by nature (either in the notes to the financial statements or as a secondary classification scheme on the income statement)?

7. If you believe income statement items should be required to be presented by **nature**, what information, if any, should be reported by function (either in the notes to the financial statements or as a secondary classification scheme on the income statement)?

ATTACHMENT F

LEASE ACCOUNTING

Small Business Advisory Committee
June 21, 2006

PURPOSE

In July 2006, the FASB plans to decide whether to add to its agenda a project to comprehensively reconsider the existing accounting for leases (FASB Statement No. 13, *Accounting for Leases*, and related literature). The Board plans to conduct such a project, if undertaken, jointly with the IASB.

The purpose of the June 21, 2006, SBAC meeting is to discuss with Committee members specific issues that should be considered in such a project from the perspective of preparers, auditors, and users of financial statements of small businesses.

BACKGROUND

In late 2005, the staff began pre-agenda research work associated with a possible project on accounting for leases that might amend or replace Statement 13. The Board's direction to the staff was in response to the criticisms of Statement 13 by many of its constituents, including FASAC, the UAC, and the SEC's 2005 *Report and Recommendations Pursuant to Section 401(c) of the Sarbanes-Oxley Act of 2002 On Arrangements with Off-Balance Sheet Implications, Special Purpose Entities, and Transparency of Filings by Issuers* (Off-Balance Sheet Report). Also, in June 2004, the IASB and the FASB agreed that accounting for leases was in need of an overhaul and that improvements should be made through a major project conducted jointly when resources permitted.

Statement 13 was issued in 1976 and provides guidance on accounting for leases by both lessors and lessees. The provisions of Statement 13 derive from the view that a lease that transfers substantially all of the benefits and risks incident to the ownership of property should be accounted for as the acquisition of an asset and the incurrence of a liability by the lessee and as a sale or financing by the lessor. Under Statement 13, a lease that does not transfer substantially all of the benefits and risks incident to the ownership of property is classified as an operating lease by the lessee. Operating lease classification results in the lessee not recognizing any elements of the lease on its balance sheet (that is, no asset for the right to use the asset and no related liability for the future lease payments).

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Note: These materials are provided to facilitate understanding of the issues to be addressed at the June 21, 2006 SBAC meeting. 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.

Following the issuance of Statement 13, the FASB, EITF, SEC, and AICPA issued numerous pieces of guidance addressing various issues relating to the application of Statement 13. That additional guidance is viewed by some as adding to the complexity of existing guidance in this area.

Standard-setting activity during the past 20 years has not been limited to merely interpreting the leasing approach in Statement 13. For example, a group of international standards setters (including FASB representatives), referred to as the G4+1, undertook an effort to rethink the accounting for leases based on the existing conceptual framework. The efforts of that group resulted in the issuance of two Special Reports (*Accounting for Leases: A New Approach*, and *Leases: Implementation of a New Approach*) describing a proposed conceptual approach to lease accounting. The focus of that approach was accounting for the fundamental components of lease transactions. The FASB issued the second of those Special Reports for public comment in 2000.

Recent Criticisms of Existing Standards

Many have criticized the existing lease accounting standards. The most common of those criticisms follow.

1. The current "all-or-nothing" lease accounting guidance is not designed to reflect the wide continuum of lease arrangements that are used, and, therefore, it cannot transparently and consistently reflect the varying economics of the underlying arrangements.
2. Sophisticated users, such as credit-rating agencies, often adjust balance sheets in their work so they can analyze companies as if all leases were reflected on the balance sheet.
3. The lease accounting standards rely extensively on bright lines, greatly increasing the potential for similar arrangements to be portrayed very differently; the bright-line tests permit structuring of leases to obtain particular financial reporting goals. The extensive restructuring further erodes the effectiveness of the standards.

An extrapolation of the findings from the sample of issuers in the SEC's Off-Balance Sheet Report to the approximate population of active U.S. issuers suggests that there may be approximately $1.25 trillion (undiscounted) in noncancelable future cash obligations committed under operating leases that are not recognized on issuer balance sheets, but that are instead disclosed in the notes to the financial statements.

In a 2005 FASAC survey, Council members identified the accounting for leases as one of the top five areas the Board should focus on. Council members also ranked leases second in priority of the five specific standard-setting recommendations made by the SEC staff in its Off-Balance Sheet Report.

Current Direction of the IASB and the FASB

At a joint meeting in April 2006, the IASB and FASB Boards held a preliminary discussion on whether to add a project on leases to their agendas. Both Boards broadly supported the proposal and agreed that a joint leasing project would be preferable.

Because accounting thinking has evolved since Statement 13 was issued (it was developed and issued before the existing conceptual framework), some believe the best approach to improving financial reporting in this area would be to undertake a comprehensive project that starts with a clean sheet of paper. The clean-sheet-of-paper approach is consistent with the FASB's objectives—improvement and simplification of U.S. GAAP by principles-based standards grounded in the conceptual framework and convergence of accounting standards internationally.

Given the significance of the changes that are anticipated, the staff does not think it would be appropriate to move directly to an Exposure Draft. Instead, the staff proposes to develop a discussion paper that the IASB and the FASB would issue jointly (no earlier than 2007). The Boards plan to make an agenda decision in July 2006.

POSSIBLE APPROACH

The conceptual approach to leasing developed by the G4+1 derives from the view that lease contracts convey "rights of use" to a lessee that meet the financial reporting definition of an asset. Under that view, the lessor is deemed to have performed under the contract when it delivers the property (or access to it) to the lessee. Once performance has occurred, the lessee would record an asset representing its right to use the asset over its lease term and an obligation to pay for that right. Said differently, leases that are currently characterized as operating leases (and therefore not included on the balance sheet) would give rise to assets and liabilities under this view—but only to the extent of the fair values of the rights and obligations that are conveyed by the lease. The example below is a highly simplified description of the above approach. (The Boards will need to consider many other items such as scope, renewal options, residual values, etc., that are not discussed in this paper.)

EXAMPLE

Lessee

A lessee agrees to lease equipment for 3 years at an annual rental of $5,000. At the end of the lease term, the lessee is to return the equipment to the lessor.

The lessee's rights and obligations can be analyzed as:

1. The right to use the equipment for three years

2. The obligation to pay $5,000 per year for 3 years

3. The obligation to return the equipment to the lessor at the end of three years.

Under the approach discussed above, when the equipment is delivered to the lessee, the lessee should recognize an asset and a liability and measure them at fair value (which would be estimated by the present value of the three annual payments). The liability is the present obligation incurred under the lease contract. The asset represents the fair value of the right to use the equipment for three years only—the lessee controls the usage rights for that period and does not have any rights to the equipment beyond the end of the lease term.

Under current authoritative guidance, if the above lease were classified as an operating lease, there would be no asset or liability on the balance sheet, but rather those leases would be off-balance sheet and only disclosed in the footnotes. The staff has been told that many users often adjust financial information reported by lessees to produce results that are similar to that described above. That is, they adjust reported balance sheets to include their estimate of the “right to use” asset and associated debt-like obligations that they believe arise from operating leases. The staff is interested in understanding from Committee members who are users of financial statements how they consider operating leases in their analyses of financial statements of small business enterprises.

Lessor

Under the G4+1 conceptual approach, the lessor’s rights and obligations would be analyzed as:

1. The right to collect the lease payments ($5,000 per year for 3 years)

2. The right to the return of the equipment at the end of three years.

At the inception of the lease, the change in the nature of the lessor’s asset as a result of entering into the lease would be reflected in the balance sheet by changing its classification. That is, part of the lessor’s existing asset (the equipment) would be replaced by a financial asset (a receivable) that would be recognized and measured at fair value (estimated by the present value of the three rental payments). The residual value of the equipment (assume $3,000 for this example) would remain on the lessor’s balance sheet as equipment as it represents the rights to the economic benefits inherent in the equipment at the end of the lease; that is, the future cash flows obtainable from selling, reletting, or using the equipment. The accounting treatment would reflect a sale by the lessor to the lessee of an economic interest in the equipment, with the consideration being receivable in installments from the lessee.

Balance Sheet Implications

Lessor (current guidance)	Lessor (possible new approach)	Lessee (current guidance)	Lessee (possible new approach)
Assets: Equipment leased to others $18,000	Assets: Receivable from lessee $15,000 Equipment—Residual value $3,000	No impact on balance sheet	Assets: Leased equipment $15,000
			Liabilities: Obligation to lessor $15,000

QUESTIONS FOR COMMITTEE MEMBERS

1. How do Committee members who are users of financial statements prepared by small business enterprises consider operating and capital leases in their analyses? Do they view leases as giving rise to “debt-like” obligations that should be reported in the statement of financial position?
2. What types of assets do small business enterprises lease and why? Are there specific issues arising from those lease transactions that Board members should consider in a project to revisit the accounting for them?