



## **SMALL BUSINESS ADVISORY COMMITTEE**

**June 22, 2005 - - - - 9:00 A.M.**

**FASB Offices - - - - Norwalk, Connecticut**

### **Agenda**

1. Welcome and 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. Private Company Financial Reporting  
(Messrs. Batavick, Ellis, Golden, and Noll) Committee members will discuss issues concerning generally accepted accounting principles for private companies. (Attachment B)

### **B R E A K**

4. Financial Performance Reporting  
(Ms. Sullivan) Committee members will discuss the Board's decisions to date and the issues discussed with the Joint International Group at its June meeting. (Attachment C)

### **L U N C H**

5. The Conceptual Framework  
(Mr. Bullen) Committee members will discuss the objectives of financial reporting, primarily the needs of users of financial reports and the role of stewardship or accountability. (Attachment D)
6. Codification and Retrieval Project  
(Mr. Smith) Committee members will discuss the status of the Board's codification and retrieval project. (Attachment E)
7. 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**

REPORT OF THE CHAIRMAN OF THE FASB  
TO THE FINANCIAL ACCOUNTING FOUNDATION  
February 1 through April 30, 2005

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**ITEM 1: TECHNICAL ACTIVITIES**

**BOARD AND STAFF ACTIVITIES**

- a. The following documents were posted to the website:
  1. FASB Interpretation No. 47, *Accounting for Conditional Asset Retirement Obligations* (March 2005)
  2. FASB Exposure Draft, *The Hierarchy of Generally Accepted Accounting Principles* (April 28, 2004).
- b. On February 6, the Board considered a number of possible agenda projects related to property, plant, and equipment. The Board decided not to add projects to its agenda to address (1) the accounting for rental costs that are incurred during construction of a real estate project, (2) liquidated damages received during the acquiring of property, plant, and equipment, and (3) the threshold for beginning to capitalize property, plant, and equipment. The Board directed the staff to further research the accounting for planned major maintenance activities of property, plant, and equipment with the objective of refining the scope of the potential project. Based on that research, the Board will consider whether to add a project on planned major maintenance activities to its agenda at a future meeting.
- c. On March 9, the Board decided to add a project to its technical agenda to reconsider the disclosure requirements of FASB Statement No. 133, *Accounting for Derivatives and Hedging Activities*. Various constituents have expressed criticism that Statement 133 lacks transparent disclosures that allow a user of financial statements to assess the overall risk of derivatives on a reporting entity from both a quantitative and a qualitative perspective. This project will consider enhanced disclosures, which will include a reconsideration of the usefulness of the existing disclosure requirements. The Board instructed the staff to consider whether the scope of the project should be expanded to include financial instruments that are not within the scope of Statement 133.
- d. Also on March 9, the Board decided not to add a project to its agenda that would reconsider the accounting and reporting for contingent environmental liabilities. The Board specifically considered whether contingent environmental liabilities that meet the recognition criteria in paragraph 8 of FASB Statement No. 5, *Accounting for Contingencies*, should be recognized at expected value. In declining this request the Board indicated that it did not intend to reconsider Statement 5 and FASB Interpretation No. 14, *Estimation*

*of the Amount of a Loss*, solely in the context of environmental liabilities. The request also raised a question as to whether contingent environmental liabilities of a similar nature should be aggregated for purposes of assessing materiality. The Board indicated that it believes the current accounting literature addresses this question.

- e. On March 30, the Board decided to defer work on the second phase of its project on share-based payment until such time as it completes (or makes substantial progress toward completing) its project on accounting for financial instruments with characteristics of both liabilities and equity.
- f. On April 6, the Board decided to add a project to its agenda to consider risk transfer in insurance and reinsurance contracts. The project will include developing a definition of insurance contracts and exploring simplified approaches to bifurcating insurance contracts.
- g. The following proposed Statement 133 Implementation Issues were posted to the website:
  1. No. B38, "Evaluation of Net Settlement with Respect to the Settlement of a Debt Instrument through Exercise of an Embedded Put Option or Call Option" (April 2005)
  2. No. B39, "Application of Paragraph 13(b) to Call Options That Are Exercisable Only by the Debtor" (April 2005).
- h. The Board held approximately 44 separate sessions on 12 dates to deliberate technical issues for 30 agenda or possible agenda projects.
- i. The following FSPs were posted to the FASB website:
  1. FSP FAS 19-1— *Accounting for Suspended Well Costs* (Posted: April 4, 2005)
  2. FSP EITF 85-24-1— *Application of EITF Issue No. 85-24, Distribution Fees by Distributors of Mutual Funds That Do Not Have a Front-End Sales Charge, When Cash for the Right to Future Distribution Fees for Shares Previously Sold Is Received from Third Parties* (Posted: March 11, 2005)
  3. FSP FIN 46(R)-5— *Implicit Variable Interests under FASB Interpretation No. 46 (revised December 2003), Consolidation of Variable Interest Entities* (This FSP is applicable to both nonpublic and public reporting enterprises. This issue commonly arises in leasing arrangements among related parties, and in other types of arrangements involving related parties and previously unrelated parties.) (Posted: March 3, 2005)
  4. Proposed FSP FAS 150-e— *Issuer's Accounting under Statement 150 for Freestanding Warrants and Other Similar Instruments on Shares That Are Redeemable* (Posted: April 18, 2005) (Comment Deadline: June 2, 2005)

5. Proposed FSP EITF 00-19-a—*Application of EITF Issue No. 00-19, Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock, to Freestanding Financial Instruments Originally Issued as Employee Compensation* (Posted: March 11, 2005) (Comment Deadline: April 15, 2005)
  6. Proposed FSP APB 18-a—*Accounting by an Investor for Its Proportionate Share of Other Comprehensive Income of an Investee Accounted for under the Equity Method in Accordance with APB Opinion No. 18, The Equity Method of Accounting for Investments in Common Stock, upon a Loss of Significant Influence* (Posted: March 11, 2005) (Comment Deadline: April 25, 2005)
  7. Proposed FSP FAS 143-a—*Accounting for Electronic Equipment Waste Obligations* (Posted: March 7, 2005) (Comment Deadline: April 21, 2005)
  8. Proposed FSP FAS 131-a—*Determining Whether Operating Segments Have Similar Economic Characteristics under Paragraph 17 of FASB Statement No. 131, Disclosures about Segments of an Enterprise and Related Information* (Posted: March 3, 2005) (Comment Deadline: April 18, 2005).
- j. At the March 30, 2005 Board meeting, the Board ratified the consensus reached at the March 17, 2005 EITF meeting on Issue No. 04-6, "Accounting for Stripping Costs Incurred during Production in the Mining Industry."
  - k. At the March 30, 2005 Board meeting, at the request of the EITF, the Board agreed to provide guidance on the variability that should be considered when determining whether an interest is a variable interest in a potential variable interest entity. The Task Force's request arose from its discussion of Issue No. 04-7, "Determining Whether an Interest Is a Variable Interest in a Potential Variable Interest Entity," at the March 17, 2005 EITF meeting. The guidance will be presented in the form of an FSP.
  - l. Six Board members participated in the March meeting of the EITF.
  - m. The chairman and the executive director of FASAC attended the SEC Roundtable on Implementation of Sarbanes-Oxley Internal Control Reporting Provisions.
  - n. Three Board members and staff met with representatives of the Design Professionals Coalition to discuss the liabilities and equity milestone draft.
  - o. Three Board members met with representatives of FEI/CCR to give them a quarterly update on various projects.
  - p. Six Board members attended a dinner meeting with representatives of FEI.
  - q. The TA&I director and various staff participated in closed meetings of EITF working groups.

- r. Three Board members, the TA&I director, and staff met with representatives from the Bond Market Association to discuss the balance sheet classification of auction rate securities.
- s. Various staff attended one AcSEC meeting.
- t. Several staff members met with the president and other representatives of the Stable Value Investment Association (SVIA) to assist the staff with the finalization of a proposed FSP regarding the accounting for fully benefit-responsive investments held by bank collective trusts.
- u. A staff member met with AITF and inter firm Fair Value Measurement Committee to discuss matters relating to the proposed Statement on fair value measurement and other matters of mutual interest.

#### INTERNATIONAL ACTIVITIES

- a. Two staff members discussed the liabilities and equity project at the March IASB Board meeting in London.
- b. Three Board members and the MP&T director attended the National Standards Setters meeting in London.
- c. The IASB and FASB held a joint meeting in London and discussed the following projects: short-term convergence (income taxes), performance reporting, and conceptual framework. In addition, the Board discussed possible projects related to financial instruments. The Boards also met in a joint administrative session to discuss various issues related to convergence activities and the management of joint projects.
- d. In preparation for the joint administrative meeting, the MP&T and PD&S directors held an administrative meeting with the Board to discuss convergence activities.
- e. Two staff members participated in a Financial Instruments Working Group meeting in London.
- f. A staff member attended an IASB Insurance Working Group meeting in London to continue discussions of accounting issues related to the IASB's Insurance Contracts, Phase II project.
- g. The Board, senior staff, FASB staff monitoring IASB projects, and the IASB liaison Board member met after each IASB meeting to discuss IASB agenda and research projects with a focus on recent decisions by the IASB and areas of potential divergence.
- h. The Board and staff continue to work closely with the IASB and staff on their joint projects on purchase method procedures, revenue recognition,

performance reporting, conceptual framework, short-term convergence, and liabilities and equity (modified joint). For joint projects, the FASB staff generally participates in IASB meetings by video conference or telephone. The IASB staff participates in FASB meetings by phone.

- i. One Board member and staff met with Professor Makita from Japan and updated him on the Financial Performance Reporting project.

#### OTHER ACTIVITIES

- a. The following professional development sessions were presented to the Board and staff:
  - 1. Robert Attmore, incoming GASB Chairman, discussed his perspective of the goals and challenges of the Governmental Accounting Standards Board.
  - 2. Mike Tovey, Project Manager, FASB, presented to the staff the basic principles of Statement 123(R).
  - 3. Jeffrey Mahoney, Counsel to the FASB Chairman, updated the staff on activities in Washington, D.C. that relate to the FASB.
  - 4. New Horizons provided basic and intermediate training in Microsoft PowerPoint.
  - 5. Jenifer Minke-Girard, SEC Senior Associate Chief Accountant, and Pamela Schlosser, SEC Professional Accounting Fellow, gave an overview of the Office of the Chief Accountant and discussed SEC "hot topics."
  - 6. FASB Board member Katherine Schipper described the extent to which accounting research uses (or attempts to use) constructs from the FASB's Conceptual Framework.
- b. One staff member participated in two meetings of the AICPA's Reporting Simplification Task Force.
- c. Three staff members attended a panel discussion at the Center for Excellence in Accounting and Security and Analysis to hear their approach to classifying equity based compensation.

#### **ITEM 2: ADMINISTRATIVE AND STRATEGIC ACTIVITIES**

- a. A staff member participated in the 11<sup>th</sup> International XBRL Conference in Boston. The theme of the conference was better, faster smarter business reporting using XBRL.
- b. The Board and the TA&I director attended an FAF Trustees meeting.
- c. Various Board members and staff directors met with various staff to discuss the project plans for 11 agenda projects.

- d. In advance of the March 30 Technical plan meeting, the Board and staff directors participated in an administrative meeting to discuss the Board's technical agenda and its priorities for the second and third quarters of 2005.
- e. The Board and staff directors held several informal administrative meetings to have follow-up discussions on issues raised at their retreat in January, relating to various operating and process issues.
- f. A new staff member participated in training sessions covering the following topics: processes and procedures, effective writing, project planning and communications, and staffing/personnel issues.
- g. Two staff members attended a three-day seminar on critical thinking skills.
- h. A staff member attended a two-day training session on Microsoft Project 2003.

### **ITEM 3: WASHINGTON ACTIVITIES**

- a. The chairman testified at a hearing of the Subcommittee on Financial Institutions and Consumer Credit of the Committee on Financial Services on H.R. 1042, the "Net Worth Amendment for Credit Unions Act."
- b. Two Board members, the TA&I director, and staff held their quarterly meeting with the SEC and the PCAOB to discuss current issues.
- c. Two Board members, the TA&I director, and staff held their quarterly meeting with financial institution regulators to discuss current issues.
- d. A staff member met with representatives of a number of associations, staff to Members of Congress, Congressional committees, government agencies, and other entities and organizations to discuss current FASB activities and other issues.
- e. Six Board members and the staff directors held a full-day meeting with all of the members of the PCAOB and several members of the PCAOB staff at the FASB offices in Norwalk. FASB Board members provided an overview of several technical agenda projects with a focus on the potential audit implications of those projects.
- f. One Board member, the TA&I director, and a staff member met with the director and other representatives of the Financial Analysis and Risk Assessment office of the PCAOB to discuss certain aspects of the FASB's current technical plan and establish protocols for future correspondence between the FASB's TA& I director and members of that particular office of the PCAOB.

**ITEM 4: SPEECHES DELIVERED**

Principal platforms addressed by the Board and staff members during the February 2005 to April 2005 period included:

- - American Accounting Association
- - American Accounting Association Deloitte Trueblood Seminar
- - American Council of Life Insurers
- - American Law Institute/American Bar Association
- - Canisius College
- - CFO Rising Conference
- - Coastal Fairfield Chapter of the Institute of Management Accountants
- - Colorado State University
- - Duke University Global Capital Markets Center
- - Financial Executives International
- - FTN Financial
- - Group of North American Insurance Enterprises
- - Institute of Chartered Accountants
- - Interagency Accounting Conference
- - Japan Society
- - National Association of College and University Business Officers
- - National Association of Regulatory Utility Commissioners
- - National Association of State Credit Union Supervisors
- - National Association of Stock Plan Professionals
- - National Cooperative Business Association
- - National Investor Relations Institute
- - PricewaterhouseCoopers Tax Conference
- - Raymond James
- - Rutgers Business School
- - Sanford Bernstein Quant Conference
- - St. Joseph's University
- - University of Dayton
- - University of Evansville
- - University of Mississippi
- - University of West Florida
- - World Trade Group
- - XBRL International

**ITEM 5: ADDITIONAL PUBLIC RELATIONS ACTIVITIES**

- a. The FASB, in conjunction with the Public Relations department, issued one press release this quarter on Interpretation No. 47, *Accounting for Conditional Asset Retirement Obligations*.
- b. Media inquiries focused on two main areas: stock options expensing and finite risk insurance.
- c. The FASB continued its frequent contact with the major press including the *Wall Street Journal*, *New York Times*, *Financial Times*, and *Washington Post*. In addition, the Public Relations department held separate orientation meetings with two reporters that have recently begun covering the FASB, representing the *Wall Street Journal* and *Dow Jones Newswire*. The meetings included the participation of two FASB directors.
- d. One Board member received media training through the Public Relations department and Franchetti Communications. The half-day program focused on more effectively dealing with the media and message communication.
- e. Members of the FASB staff, with the Public Relations department, held interviews and selected a candidate to write an article on the conceptual framework, primarily targeting CEOs.
- f. Three issues of *The FASB Report*, the FASB's monthly newsletter, were produced and distributed. Topics included the conceptual framework, FASB's efforts toward simplification, and the Joint International Group on Performance Reporting.
- g. The Foundation's 2004 Annual Report was produced by the Public Relations department with copies distributed to members of the financial community, members of the SEC and PCAOB, FASAC members, GASAC members, UAC members, SBAC members, and the media, among others.

#### **ITEM 6: GASB LIAISON ACTIVITIES**

- a. FASB meeting minutes were sent to the GASB RTA director and certain GASB staff.
- b. GASB meeting minutes were sent to the FASB chairman and the staff directors.
- c. The GASB RTA director and the FASB PD&S director held monthly meetings and met quarterly with the FASB and GASB chairmen.
- d. The GASB forwarded the following drafts to the FASB for review:  
--GASB Concepts Statement No. 3, *Communication Methods in General Purpose External Financial Reports That Contain Basic Financial Statements*

--GASB Preliminary Views, *Accounting and Financial Reporting for Pollution Remediation Obligations*.

- e. The FASB staff distributed the following drafts to the GASB for review:
- FASB Interpretation No. 47, *Accounting for Conditional Asset Retirement Obligations*
  - FASB Exposure Draft, *The Hierarchy of Generally Accepted Accounting Principles*
  - FASB Statement No. 15X, *Accounting Changes and Error Corrections*



--FASB Exposure Draft, *Business Combinations*.

## **PRIVATE COMPANY FINANCIAL REPORTING**

**Small Business Advisory Committee  
June 22, 2005**

### **Background**

In February of 2005, the Private Company Task Force (Task Force) of the American Institute of Certified Public Accountants (AIPCA) issued its conclusions and recommendations related to research conducted to explore:

- Whether the general purpose financial statements of private companies, prepared in accordance with generally accepted accounting principles (GAAP), meet the financial reporting needs of constituents who use them.
- Whether the costs of providing GAAP financial statements is justified when compared to the benefits they provide to private company constituents.

The conclusions of the Task Force were:

- General purpose financial statements of private companies prepared in accordance with GAAP have moderately high to high value to the constituents who use them, especially with respect to the characteristics of consistency and comparability.
- GAAP for private companies should be developed based on concepts and accounting that are appropriate for the distinctly different needs of constituents of private company financial reporting.

- The current approach to providing exceptions and other bases of accounting is not the best response to private company financial reporting needs.
- Fundamental changes should be made in the current GAAP standards-setting process to ensure that the financial reporting needs of private company constituents are met.

The Task Force recommended that a cooperative effort that includes representatives of the key constituents of private company financial reporting, be undertaken to:

- Determine who should establish private company GAAP.
- Identify how to best effect fundamental change in the GAAP standards-setting process to ensure that the financial reporting needs of private company constituents are met.
- Develop and oversee the implementation process on a timely basis.

The Financial Accounting Foundation, the Financial Accounting Standards Board (FASB), and the AICPA have agreed to collectively evaluate potential changes to GAAP for privately held, for-profit companies to further enhance the overall value of private company financial reporting. Any proposed changes that might result from this effort would need to be fully exposed for public comment and debate.

A copy of the Task Force's report is included as an appendix. Further, a presentation will be made to the committee by representatives of the Task Force describing in more detail the research, conclusions, and recommendations of the Task Force.

### **Questions for Committee Members**

To support the goal of exploring an appropriate course of action please be prepared to discuss the following topics:

- Does the committee agree with the Task Force conclusion that general purpose financial statements of private companies prepared in accordance with GAAP have high value to constituents of that reporting? Why or why not? What are the primary purposes of general purpose financial statements for private companies? Who are the primary users?
- Does the committee believe the cost of providing GAAP financial statements is justified when compared to the benefits they provide to private company constituents? Why or why not?
- Does the committee agree with the Task Force's conclusion that GAAP for private companies should be developed based on concepts and accounting principles that are appropriate for the distinctly different needs of constituents of private company financial reporting? Why or why not? If yes, what are some of

those distinctly different needs? Are those needs based on the user, preparer, or auditor? If those needs are different, what are the attributes of private companies that cause the differences?

- Does the committee believe fundamental changes should be made in the current GAAP standards-setting process to ensure that the financial reporting needs of private company constituents are met? If so, what are those changes? Should those changes be limited to a specific type of accounting principle or all accounting principles including concept statements, measurement and recognition models, and presentation and disclosure requirements?



FINANCIAL PERFORMANCE REPORTING  
BY BUSINESS ENTERPRISES  
Small Business Advisory Committee  
June 22, 2005

**BACKGROUND**

The objective of this joint FASB-IASB project is to establish standards for the presentation of information in financial statements that would improve the usefulness of that information in assessing the financial performance of a business enterprise. The FASB and IASB are conducting this project in phases. The first phase, Segment A, will address narrow differences between U.S. GAAP and International Financial Reporting Standards (IFRSs) relating to the definition of a comparable set of financial statements, the presentation of comparative information, and related matters. In the second phase, Segment B, the Boards will develop standards for presentation and display of information in all financial statements. Each phase will result in a separate final Statement.

The Boards established a Joint International Group (JIG) on performance reporting, which assists the Boards and staff in identifying issues to be considered in this project and developing proposed solutions. The JIG consists of senior professionals with extensive experience in and responsibility for the preparation, analysis, audit, and regulation of financial statements. The JIG will

hold its second meeting on June 14 in New York City with members of both Boards and staff to discuss various issues.

#### **DISCUSSION AT THE JUNE SBAC MEETING**

At the June meeting, the FASB would like to discuss with SBAC members the decisions reached to date as well as several of the issues to be discussed with the JIG on June 14.

#### **SUMMARY OF RECENT DECISIONS**

On Segment A issues, the FASB and IASB made the following decisions at meetings in April and May 2005:

1. A full/complete set of financial statements<sup>1</sup> includes:
  - a. A statement that shows (at a point in time) balances of assets, liabilities, and equity as of the beginning of the period—referred to as a *Beginning of the Period Statement of Financial Position*.
  - b. A statement that shows (at a point in time) balances of assets, liabilities, and equity as of the end of a period—referred to as the *End of the Period Statement of Financial Position*.
  - c. A statement that shows (for a period of time) the changes in assets and liabilities other than from transactions with owners in their capacity as owners—referred to as a *Statement of Earnings and Comprehensive Income*.
  - d. A statement that shows (for a period of time) the changes in assets and liabilities accompanied by changes in equity and the changes within the classes of equity that do not affect assets and liabilities—referred to as a *Statement of Changes in Equity*.
  - e. A statement that shows (for a period of time) inflows and outflows of cash—referred to as a *Statement of Cash Flows*.
2. Each statement in a full/complete set of financial statements shall be shown with equal prominence.
3. The statement of earnings and comprehensive income shall be a single statement that includes a required total for comprehensive income and subtotal for net income/profit or loss.

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<sup>1</sup> A complete set of financial statements includes notes to the financial statements. A full set of financial statements does not include notes to the financial statements.

4. Required comparative information will consist of, at a minimum, a full set of financial statements for two annual periods (the current and prior annual period). This decision, when combined with the decision to include a beginning of the period statement of financial position in a full set of financial statements, means that each reporting entity would provide three statements of financial position and two of each of the other required statements (the statement of earnings and comprehensive income, the statement of changes in equity, and the statement of cash flows).
5. Entities may voluntarily present financial statements in addition to the required minimum (for example, an entity could voluntarily provide a statement of earnings and comprehensive income for three periods—the current annual period and the two preceding annual periods).
6. The Boards decided not to amend the current requirements in IAS 33, *Earnings per Share*, and FASB Statement No. 128, *Earnings per Share*, in the context of the single statement of earnings and comprehensive income, which means that:
  - a. Presentation of basic and diluted earnings per share (EPS) on the face of the statement of earnings and comprehensive income will continue to be required (paragraph 66 of IAS 33 and paragraph 36 of Statement 128).
  - b. Disclosure of basic and diluted comprehensive income per share (CPS) in notes to financial statements will continue to be permitted but not required (paragraph 73 of IAS 33 and paragraph 37 of Statement 128).
  - c. Disclosure of the weighted average number of shares used as the denominator in calculating per share metrics in the notes to financial statements will continue to be required (paragraph 70 of IAS 33 and paragraph 40(a) of Statement 128).
7. This project will not develop guidance on the form and content of information contained in the notes to the financial statements (other than consequential amendments).
8. The IASB will not consider, as part of this project, possible changes to the form and content of information in interim financial statements (other than consequential amendments).
9. The FASB will consider, as part of this project, the impact of decisions reached on the financial reporting for interim periods.
10. The Boards agreed to issue a common Exposure Draft for the following Segment A issues:
  - a. The definition of a full set of financial statements and their prominence in a financial statement package

- b. Requirements for the statement of earnings and comprehensive income
- c. Required number of full sets of financial statements for annual periods.

On Segment B topics, the Boards have decided:

11. To develop common standards under Segment A and Segment B that would apply broadly to all business entities. The scope of the FASB Statement would exclude not-for-profit organizations.
12. To first develop a display model for Segment B that would apply broadly to all for-profit entities other than financial institutions. Second, to consider the application of that model to financial institutions.
13. To include in Segment B (rather than Segment A) consideration of IAS 7, *Cash Flow Statements*, and FASB Statement No. 95, *Statement of Cash Flows*, including whether to require use of the direct or indirect method of disaggregation and categorization issues.

(If you would like to read a discussion of the reasoning behind certain of the Boards' decisions summarized above, please refer to Appendix 1.)

## **ISSUES TO BE DISCUSSED AT THE JIG MEETING**

AT THE JIG MEETING ON JUNE 14, THE DISCUSSION WILL FOCUS PRIMARILY ON TWO ISSUES: THE MEANING OF *NET INCOME* AND HOW TO CATEGORIZE OR AGGREGATE INFORMATION IN A STATEMENT OF EARNINGS AND COMPREHENSIVE INCOME.

### **What Does *Net Income* Mean?**

The Boards decided as part of Segment A to require a single statement of earnings and comprehensive income that includes a subtotal for net income and a total for comprehensive income. That decision creates two basic categories within a single statement:

- Items included in net income
- Items excluded from net income (and therefore included in other comprehensive income).

While the Boards decided to retain the net income subtotal in Segment A, the Boards and staff continue their research on ways to improve the presentation and display of disaggregated information in the statement of earnings and comprehensive income. At the JIG meeting, the Board will hear presentations

from JIG members on what *net income* means. JIG members will be asked to share their views on the following questions.

1. Is it useful to financial statement users to present the following items outside net income:
  - unrealized gains and losses on available-for-sale (AFS) securities
  - gains and losses resulting from foreign currency translation adjustments
  - revaluations on PP&E
  - minimum pension liability adjustments
  - gains and losses resulting from cash flow hedges or foreign currency hedges.
2. What criteria/characteristics would you use to determine if a transaction or event should be included within net income or outside of net income?
3. Are there other transactions or events that are currently included within net income that would, according to the explanation given in response to the second question, provide more useful information if they were presented outside of net income?
4. Does the reclassification of items from OCI into net income provide value-relevant information and, if so, why?

### **Categorization in a Statement of Earnings and Comprehensive Income**

The other main issue that will be discussed at the JIG meeting is how information in a statement of earnings and comprehensive income should be aggregated or categorized. The JIG will focus on four primary issues which are laid out in Appendix 2 (the agenda paper from the JIG meeting on this subject) as Parts I-IV.

The first issue (Part I of Appendix 2) is whether a financing category is useful and, if so, the types of revenues, expenses, gains, and losses that should be included within that category.

The second issue (Part II) is how to categorize the remainder of the revenues, expenses, gains, and losses assuming that a financing category is useful. As more fully described in Part II, several categorization models have been developed for the discussion:

- Model 1—Nonexceptional-Exceptional
- Model 2—Recurring-Nonrecurring

- Model 3—Realized-Unrealized
- Model 4—Operating-Nonoperating
- Model 5—Cash Accruals-Market Value-Estimated Value

The third issue (Part III of Appendix 2) is how items presently reported as other comprehensive income (changes in assets and liabilities that are reported outside of net income) might be classified in the alternative categorization models discussed in Part II.

The fourth issue (Part IV) is whether the category definitions should be aligned across the different financial statements. For example, should the definition of “financing” be aligned across the statement of earnings and comprehensive income, cash flow statement, and balance sheet?

The memo presented in Appendix 2 (approximately 31 pages) was prepared to facilitate a full day’s discussion at the JIG meeting. Given that significantly less time will be available to discuss the issues at the SBAC meeting, we will not delve into the same level of detail. We invite SBAC members to read those parts that are of particular interest. To the extent SBAC members have an interest in and an opinion on the issues, we ask that you share those views at the meeting.

### **Results of JIG Meeting**

At the SBAC meeting, the FASB staff will report on the discussion at the June 14, 2005 JIG meeting.

### **QUESTIONS FOR DISCUSSION**

1. Do Committee members have any comments or questions about the FASB and IASB decisions to date?
2. With regard to net income, is it useful to financial statement users to present the following items outside net income:
  - unrealized gains and losses on available-for-sale (AFS) securities
  - gains and losses resulting from foreign currency translation adjustments
  - revaluations on PP&E
  - minimum pension liability adjustments
  - gains and losses resulting from cash flow hedges or foreign currency hedges.
3. What criteria/characteristics would you use to determine if a transaction or event should be included within net income or outside of net income?

4. Are there other transactions or events that are currently included within net income that would, according to the explanation given in response to the second question, provide more useful information if they were presented outside of net income?
5. Does the reclassification of items from OCI into net income provide value-relevant information and, if so, why?
6. Do Committee members have any comments about how information in a statement of earnings and comprehensive income should be aggregated or



categorized?

## **JOINT CONCEPTUAL FRAMEWORK PROJECT**

**Small Business Advisory Committee  
June 2005**

### **BACKGROUND**

In the six months since this Committee last discussed the new conceptual framework project, the IASB and FASB in February approved plans to start work on the project by considering the objectives of financial reporting and the qualitative characteristics of accounting information. The Boards started discussing those topics in April and May, and will discuss them further in June (on Wednesday afternoon, just after this Committee's meeting) and July. In the next phase, beginning later in 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 the appendix to this paper for a list of tentative decisions reached to date.

The FASB also decided that, rather than forming its own conceptual framework working group or task force, it plans to consult with FASAC for advice on broad, strategic issues in the project. Also, of course, the Board is looking to this Committee for advice on how the matters being discussed in the project look from the small business perspective.

This paper focuses on the objectives of financial reporting discussed by the Boards in April, in particular (1) the financial information needs of users and (2) the relative importance of decision-usefulness and accountability or stewardship.

### **OBJECTIVES OF FINANCIAL REPORTING – USER NEEDS**

At their joint meeting in April, the FASB and IASB reached two tentative conclusions about the needs of users of financial reports.

The first conclusion is that financial reports should be prepared from the entity's perspective and should aim to provide information to a wide range of users, rather than focusing 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 advisers). Later in the project, the Boards will consider whether financial reporting also should provide information to meet the information needs of particular types of users, such as different types of equity participants.

That conclusion is consistent with both Boards' existing frameworks, but it may become controversial. Some constituents primarily concerned with publicly held companies have suggested that the focus should be on existing common shareholders, rather than also, for example, holders of stock options, preferred stock, or redeemable stock. That might have implications for later stages of the concepts project: some of those constituents would classify those other kinds of interests as liabilities, rather than equity, primarily so that the "bottom line" net income would be what is attributable to existing common shareholders. While not ruling out that possibility, the Boards' conclusion points in a different direction.

The second conclusion is that the overriding objective of financial reporting is to provide information about the entity that is useful *to the external users who lack the power to prescribe the information they require and must therefore rely on the information provided by an entity's management*. The entity's management will also 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. Similarly, certain external users, for example, a credit rating agency or a bank lender, generally have the power to prescribe the information they require and their *additional* information needs may therefore be beyond the scope of the framework (emphasis added).

That conclusion also is consistent with both Boards' existing frameworks. Constituents primarily concerned with privately held businesses—such as members of this Committee—may be inclined to question the focus on those

external users. The FASB has heard comments along the lines of “the only people who ever see these financial statements are the owner-managers and the bank, so why shouldn’t the focus be on them, not on hypothetical external users?” The conclusion reflects other constituents’ comments, and Board members’ experience, that general-purpose external financial statements of privately held entities, or at least information derived from those statements, do tend to find their way into the hands of other external users—suppliers, customers, bonding agencies, government regulators, employee groups, and others who use that information in making various kinds of economic decisions that affect the entity.

Some constituents concerned primarily with privately held businesses have suggested that the information needs of users of their financial statements are narrower than the information needs of investors and creditors of publicly held businesses. One recent letter proposed that:

. . . we would like to see the Concepts Statement project broadened, from the primary goal of reaching a common framework with the IASB, to a full consideration of the different needs of the users of private company financial information. We note that at a recent meeting on this project the Board directed the staff to add a project phase to determine the applicability of the concepts to the not-for-profit sector. We request that the Board add an additional phase directing the staff to determine the applicability of the concepts to private, for-profit entities (versus public, for-profit entities). Such a phase should include a full due diligence study of the user needs and objectives of financial reporting of private companies.

That proposal would require a substantial commitment of Board resources as well as constituents’ time and energy. It is not clear that it is needed. The basic strategy of this project is to update, refine, and complete the conceptual

frameworks developed in the 1970s and 1980s, and converge them, focusing particularly on troublesome issues that ‘cut across’ several standards-level projects. To summarize, the strategy is to focus on what may need changing, rather than to “reinvent the wheel” by reconsidering every decision made in the original concepts projects.

In the early 1980s, the FASB engaged in a substantial process of assessing the information needs of users of smaller companies,<sup>2</sup> including detailed questionnaires answered by hundreds of preparers, auditors, and users; the details and results of that process are available in the Board’s public records. On page 5 of the separately attached November 1983 *Status Report* is a summary of the results, which the Board published as part of its response to the February 1983 report of an AICPA Special Committee on Accounting Standards Overload, which focused particularly on small, closely held businesses. Based on that process, the Board concluded that consideration of users’ needs supported omitting certain disclosure requirements for privately held or smaller businesses (and the Board issued standards that did that) but retaining the same recognition or measurement principles for both large and small businesses.

Recently a new AICPA Task Force on Private Company Financial Reporting has been looking into the same issues. The task force reported on its work to the

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<sup>2</sup> FASB Invitation to Comment, “Financial Reporting by Private and Small Public Companies” (November 20, 1981). Results were reported in a FASB Special Report, February 1983. Academic research studies were also commissioned. One research report, funded with support from the National Association of Accountants, was published by the FASB in August 1983.

Financial Accounting Standards Advisory Council in March 2005. The task force concluded that “GAAP for private companies should be developed based on concepts and accounting that are appropriate for the distinctly different needs of constituents of that financial reporting.” Council members questioned many aspects of the task force’s work and took exception to that conclusion. [Note: SBAC members will discuss the same report at the June 22 meeting.]

Board members would be interested in hearing comments about *why* the needs of users of small or privately held business financial statements differ from the needs of users of large, publicly held business financial statements.

The FASB has also heard from bank lenders that “I don’t have this ‘power to prescribe the information I require.’ If I try, the customer will just switch to another bank that doesn’t ask so many questions.” Perhaps so, although to ‘just switch to another bank’ is not so easy for many smaller businesses. But the Boards’ first conclusion on objectives calls for information needed by present and potential investors and creditors, and an entity’s banks are certainly present or potential creditors, so they are hardly being left out of consideration by these objectives.

In more detailed conclusions, the Boards agreed that “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” and that 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.

Board members would be interested in hearing comments about whether the concepts should place more emphasis on information needed by bank lenders or others to assess liquidity and solvency.

### **OBJECTIVES OF FINANCIAL REPORTING – STEWARDSHIP**

The Boards also discussed the relative roles of decision-usefulness and the stewardship or accountability of management. In the two Boards' existing frameworks, the overriding objective of financial reporting is to provide information to assist users in making economic decisions. The objective of providing information to help users to assess the stewardship or accountability of management is a subset of the decision-usefulness objective.<sup>3</sup> The Boards asked the staff to investigate further the meaning of 'stewardship' and 'accountability,' and the implications of having such an objective in the framework. The Boards plan to discuss further, at their July meetings, whether the stewardship/accountability objective should be retained or eliminated from the conceptual framework.

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<sup>3</sup> In that discussion, Board members suggested that in the not-for-profit and public sectors, stewardship has a much larger role, which is distinct from (rather than a subset of) decision-usefulness. However, the Boards have agreed to begin the conceptual framework project by focusing on entities in the private (that is, nongovernment) business sector. Later, the Boards will consider the applicability of the concepts to other sectors

The tradition of stewardship in accounting originated in the reports demonstrating a steward's accountability for assets entrusted to him by the lord of the manor. Such reports make it difficult for an embezzling steward to escape detection. Some of the day-to-day activity of accounting still has that general goal. Accountability reports also may show how efficiently a steward has employed the assets as a basis for deciding whether to retain or dismiss the steward or how much to pay him or her. More recently, some have expanded that second meaning, attaching the term stewardship to suggestions to emphasize the portion of results of operations that is in some sense under management control, separating that portion of comprehensive income from other recognized gains or losses that are said not to be under management's control. Suggestions for the latter, all debatable, have included effects of changes in interest rates or securities prices (either all or the unrealized portion), foreign exchange translation, windfall gains, and uninsured casualty losses.

Board members would be interested in hearing views about whether stewardship, either in the traditional sense or the more recent sense, should be an objective on a par with usefulness in investment and credit decisions or, as the Boards have concluded, is a subsidiary of the overriding decision-usefulness objective.

#### **QUESTIONS FOR DISCUSSION BY THE COMMITTEE**

1. Do you agree with the Boards' conclusions (a) that general-purpose external financial statements are aimed at a wide range of users, primarily present and potential investors and creditors (and their advisers), and (b) that the overriding objective is to provide decision-useful information to external users who lack the power to prescribe the information they require?

2. Do you perceive that the needs of users of small or privately held business financial statements differ from the needs of users of large, publicly held business financial statements? If so, **why**?
3. Should the concepts place more emphasis on information needed by bank lenders or others to assess liquidity and solvency?
4. Should stewardship, either in the traditional sense or the more recent sense, be an objective on a par with usefulness in investment and credit decisions or, as the Boards have concluded, should it be a subsidiary of the overriding decision-usefulness objective?

**Appendix****TENTATIVE DECISIONS REACHED BY THE FASB AND IASB**

The Boards deliberated issues relating to the objectives of financial reporting at the Boards' joint meeting in April. They reached the following tentative conclusions:

- Financial reports should be prepared from the entity's perspective and should aim to provide information to a wide range of users, rather than focusing 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 advisers). Later in the project, the Boards will consider whether financial reporting also should provide information to meet the information needs of particular types of users, such as different types of equity participants.
- The objective is to provide information about the entity that is useful to the external users who lack the power to prescribe the information they require and must therefore rely on the information provided by an entity's management. The entity's management will also 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. Similarly, certain external users, for example, a credit rating agency or a bank lender, generally have the power to prescribe the information they require and their additional information needs may therefore be beyond the scope of the framework.
- As discussed in the two Boards' existing frameworks, the financial statements should provide information to help users to assess an entity's liquidity and solvency. However, that objective should be consistent with the overall objective of providing decision-useful 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.

- 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.

The Board continued its deliberations on its joint IASB/FASB conceptual framework project at its meeting on May 25, 2005. The Board discussed issues relating to some of the qualitative characteristics of accounting information and reached the following conclusions, which are generally consistent with the present frameworks except as noted:

1. *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 framework. Also, the information must be available when the users need it (timeliness).
2. 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 or as synonymous with statistical predictability or persistence.

3. *Faithful representation* of real-world economic phenomena is an essential qualitative characteristic, which includes capturing the substance of those economic phenomena. Faithful representation also includes the quality of *completeness*. The common conceptual framework will need to discuss thoroughly what faithful representation means and what it does not mean.
4. 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.
5. 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, complete, and 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.
6. 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.
7. Although empirical research may provide evidence useful in standard-setting decisions, for example, in assessing trade-offs between desirable qualities, the conceptual framework project should not seek to develop empirical measures of faithful representation or its component qualities.

The staff was directed by Board members to address the following at a subsequent meeting:

- Possibly using another term for the concept of predictive value to avoid potential confusion stemming from its different meanings outside of accounting.
- The notion of the need to exercise due care in the preparation of financial information.
- Whether the discussion of user-specific characteristics needs to be developed further.

The staff was directed to consider how to emphasize the following suggestions by Board members in drafting:

- Information with *predictive value* is not information that predicts itself, that is, that by looking at one number in a series a user would not be able to predict the next number in the series.
- Information can be capable of being used even if there is no evidence of a present use. In addition, whether information is capable of making a difference in a decision should be thought of in the context of the objectives of financial reporting.
- Why *faithful representation* encompasses the other qualities previously considered subqualities of reliability.
- *Verifiability* does not mean not having to change a recorded accounting number (such as an estimate) when the ultimate outcome is determined or as economic conditions change.
- *Relevance* and *faithful representation* are both essential qualitative characteristics, but relevance may be used as a filter in the thought process before faithful representation. That is, if information is not relevant, there is no need to consider whether it faithfully represents what it purports to represent.



## CODIFICATION AND RETRIEVAL PROJECT

**Small Business Advisory Committee  
June 22, 2005**

### **Background**

The Board's long-term goal is to create a single, authoritative codification of U.S. GAAP. In September 2004, the Financial Accounting Foundation (FAF) trustees approved the Board's plan to develop a U.S. GAAP Codification. The objective of the codification is to integrate and topically organize all relevant accounting guidance issued by the U.S. standard setters (FASB, AICPA, EITF, and SEC). The Board will issue the codification draft to constituents for an extended verification period. The objective of the verification process is to ensure that the codification accurately reflects existing U.S. GAAP. Once the Board addresses constituent comments, the codification will become the single authoritative source of U.S. GAAP and will supersede all existing standards.

The September 2004 and February 2005 editions of the FASB Report included articles (attached to this memo) related to the codification project. These articles provide a good background regarding the planned direction for the codification and retrieval project.

### **Status**

Since September 2004 (the FAF trustee approval date), the codification and retrieval project team has made substantial progress on the project plan. Below are some of the major items in process, or achieved, by the team:

- 1) Finalizing development of the "mapping" phase of a system used to track the migration of standards to the codification (the "tracking system").
- 2) Finalizing conversion of all existing GAAP literature into a standard format for use in the tracking system.
- 3) Acquired office space at "FASB North" (488 Main Avenue) to house the project team.

Note: These materials are provided to facilitate understanding of the issues to be addressed at the June 22, 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.

- 4) Retained individuals to serve as codification director, codification project manager and as codification technical review manager.
- 5) Retained 22 individuals to serve as codifiers (or "mappers") and authors.
- 6) Completed training for the 22 individuals on the codification process and vision.
- 7) Developed a draft prototype of the investments in debt and equity securities topic.
- 8) Obtained user feedback regarding the codification structure.

The 22 individuals retained as "mappers" and authors include:

- 1) University professors (6).
- 2) Recently retired public accounting partners (5).
- 3) Partners/directors of professional service firms of various sizes (5).
- 4) Professional writers of accounting guidance—all were previously on staff at the FASB or AICPA (4).
- 5) Recently retired chief financial officer and consultant (2).

In December 2004, we completed a survey of EITF members, AcSEC members, FEI participants, and others. The results demonstrate substantial agreement with the proposed structure for the codification.

- 1) Results:
  - a) 93 percent agree / strongly agree that the structure is easy to understand.
  - b) 93 percent agree / strongly agree that the structure will simplify access.
  - c) 80 percent agree / strongly agree that the structure will reduce research time.
  - d) 80 percent agree / strongly agree that the structure places all guidance in one spot.
  - e) 83 percent agree / strongly agree that the structure will be easier to understand for new users.
- 2) In relation to existing U.S. GAAP, 97 percent believe that the structure is an improvement or significant improvement when compared with existing GAAP.

## **Miscellaneous Matters**

### Private Companies

The codification will contain the text of all relevant U.S. GAAP literature issued by the FASB, ARB, APB, AICPA, EITF and SEC. However, the codification will segregate the SEC content so that it will not interfere with the needs of private companies. Ultimately, we

may develop functionality within the electronic retrieval system that will allow users to exclude SEC content from their user interface.

### Ongoing Surveys and Feedback

During the coming year, the project team expects to initiate several surveys and focus groups to capture comments on the codification retrieval system. The initial surveys will capture suggestions that we will use to develop system requirements.