SMALL BUSINESS ADVISORY COMMITTEE

November 30, 2005 - - - - 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 and *The FASB Report*)
3. Private and Smaller Public Company Reporting (Mr. Batavick)	Mr. Batavick will report on private and smaller public company financial reporting initiatives.
4. Increasing User Involvement (Mr. Young)	Mr. Young will report on the Board's initiatives to increase user involvement in standard setting.
5. Report from the SEC (Ms. Minke-Girard)	Ms. Minke-Girard will comment on accounting and related matters at the SEC.
6. Report from the PCAOB (Mr. Fletcher)	Mr. Fletcher will comment on Public Company Accounting Oversight Board matters.
7. Assets and Liabilities with Uncertainties (Mr. McBeth)	Committee members will discuss the Board's Invitation to Comment, *Selected Issues Relating to Assets and Liabilities with Uncertainties*. (Attachment B)
B R E A K	
8. Uncertain Tax Positions (Messrs. Trott and Thomas)	Committee members will discuss the Board's project on uncertain tax positions. (Attachment C)
9. Conceptual Framework (Mr. Bullen)	Committee members will discuss whether the objectives of financial reporting and the qualitative characteristics of accounting information should differ for particular types of entities. (Attachment D)
L U N C H	
10. Postretirement Benefit Obligations, Including Pensions (Mr. Proestakes)	Committee members will discuss the scope of the Board's project on pensions and other postretirement benefits. (Attachment E)

11.	Closed Session on Complexity (Messrs. Herz and Golden)	Committee members will discuss complexity in the financial reporting system.
12.	Closed Administrative Session (Mr. Batavick)	Committee members will discuss administrative matters pertaining to the SBAC.

A D J O U R N M E N T

SBAC MEETING
NOVEMBER 30, 2005
FASB CHAIRMAN'S REPORT

- **TECHNICAL ACTIVITIES**
- **PRIVATE COMPANY REPORTING**

INVITATION TO COMMENT
Selected Issues Relating to Assets and Liabilities with Uncertainties

Small Business Advisory Committee
November 2005

BACKGROUND

FASB Statement No. 5, *Accounting for Contingencies,* is the general standard governing U.S. accounting for assets and liabilities for which there are uncertainties about the amount or timing of cash flows that extend beyond the uncertainty associated with general business risks. The FASB issued Statement 5 in 1975; it therefore preceded the original conceptual framework project. When the Board published Concepts Statement No. 6, *Elements of Financial Statements,* in 1985, it made no mention of any inconsistency between Statement 5 and the framework.

Since then, the Board's composition has changed, and the way the Board thinks about probability and uncertainty has changed, too. In the last five years, those changes in thinking have been reflected in the most recent Concepts Statement, created a tension between that Concept Statement and Statement 5, and resulted in interpretations of the application of Statement 5 to certain liabilities.

The change in thinking was first formally reflected in 2000 with the issuance of FASB Concepts Statement No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements*. Concepts Statement 7 discussed the difference in meaning between *probable* as used in the framework and *probable* as used in Statement 5. It also implied that Statement 5 did not apply to a liability measured at fair value.

FASB Statement No. 143, *Accounting for Asset Retirement Obligations,* issued in 2001, made the Concepts Statement 7 implication explicit. Statement 143 required AROs to be initially measured at fair value and determined that the probability recognition criterion of Statement 5 did not apply to AROs. FASB Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others,* published in 2002, clarified that some liabilities have two components, an unconditional obligation and a contingent or conditional obligation. Interpretation 45 required the unconditional component of financial guarantees to be measured at fair value and omitted the probability recognition criterion of Statement 5 with respect to them. Finally, FASB Interpretation No. 47, *Accounting for Conditional Asset Retirement Obligations,* issued earlier this year, clarified that fair value measurement and omission of Statement 5's probability recognition criterion applied to AROs whose amount or timing of settlement were conditional on future events.

As the current conceptual framework project is a joint effort, the IASB's views on probability and uncertainty are important as well. In 1998, before the above pronouncements were issued, the IASC (the predecessor organization to the IASB) released IAS 37, *Provisions, Contingent Liabilities and Contingent Assets,* the principal counterpart to Statement 5. While the two standards are not identical, their approach to probability and uncertainty is basically the same (that is, probability and uncertainty are recognition considerations). In June 2005, the IASB issued an Exposure Draft, *Amendments to IAS 37* Provisions, Contingent Liabilities and Contingent Assets, *and IAS 19,* Employee Benefits. If the IASB adopts its proposed amendments, IAS 37 will substantially converge with the FASB's recent standards that have shifted the role of probability and uncertainty from recognition to measurement. However, adoption of the amendments will also create divergence because IAS 37 will apply to all nonfinancial liabilities not covered by some other specific IASB standard, extending the newer thinking about probability and uncertainty to liabilities beyond the scope of the FASB's recent standards.

In September 2005 the FASB issued an Invitation to Comment, *Selected Issues Relating to Assets and Liabilities with Uncertainties* (ITC). (The ITC has been distributed separately to SBAC members in advance of this meeting.) The ITC's principal purpose is to obtain input for the next phase of the Board's joint conceptual framework project with the IASB. That phase will revisit issues surrounding the elements of financial statements, including the role of probability and uncertainty in defining, recognizing, and measuring assets and liabilities. The changes that the FASB has made and that the IASB is proposing create conceptual conflicts among the frameworks and standards of both Boards that will be addressed as part of the conceptual framework project.

COMPARING OLD AND NEW APPROACHES

The current conceptual framework divides the process of incorporating an item into financial statements into two stages, recognition and measurement. The recognition stage for assets and liabilities subjects an item to four criteria. To be recognized as a financial statement element, an item must (1) meet the definition of one of the financial statement elements and have an attribute that is (2) measurable, (3) relevant, and (4) reliable. In the context of liabilities, if an obligation meets the definition of a liability and has a measurable attribute that is both relevant and reliable, then it meets the recognition criteria and passes to the measurement stage. The task in the measurement stage is to find a method of measuring the chosen attribute that will result in a relevant and faithful representation of the liability in the financial statements.

The FASB's recent approach to probability and uncertainty and the IASB's Exposure Draft proposals relate to the two stages of financial statement incorporation in a different manner than Statement 5 and IAS 37. The older approach focuses more on the recognition stage and assigns the probability and uncertainty of contingent events a role in that stage in the form of a probability criterion that must be met in addition to the four criteria in the conceptual framework. The new approach focuses more on the definition criterion in the recognition stage and shifts the role of probability and uncertainty from the recognition stage to the measurement stage.

An example illustrates the differences in the two approaches. Consider the case of an entity that manufactures a new product for the retail market. As part of the price paid for the product, the entity also provides customers a three-year warranty to repair any defects that appear during that period. Statement 5 and IAS 37 assume an obligation has been identified that meets the definition of a liability (warranty liability), but gloss over the precise nature of that liability. The recognition stage focuses on the contingent event (warranty claim) and subjects it to the additional probability criterion. Statement 5 and IAS 37 require recognition of a warranty loss or a warranty liability, respectively, if it is *probable* that customers will make warranty claims for products still under warranty at a financial statement date and the amount of the claims can be reasonably estimated.

Probable is not precisely defined in either standard, but is equated with likely or highly likely in Statement 5 (that is, much greater than a 50 percent probability) and more likely than not in IAS 37 (that is, at least a 50 percent probability). Therefore, whether the entity recognizes a warranty liability will depend on a forecast of future claims, the unit of account chosen for the forecast, the entity's interpretation of *probable,* and whether Statement 5 or IAS 37 applies. A large liability with a low probability could escape recognition while a small liability with a high probability would not.

The new approach differs conceptually from the old approach in that the definition criterion in the recognition stage is emphasized, and probability and uncertainty are considered as part of measurement rather than in a separate recognition criterion. In the definition step of recognition, the contract (warranty agreement) is analyzed to identify all obligations. In the case of the entity's new product warranty, two obligations exist. The more obvious is the entity's conditional obligation to repair its product under warranty if it fails to operate properly and the customer requests a repair. Because the obligating event (legitimate warranty claim) resides in the future (or may not occur at all) this conditional obligation does not meet the definition of a liability. The less obvious obligation, the one assumed by Statement 5 and IAS 37 but not carefully considered, is the entity's unconditional obligation to stand ready to fulfill the associated conditional repair obligation. This obligation satisfies all the components of the liability definition and becomes effective when the warranty agreement is signed. Furthermore, the unconditional warranty obligation to provide warranty coverage (to stand ready to make repairs) is like that of an insurance contract: even if a particular product develops a defect and is repaired under the warranty, the entity is still obligated to cover the product for future possible defects until the warranty period expires.

In the new approach, only the unconditional obligation qualifies as a liability and is tested against the remaining recognition criteria of the conceptual framework. There is no probability criterion in the recognition stage. If the remaining recognition criteria are met, the liability enters the measurement stage.

It is in the measurement stage that the new approach considers probability and uncertainty. It does so by incorporating the probability and uncertainty surrounding the conditional repair obligation into the measurement of the unconditional warranty coverage obligation. The measurement attribute used in newer FASB standards is fair value, while that in the IASB Exposure Draft is the amount that would be required to currently settle the liability or transfer it to a third party. (This sounds like fair value. However, the IASB has yet to define or adopt fair value.) Both the FASB and IASB attributes depend on the concept that a market price for an unconditional stand ready obligation will automatically impound the risks and uncertainties of the associated conditional obligation. When estimates must be used rather than observed prices, an expected value approach can be used that takes into account the probabilities of various settlement outcomes.

Both FASB and IASB staffs favor the new approach to probability and uncertainty because its orientation toward measurement rather than recognition focuses attention on the easily overlooked unconditional obligation that meets the definition of a liability instead of the readily apparent associated conditional obligation that does not qualify as a liability. This focus may be expected to reduce omission of legitimate present liabilities and the inclusion of estimates of future liabilities in current financial statements.

QUESTIONS FOR COMMITTEE MEMBERS

The following questions are presented for discussion:

1. The liabilities that the FASB and IASB staffs have identified in the new approach to probability and uncertainty have all been described as having both unconditional and conditional aspects or components. The Boards have found the unconditional-conditional model of analysis helpful in understanding the nature of these liabilities. Do you agree? If not, why not? Is there something missing from the analysis?

2. Adopting the new approach would likely result in earlier recognition of more liabilities. Disregarding challenges in implementing fair value measurement, is it more decision-useful to recognize liabilities that may have a low probability of a large future sacrifice of resources? Why or why not?

If the new approach to liabilities with uncertainties were adopted, do you think additional financial statement information about those liabilities would be helpful? If so, what?

UNCERTAIN TAX POSITIONS
Small Business Advisory Committee

November 30, 2005

Background

On July 14, 2005, the Financial Accounting Standards Board issued an Exposure Draft of a proposed Interpretation, *Accounting for Uncertain Tax Positions*. This Exposure Draft would interpret FASB Statement No. 109, *Accounting for Income Taxes*.

The FASB added the project to its agenda due to significant diversity in practice in the accounting for uncertain tax positions. Due to several different interpretations of the recognition threshold required to recognize the financial statement benefits of a tax position, the SEC staff asked the FASB staff to present an agenda request to the FASB.

In researching the issues of this project, the FASB staff met with financial statement preparers, auditors, tax attorneys, and taxing authorities and discussed accounting for uncertain tax positions, income tax dispute, resolution and settlement processes, and difficult taxation issues that could lead to implementation difficulties.

Summary of Key Provisions

The key provisions of the Exposure Draft follow:

1. Recognition: A tax position taken or expected to be taken must be probable of being sustained before the benefit of that position can be recognized in the financial statements of the enterprise. The term *probable* is used in the proposed Interpretation consistent with use of the term in FASB Statement No. 5, *Accounting for Contingencies*, to mean that "the event or events are likely to occur." This recognition criterion is referred to as the probable recognition threshold.
2. Detection: The probable recognition threshold would require that the enterprise presume that the tax position will be evaluated by the taxing authority when making the assessment that the position is probable of being sustained.
3. Subsequent Recognition: A tax position not previously recognized would be recognized in the first fiscal period in which the probable recognition threshold is met.

4. Derecognition: The benefit of a tax position would be derecognized in the first fiscal period that it becomes more likely than not that the tax position will no longer be sustained.
5. Measurement: Management's best estimate of the amount that is expected to be sustained would be recognized. The term *best estimate* is used in the proposed Interpretation consistent with the use of the term in FASB Concepts Statement No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements*, to mean the single most likely amount in a range of possible estimated amounts.
6. Classification: The liability arising from the difference between the tax position taken and the amount recognized and measured in the proposed Interpretation would be classified as a current liability to the extent it is anticipated to be paid within one year or the operating cycle, if longer. Unless the liability arises from a taxable temporary difference as the term is used in Statement 109, it should not be classified as a deferred tax liability.
7. Change in Judgment: A change in judgment about the recognition, derecognition, or measurement of a tax position would be recognized entirely in the first fiscal period that the change in judgment occurs.
8. Disclosures: The proposed Interpretation does not require any additional disclosures; rather, it refers to Statement 5 for appropriate disclosures on gain or loss contingencies.
9. Transition and Effective Date: The impact of initially applying the proposed Interpretation would be accounted for as the cumulative effect of a change in accounting principle. Early adoption is encouraged, and retroactive restatement is not permitted. While the proposed Interpretation would be effective as of the end of the first fiscal year ending after December 15, 2005, the FASB's new project plan recognizes that this final Interpretation will be issued such that the proposed Interpretation's effective date is highly unlikely to be retained in a final Interpretation.

Comment Letters and Public Roundtable Meeting

The Board is required by its Rules of Procedure to solicit and consider comments from the public prior to issuing authoritative guidance in the form of an Interpretation. When comment letters are received, they are posted to the FASB's website and become part of the public record on the project. Additionally, the comment letters are distributed to all Board members, staff members on the project team, and any other staff members interested in the project.

The staff summarizes the views expressed in the comment letters and presents a summary of the comment letters to the Board. The staff considers the results from the comment letters when researching and preparing recommendations to the Board during redeliberation of the project's issues. The Board considers the results from the comment letters when considering the staff's recommendation. The comment period expired on September 12, 2005, and the Board has received 118 comment letters to date.

On October 10, 2005, the Board held a public roundtable meeting to discuss the provisions of the Exposure Draft. Roundtable participants included individuals from the preparer community, audit firms, the IASB, the SEC, and the PCAOB.

Future Project Activities

Early in the project, the International Accounting Standards Board's staff concluded that the issues that arose in this project are also applicable to IAS 12, *Income Taxes*. While the FASB has taken the lead in deliberations to date, the IASB will be considering the FASB's decisions as well as the project issues within the context of the IASB's framework.

The FASB is currently redeliberating the project's issues, with a goal of publishing a final Interpretation in early 2006. The first Board meeting in redeliberations is scheduled for November 22, 2005, and substantive deliberations should occur during December of 2005 and January of 2006.

Questions for SBAC Members

1. Are there particular issues that smaller companies might encounter that could make the provisions of uncertain tax positions more or less difficult to implement than larger companies?
2. What provisions of the uncertain tax positions document do you think are difficult to apply? Why, and is this different than issues that larger companies would face?
3. What changes should the Board consider in redeliberations that would make the document easier to apply?

JOINT CONCEPTUAL FRAMEWORK PROJECT

Small Business Advisory Committee
November 2005

BACKGROUND

In the five months since this Committee last discussed the conceptual framework project, the IASB and FASB completed their discussions on the objectives of financial reporting and the qualitative characteristics of accounting information, except for cost-benefit issues, which will be discussed in December 2005. At the joint FASB-IASB meeting in October, the Boards discussed whether the objectives and qualitative characteristics should differ for particular types of entities and directed staff to proceed to drafting the objectives and qualitative characteristics concepts. In the next phase, beginning in December 2005, the Boards plan to work on the concept of the reporting entity, along with work on the elements of financial statements and their definitions, recognition and derecognition, and defining the various measurement attributes, focusing on the “cross-cutting” issues that keep arising in standards-level projects. Work on selecting measurement attributes, presentation, disclosure, and scope will be undertaken later. Please see Appendix 1 to this paper for a list of tentative decisions reached to date.

As part of its plans to consult with its advisory groups for advice on broad, strategic issues in the project, the Board is looking to this Committee for advice on how the matters being discussed in the project look from the small business perspective.

At the October joint meeting, the FASB and IASB tentatively concluded that there is no need to modify the objective of financial reporting or qualitative characteristics of decision-useful financial reporting for any types of private-sector entities. The Boards

Note: These materials are provided to facilitate understanding of the issues to be addressed at the November 30, 2005, 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.

did acknowledge that there might be differences in how certain qualitative characteristics are applied.

In the June 2005 SBAC meeting, the Board sought Committee members' views on the objectives of financial statements with regard to users of small or privately held business financial statements. Accordingly, this paper focuses on whether the qualitative characteristics should differ for particular types of entities.

The scope of this paper is limited to the conceptual framework project and considers only business entities that operate in the private sector. This paper does not consider whether the qualitative characteristics could be applied differently to different entities, and it does not consider the possibility that different standards could be developed for different types of entities.

QUALITATIVE CHARACTERISTICS—

DO THEY NEED TO DIFFER FOR PARTICULAR TYPES OF ENTITIES?

The conclusion that there is no need to modify the qualitative characteristics of decision-useful financial reporting for any types of private-sector entities is based on an assessment of the range of users and the informational needs of users of particular types of entities' financial reports. With those users and informational needs in mind, the Boards assessed whether different qualitative characteristics apply or whether the qualitative characteristics identified, or the process for applying them, need to change in any way for certain types of entity.

In researching this topic, the Boards consulted the frameworks of other standard setters and noted that those frameworks applied to all entities and that no standard setter had tailored or modified the qualitative characteristics. In contrast, at the standards level, some standard setters have adapted different accounting standards for particular types of entities.

The frameworks are applicable to a wide range of entities. Entities could be classified in many ways, for example, by industry, public accountability, size, nature, and type of structure, or some combination of those factors. This analysis considers distinguishing entities that:

(a) Are relatively smaller than other entities

(b) Are unlisted

(c) Are not publicly accountable by virtue of a fiduciary relationship with the public (are not, for example, deposit-taking institutions, insurers)

(d) Are closely held by a small group of shareholders.

For convenience, these types of entities are referred to as “smaller/non-publicly accountable entities.”

Users of Financial Reporting by Smaller/Non-Publicly Accountable Entities

To assess whether the users of financial reporting by smaller/non-publicly accountable entities might differ from users of financial reporting by other entities, relevant sources dealing with such entities were reviewed (see Appendix 2, including the views of Committee members shared at prior meetings) to identify users of financial reporting by smaller/non-publicly accountable entities. The users of financial reporting referred to in the sources included owner-managers, absentee managers, bankers, bonding and credit rating agencies, customers, other lenders, and management. Depending on the particular facts and circumstances, these users may or may not have the authority to prescribe the financial information they want from an entity. If these users do not have that ability, they must rely on the information provided by management.

The distinction between users with and without the ability to require information is significant. Based on the sources consulted, the general message is that there are significantly more users of smaller/non-publicly accountable entities’ financial reporting that have the ability to require information than users who do not have that ability. This bias is important when the objective of general purpose financial reporting is to provide decision-useful financial information to users that do not have the ability to require information. While users who have the ability to require information are not the primary focus of general purpose financial reporting, to the extent these users have informational needs that are consistent with users who do not have that ability, they also benefit from general purpose financial reporting. Given the significant economic contribution to society that smaller/non-publicly accountable entities make, satisfying the general financial informational needs of all these entities' users is important and will be acknowledged in the framework.

Information Needs

Even if the users do not differ, it is possible that their information needs might differ. Based on the sources consulted (see Appendix 2), some of the information needs[1] of smaller/non-publicly accountable entities' users include:

(a) Evaluating business risks, such as the ability to continue or to be profitable

(b) Evaluating an entity's ability to generate cash flows, for example, to repay obligations

(c) Evaluating the effectiveness and efficiency of management

(d) Providing inputs for credit models, for example, bankers' use of behavioral scoring as a standardized approach for all types of entities, which then may be tailored based on the size of funds loaned and size of the entity's operations.[2]

Those information needs seem consistent with the information needs of users of all entities' financial reporting.

Are New Qualitative Characteristics Needed?

In considering whether the qualitative characteristics of decision-useful financial reporting might differ for smaller/non-publicly accountable entities, one might first ask whether any new qualitative characteristics need to be considered. In May 2005, the Boards considered whether any qualitative characteristics in addition to those in existing

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1 The list of informational needs of smaller/non-publicly accountable entities' users is a summary of common themes identified from the sources consulted, and not an exhaustive list of all possible needs. Readers should keep in mind that smaller/non-publicly accountable entities' users may express these needs differently or place different levels of importance on them.

2 Richard Roberts (July 2005) Presentation on "Credit Sanctioning," IASB Education Session.

frameworks needed to be added and concluded that there were none (see “Other Characteristics” in Appendix 1 for other characteristics considered).

This conclusion is supported by research undertaken by Riistama and Vehmanen.[3] They evaluated the unique conditions of small and medium-sized entities and their impact on required qualitative characteristics in order to develop an accounting framework that would better meet these characteristics. They proposed that the minimum qualitative characteristics are relevance, completeness (incorporates faithful representation of relevant phenomena), understandability, comparability, consistency, and cost-benefit relationship.[4] Their definitions of qualitative characteristics are consistent with those definitions proposed in the converged framework, except for understandability. Riistama and Vehmanen define understandability by saying that “financial statements should be simple enough to be understood even by well educated non-accountants.” In addition, Riistama and Vehmanen recommend the following additional requirements: simplicity, intelligibility, objectivity, universality, applicability, frugality, and tested functionality.[5] In their view, the descriptions of these additional requirements emphasize aspects of the qualitative characteristics from a small and medium-sized entity’s user perspective. But to the project staff those requirements seem to be aspects of already identified qualitative characteristics. Simplicity[6] and intelligibility focus on the understandability of the information by the users. Objectivity links to neutrality and comparability, universality[7] and applicability to comparability, and frugality to cost-benefit relationship. For example, intelligibility is defined as follows: “Accounting expertise being scarce in small and medium-sized entities, also non-accountants should be able to understand the basic concepts of the framework.”[8]

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3 V. Riistama and P. Vehmanen (2004) “Globally applicable conceptual framework for small and medium-sized entities,” recommend a framework based on the Monetary Flow Theory of Accounting (financial reporting on a cash basis).

4 Ibid, page 8.

5 Ibid, page 9.

6 In the June 2005 Board discussions, operationality and simplicity were discussed as other possible characteristics, but the Board decided not to add these characteristics to the conceptual framework.

7 Universality refers to a framework being applied independently of institutional or national peculiarities.

8 Riistama and Vehmanen (2004), page 8.

From the staff's analysis, Riistama and Vehmanen's evaluation of the qualitative characteristics did not identify any new characteristics that should be considered but does suggest that certain qualitative characteristics might be applied differently to smaller/non-publicly accountable entities.

Board members would be interested in hearing comments as to whether any new qualitative characteristics are necessary to deal with smaller/non-publicly accountable entities.

Do the Qualitative Characteristics Identified Need to Be Modified?

Having concluded that no new qualitative characteristics are required, the Boards then considered whether any modification to the qualitative characteristics identified is necessary. The following considers each of the qualitative characteristics in turn.

Relevance—Information still needs to be relevant for the same purpose—to assist in making economic decisions. Based on the earlier analysis in this paper, that the information needs of smaller/non-publicly accountable entities' users are considered to be consistent with the needs of other users of general purpose financial statements, the application of the relevance characteristic should be consistent and result in selecting the same most relevant depiction of the same economic phenomenon regardless of the type of entity.

Faithful representation—It seems unlikely that an insufficiently faithful representation of a phenomenon or item would be adequate, regardless of the type of entity or the users. The report ought to represent what it purports to represent, and represent it faithfully. Accordingly, the consideration of faithful representation should not differ according to the type of entity.[9]

[9] One might consider selecting a different representation as a result of cost-benefit considerations, but that does not mean that the faithful representation characteristic needs to be assessed in a different way. Cost-benefit considerations will be considered in December.

Understandability—Many people, like Riistama and Vehmanen, have voiced concerns that users of smaller/non-publicly accountable entities' financial reports have less financial knowledge or training and find certain financial information to be too complex. Two different FASB studies from the 1980s[10] noted that while users of smaller/non-publicly accountable entities' financial reporting tend to have a sophisticated knowledge of the businesses issuing the statements, they have less financial training than users of public entity financial statements. For example, an FASB study reported that the majority of managers and bankers felt that college or other formal training contributed to their knowledge of accounting.[11] One solution offered is to *simplify* smaller/non-publicly accountable entities' financial reporting, such that more smaller/non-publicly accountable entities' users are able to understand the information provided and use it in making economic decisions.

Care needs to be taken to understand what is meant by "simplifying." To many people, simplification means making the accounting easier for the accountants. That is not what is contemplated when the Boards think about understandability. Many factors result in complex (or less simple) accounting, including sophistication of economies, sophistication of the businesses being conducted, and complexity of transactions conducted, as well as the establishment of certain complex accounting practices. However, the question is not whether the accounting should be simpler, but whether financial information can be provided in a manner that might better achieve the decision-usefulness objective of financial reporting. This might be achieved through such measures as:

(a) Using treatments nonaccountants can understand, for example, not allowing smoothing of costs

10 A. Rashad Abdel-Khalik (August 1983) FASB Research Report, *Financial Reporting by Private Companies: Analysis and Diagnosis* (171 responses), and Financial Accounting Standards Board (February 1983) Special Report, *Financial Reporting by Privately Owned Companies: Summary of Responses to FASB Invitation to Comment* (283 responses).

11 A. Rashad Abdel-Khalik (August 1983), page 43.

(b) Selecting the most cost-effective method of achieving a desired accounting treatment and/or disclosure

(c) Providing information on important points in a clear and concise manner that can be understood by nonaccountants

(d) Using commonly understood words, in their common meaning.[12]

Understandability is a user-specific quality. Users of smaller/non-publicly accountable entities' financial reporting do not seem to have a different kind of need for understandability. Their need just might be more pronounced because of the greater likelihood of a relative lack of sophistication of some smaller/non-publicly accountable entities' users.[13] If sophisticated users are missing from the range of a particular entities' users, that might lead one to conclude that a greater emphasis on understandability directed toward the range of users that exists for that particular entity is necessary.[14] It does not, however, diminish the need in any financial report to assess whether information has been provided in an understandable manner.

Comparability—For smaller/non-publicly accountable entities, comparability (including consistency) seems no less important than for other entities. Some at the September IASB World Standard Setters meeting in London suggested that comparability might be less important for smaller/non-publicly accountable entities, noting that it had not been a significant factor in their assessment as to whether certain accounting treatments might differ for smaller and medium-sized entities from other entities. It seems that comparability of accounting treatments from period-to-period and between transactions within an entity would certainly continue to be important. Thus, comparability between similar entities may be viewed as less important. However, smaller/non-publicly accountable entities compete for capital with one another and with other entities, and to the extent that financial reports are used in assessments by current and potential

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12 Such as envisaged by the U.S. Securities & Exchange Commission's "Plain English" initiative.

13 Of course, some users of smaller/non-publicly accountable entities' financial reporting might be very sophisticated.

14 All such users are expected to have a reasonable level of business, economic, and accounting knowledge and put forth effort to understand the information.

providers of that capital, it seems no less important that there be comparability between these entities as between other entities. Accordingly, it seems that comparability should not be assessed any differently for smaller/non-publicly accountable entities than for other entities.

Materiality—Materiality is not a qualitative characteristic but is considered here for completeness. Materiality can only be judged relative to the entity being assessed. In that regard, its application is already tailored to the qualitative and quantitative aspects of each entity, and no special consideration for smaller/non-publicly accountable entities seems necessary.

Cost-benefit considerations—Cost-benefit is a constraint, rather than a qualitative characteristic, but is a feature of the process for using qualitative characteristics to set standards for decision-useful financial reports. The Boards have not yet discussed cost-benefit considerations for all entities, but it seems likely that they will conclude that cost-benefit considerations matter for all entities and that the results of cost-benefit assessments may vary for different types and sizes of entities.

Board members would be interested in hearing views on the recommendation that there is no need for any differences in the qualitative characteristics, or the process of applying them to produce decision-useful financial reports, for any particular type of entity. One may sometimes reach different answers in applying the qualitative characteristics, depending on the characteristics or range of users of an entity (in particular, understandability),[15] but there is no need to amend the characteristics or application process.

QUESTIONS FOR DISCUSSION BY THE COMMITTEE

1. Are any further qualitative characteristics of decision-useful financial reporting necessary for smaller/non-publicly accountable entities?

[15] Cost-benefit considerations also might lead to different answers. However, they will be considered separately.

2. Do you agree with the Boards' conclusion that there is no need for any differences in the qualitative characteristics for different types or sizes of entity, bearing in mind that the qualitative characteristics might be applied differently if the characteristics of an entity and/or range of its users are considered?

Appendix 1: TENTATIVE DECISIONS REACHED BY THE FASB AND IASB

OBJECTIVES

Objective of Financial Reporting

In the two Boards' existing frameworks, the overriding objective of financial reporting is to provide information to assist users in making economic decisions, such as making investment, credit, and similar resource allocation decisions.

Liquidity and Solvency

Also, as discussed in the two Boards' existing frameworks, the financial statements should provide information to help users assess an entity's liquidity and solvency. However, that objective should be consistent with the overall objective of providing information to a wide range of users. Therefore, the information provided in the financial statements should not be focused on meeting the information needs of particular types of users that primarily use the financial statements to help them assess an entity's liquidity and solvency.

Stewardship and Accountability

The Boards agreed that stewardship and accountability should not be a separate objective of financial reporting by business entities in the converged framework. The Boards agreed that the converged framework should clearly describe its meaning of *stewardship*, which encompasses management's responsibility not only for the custody and safekeeping of assets entrusted to it but also for their efficient and profitable use. As a consequence, the Boards agreed that the converged framework should clarify that financial information useful for making investment, credit, and similar resource allocation decisions—the primary objective—would include financial information useful for assessing management's stewardship.

Financial Reports

The objective is to provide information about the entity to *external* users, that is, users who lack the power to prescribe the information they require and therefore must rely on the information provided by an entity's management. The entity's management also will be interested in that information. However, because management has the power to obtain the information it requires, any additional information needs of management are beyond the scope of the framework.

As with the existing frameworks, the Boards' converged framework should be concerned with *general purpose* financial reports, which focus on the common information needs of users. That does not preclude the Boards from concluding, in a standards-level project, that additional information should be provided to meet the information needs of particular types of users.

Users
Financial reports should be prepared from the entity's perspective and should aim to provide information to a wide range of users, rather than focus on the information needs of existing common shareholders only. The framework should identify the primary users as present and potential investors and creditors (and their advisors).

QUALITATIVE CHARACTERISTICS

Relevance is an essential qualitative characteristic. To be relevant, information must be capable of making a difference in the economic decisions of users by helping them evaluate the effect of past and present events on future net cash inflows (predictive value) or confirm or correct previous evaluations (confirmatory value), even if it is not now being used. Being capable of making a difference, rather than now being used, is a change from the present IASB *Framework*; confirmatory rather than feedback value is a change from the present FASB Concepts Statements. Also, the information must be available when the users need it (timeliness).

Accounting information has *predictive value* if users use it, or could use it, to make predictions. Accounting information is not intended in itself as a prediction, nor as synonymous with statistical predictability or persistence.

Faithful representation of real-world economic phenomena is an essential qualitative characteristic, which includes capturing the substance of those economic phenomena. Representations are faithful—there is correspondence or agreement between the accounting measures or descriptions in financial reports and the economic phenomena they purport to represent when the measures and descriptions are verifiable and the measuring or describing is done in a neutral manner. Therefore, faithful representation requires completeness, not subordinating substance to form, verifiability, and neutrality. Consequently, the common framework should drop the widely misinterpreted term *reliability* from the qualitative characteristics, replacing it with *faithful representation.* That replacement is a change from the current IASB and FASB frameworks. The common conceptual framework will need to discuss thoroughly what faithful representation means, and what it does not mean.

Financial information needs to be *verifiable* to provide assurance to users that the information faithfully represents what it purports to represent and that the information is free from material error, is complete, and is neutral. Descriptions and measures that can be directly verified through consensus among observers are preferable to descriptions or measures that can only be indirectly verified.

Financial information needs to be *neutral*—free from bias intended to influence a decision or outcome. To that end, the common conceptual framework should not include conservatism or prudence among the desirable qualitative characteristics of accounting information. However, the framework should note the continuing need to be careful in the face of uncertainty.

Understandability also is an essential characteristic of decision-useful financial information and should be included in the converged conceptual framework. Understandability is the quality of information that enables users, who have a reasonable knowledge of business and economic activities and accounting and study the information with reasonable diligence, to comprehend the meaning of the information. Information is made more understandable by aggregating, classifying, characterizing, and presenting it in a clear and concise manner. Relevant information should not be excluded because it is too complex or difficult for certain users to understand.

The converged framework should include presumptions not only about the capabilities of financial statement users but also about the capabilities of financial statement preparers and auditors.

Comparability is an important characteristic of decision-useful financial information and should be included in the converged conceptual framework. Comparability—which enables users to identify similarities in and differences between economic phenomena—should be distinguished from consistency—the consistent use of accounting methods. Concerns about comparability or consistency should not preclude reporting information that is of greater relevance, or that more faithfully represents the economic phenomena it purports to represent. If such concerns arise, disclosures can help to compensate for lessened comparability or consistency.

Other Characteristics

Materiality relates not only to relevance, but also to faithful representation. Information is material if its omission or misstatement could influence the economic decisions of users taken on the basis of the financial statements. Materiality depends on the nature and amount of the item judged in the particular circumstances of its omission or misstatement. Given the pervasive nature of materiality, it is difficult to consider the concept except as it relates to the qualitative characteristics of relevance and faithful representation. Thus, materiality is a screen or filter used to determine whether information is sufficiently significant to influence the decisions of users in the context of the entity, rather than as a qualitative characteristic of decision-useful financial information.

Transparency, often cited recently as a desirable characteristic of financial information, seems to be difficult to define. In current usage, it appears to encompass some of the qualitative characteristics already included in the frameworks. Because it would be redundant, transparency should not be added to the converged framework as a separate qualitative characteristic of decision-useful financial information.

Other possible characteristics considered, including credibility, high quality, and internal consistency, do not describe attributes of decision-useful financial information that are distinct from other qualitative characteristics. Thus, they should not be added as separate qualitative characteristics in the converged framework.

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POSTRETIREMENT BENEFIT OBLIGATIONS, INCLUDING PENSIONS

Small Business Advisory Committee
November 30, 2005

PURPOSE

At the November 30, 2005 SBAC meeting, the Board will inform Committee members about its decision to add to its agenda a comprehensive project to reconsider the accounting for postretirement benefits. The Board is particularly interested in Committee members' input on the prevalence of defined benefit postretirement plans in Committee members' companies, the companies that Committee members audit, and companies that Committee members invest in or follow as users of financial statements. The Board also would like Committee members' input on the potential implications of the planned first phase to preparers, users, and auditors, such as possible (a) costs of implementation, (b) likely transition difficulties, and (c) potential impact of reporting changes on contractual or regulatory requirements.

BACKGROUND

On November 10, 2005, the Board added a project to its technical agenda to comprehensively reconsider the guidance in FASB Statement No. 87, *Employers' Accounting for Pensions,* and FASB Statement No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions.* In making that decision, the Board considered input received from FASB advisory groups and other constituents. The Board's objective in undertaking the project is to improve the reporting of pension and other postretirement benefit plan arrangements in the sponsoring employers' financial statements by providing information that is more useful and transparent for investors, creditors, employees, retirees, and other users. Because of the breadth and complexity of the issues associated with the accounting for postretirement benefits, a project to improve and potentially converge internationally the accounting would take years to complete. Thus, in order

Note: These materials are provided to facilitate understanding of the issues to be addressed at the November 30, 2005, 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.

to provide a timely and substantial improvement to postretirement benefit accounting, the Board agreed with the staff’s recommendation to conduct the project in two phases.

The Board's objective in the initial phase is to remedy the deficiency of current accounting guidance that permits important information about the financial status of a company's postretirement benefit plans to be reported in the notes to the financial statements but not in the balance sheet. This phase of the project is not expected to change the basic approach for determining the amount of net benefit cost included in the determination of net income. The first phase is targeted for completion by the end of 2006.

The decision to phase the project was made based on input received from constituents. In particular, many constituents who provided input that led to the agenda decision generally agreed with the idea of a phased project, but usually disagreed on the scope of a first phase. For example, they suggested including in the first phase delayed recognition of the costs of providing postretirement benefits, classification and display of costs in the income statement, measurement of benefit obligations, accounting for multiemployer plans, and footnote disclosures. Given the wide diversity of views, the Board accepted the staff’s recommendation to limit the scope of the initial phase of the project in order to make a significant improvement in financial reporting as quickly as possible.

In the second multi-year phase of the project, the Board will comprehensively reconsider the accounting for postretirement benefit obligations (described under the comprehensive phase below).

PHASED APPROACH

The following sections summarize each phase of the comprehensive project based on the staff’s current thinking. The summary is intended to provide Committee members with an understanding of the components of each phase.

INITIAL PHASE

<u>Objectives and Scope</u>

The following objectives and scope establish the boundaries for phase one of the project:

a. Improve the understandability, transparency, and representational faithfulness of amounts reported in the balance sheet by recognizing the over-funded or under-funded status of defined benefit postretirement plans.

b. Not to change how plan assets and benefit obligations are measured, meaning that the over-funded or under-funded status would be measured as the difference between the fair value of plan assets and the benefit obligation (that is, the projected benefit obligation (PBO) for pensions and the accumulated postretirement benefit obligation (APBO) for other postretirement benefits).

c. Not to change the basic approach for measuring the amount of annual net benefit cost reported in earnings.

d. Implement phase one improvements as quickly as possible with a goal of making them effective for fiscal years ending after December 15, 2006.

Technical Issues

Technical issues to be considered in the first phase are:

a. How to recognize presently unrecognized components of the plan arrangements, including actuarial gains and losses, the transitional asset or obligation, and prior service costs relating to plan amendments that increase or decrease employee benefits.

b. Whether additional guidance is needed that relates to separate line-item reporting and/or presentation of assets or liabilities recognized in a classified balance sheet.

c. Whether measurements of plan assets and benefit obligations should be as of the date of the financial statements (thereby eliminating the current option of using an alternative measurement date that is not more than three months prior to the date of the financial statements).

d. Whether, and, if so, how the decisions reached in phase one requiring annual reporting should impact reporting for interim periods.

COMPREHENSIVE PHASE

Objective and Scope

The objectives and scope of phase two are as follows:

a. Comprehensively reconsider other elements of the accounting for postretirement benefits.

b. Improve international convergence through development of one or more common, high-quality accounting standards.

Description

The second phase of the project would reconsider comprehensively most, if not all, aspects of the existing standards of accounting for postretirement benefits. The goal of that phase would be the development of one or more high-quality accounting standards that are convergent internationally.

The following issues are among those the Board would consider in the comprehensive phase:

a. How best to recognize and display in earnings and other comprehensive income the various elements that affect the cost of providing postretirement benefits.

b. How best to measure the obligation, in particular the obligation under plans with lump-sum settlement options.

c. Whether more or different guidance should be provided regarding measurement assumptions.

d. Whether postretirement benefit trusts should be consolidated by the plan sponsor.

QUESTIONS FOR COMMITTEE MEMBERS

1. How prevalent are defined benefit postretirement plans in Committee members' companies, the companies that Committee members audit, and companies that Committee members invest in or follow as users of financial statements?

2. Are there implications to the planned initial phase of the project that Committee members believe Board members should be aware of?

3. What types of costs would preparers be expected to incur to implement the changes in reporting?

Is additional reporting guidance in other related areas needed? For example, if the Board was to require recognition of the over- or under-funded status, would additional guidance be needed on presentation of that asset or liability in a classified balance sheet?