SMALL BUSINESS ADVISORY COMMITTEE

December 1, 2004 - - - - 9:00 A.M.

FASB Offices - - - - Norwalk, Connecticut

<u>Agenda</u>

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. The Conceptual Framework (Mr. Bullen)	Mr. Bullen will present an introduction and an overview of the FASB's conceptual framework. (Attachment B)
B R E A K	
4. The Board's Cost-Benefit Procedures (Mr. Bossio)	Committee members will discuss the Board's procedures for assessing the benefits and costs of proposed changes to accounting standards. (Attachment C)
L U N C H	
5. Liabilities and Equity (Ms. Schipper and Ms. Richards)	Committee members will discuss the ownership-settlement approach for distinguishing liabilities and assets from equity for single-component instruments. (Attachment D)
6. Equity-Based Compensation (Messrs. Crooch and Campbell)	Committee members will discuss changes to various aspects of the Exposure Draft on share-based payment that will affect small business issuers and nonpublic enterprises. (Attachment E)
7. Results of the SBAC Survey and Closing Remarks (Mr. Batavick)	The Committee will discuss the results of the survey. Committee members also will discuss any new issues that may require the Board's attention. (Attachment F)
A D J O U R N M E N T	

11/30/04

FASB CHAIRMAN’S REPORT

- OBSERVATIONS ON CURRENT REPORTING ENVIRONMENT
- TECHNICAL ACTIVITIES
- INTERNATIONAL
- WASHINGTON D.C. UPDATE

AN INTRODUCTION TO THE CONCEPTUAL FRAMEWORK AND A NEW JOINT PROJECT TO IMPROVE IT

What is the Conceptual Framework?

The conceptual framework is a coherent system of interrelated objectives and fundamentals that prescribes the nature, function, and limitations of financial reporting. The objectives identify the goals and purposes of financial reporting. The fundamentals are the underlying concepts of financial accounting. Those concepts provide guidance in selecting the transactions, events, and circumstances to be accounted for, how they should be recognized and measured, and how they should be summarized and reported.

The FASB’s efforts to develop the conceptual framework have resulted in seven Concepts Statements (one is a replacement of an earlier one to include nonprofit organizations in addition to business enterprises). Those Concepts Statements cover:

- The objectives of financial reporting by both business enterprises and nonprofit organizations
- The qualitative characteristics of useful accounting information

- The elements of financial statements (that is, the definitions of assets, liabilities, revenues, and so forth)
- The criteria for recognizing and measuring those elements
- The use of cash flow and present value information in accounting measurements.

The first of the Concepts Statements was issued in 1978, and all had been issued by 1985 except the most recent one, which was issued in 2000. The need to update the Concepts Statements has been become apparent in work on several of the Board's current standard-setting projects, particularly the projects on revenue recognition and liability and equity. The Board recently added to its agenda, jointly with the International Accounting Standards Board (IASB), a project to update and complete the Concepts Statements and converge them with the IASB's framework.

Why Is a Framework Needed?

The framework is intended to facilitate the provision of even-handed—neutral—financial and related information. That information serves the public interest by helping to promote the efficient allocation of scarce resources in the economy and society. As such, the framework helps the capital markets and other markets—both public and private—to function more efficiently.

A framework is needed to provide direction and structure to financial accounting and reporting. It is expected to lead to standards that are consistent both internally and with each other.

Without the guidance provided by an agreed-upon framework, standard setting ends up being based on the individual concepts developed by each member of the standard-setting body. As Charles Horngren (former member of the APB, former FASAC member, and former FAF trustee) once noted, "As our professional careers unfold, each of us develops a technical conceptual framework. Some individual frameworks are sharply defined and firmly held;

others are vague and weakly held; still others are vague and firmly held."[1] He added that:

> At one time or another, most of us have felt the discomfort of listening to somebody attempting to buttress a preconceived conclusion by building a convoluted chain of shaky reasoning. Indeed, perhaps on occasion we have voiced such thinking ourselves . . .
>
> My experience as a member of the APB taught me many lessons. A major one was that most of us have a natural tendency and an incredible talent for processing new facts in such a way that our prior conclusions remain intact. [Footnote omitted.]

Standard setting that is based on the personal conceptual frameworks of individual standard setters therefore is likely to produce agreement on a specific standard-setting issue only when a sufficient number of those personal frameworks happen to intersect on that issue. However, even those agreements may prove to be transitory because, as the membership of the standard-setting body changes over time, the mix of individual conceptual frameworks will change as well. As a result, that standard-setting body may reach significantly different conclusions about similar (or even identical) issues than it did earlier, with standards not being consistent with one another and past decisions not being indicative of future ones. That troublesome result occurred at the AICPA's Committee on Accounting Procedure, which preceded the APB, and it occurred more than once at the APB as well despite its efforts to do better.

Did the APB Develop a Framework?

The AICPA special committee whose 1958 report resulted in the creation of the APB had urged the APB to work on both concepts and standards on the grounds that such concepts would provide a meaningful foundation for standards. In response, the APB commissioned two research studies on the "postulates" and "broad principles" of accounting. However, after reviewing the studies, the APB concluded that the recommendations contained therein were "too radically different" from GAAP for acceptance at that time.

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[1] Charles T. Horngren, "Uses and Limitations of a Conceptual Framework," *Journal of Accountancy,* April 1981, p. 90.

As a result of problems that emerged from the Opinions that the APB subsequently issued, the AICPA appointed another special committee in 1964 to reexamine the program for establishing accounting principles. Among its major recommendations was that the APB develop a conceptual framework to guide its decision making. The APB responded by publishing APB Statement No. 4, *Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises*, in 1970. However, the APB itself acknowledged that APB Statement 4 was "primarily descriptive, not prescriptive," focusing on what financial accounting was at the time rather than what it ought to be. Because Statement 4 reflected only past practices, not all of which were consistent with one another, it did not prove to be a robust and helpful tool for the APB to use as guidance in setting standards.

Soon afterward, in response to criticism of the APB, the AICPA appointed two study groups—one chaired by Francis M. Wheat to consider the establishment of accounting principles and the other chaired by Robert M. Trueblood to consider the objectives of financial statements. The recommendations of those groups laid the foundation for the FASB and for its conceptual framework project.

How Does the FASB's Approach Differ?

When the FASB first began operations in 1973, among the projects on its initial agenda was one that encompassed the objectives of financial reporting. That project focused on the findings of the Trueblood Study Group, as published in *Objectives of Financial Statements* (the Trueblood Report).[2] The Trueblood Report focused on what might be thought of as "first principles," namely the objectives of financial statements. By establishing the objectives early on, that report laid a sound foundation on which the FASB could and did develop the subsequent concepts that constitute the conceptual framework.

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[2] The other study, *Establishing Financial Accounting Standards* (the Wheat Report), focused on how accounting principles should be established. In doing so, it reviewed the operations of the FASB's predecessor, the Accounting Principles Board, and proposed the establishment of an independent standard-setting body, which led to the formation of the FASB.

Have Other Standard Setters Developed Conceptual Frameworks?

Following the FASB's lead, standard setters in a number of other jurisdictions also have developed their own frameworks. Canada and the International Accounting Standards Committee (now the International Accounting Standards Board) were the first to do so, followed by Australia, New Zealand, and most recently (in 1999), the United Kingdom. Their frameworks, like that of the FASB, are based on the fundamental objective that financial reporting should provide information that is useful to investors and creditors in making investment and credit decisions. Not surprisingly, the conceptual frameworks that were developed are similar (but not identical) to the FASB's framework.[3]

The differences between those similar but not identical frameworks can lead different standard-setters to reach different conclusions. One reason to revisit the FASB's concepts statements is to avoid such differences by seeking to converge on a single, identical framework.

Who Benefits from the Framework?

The standard-setter is the most apparent beneficiary of the framework. Because the framework is a cohesive and coherent set of objectives and concepts, our framework provides the FASB with a foundation for setting standards by providing concepts to use as tools for resolving accounting and reporting questions. The framework provides a basic reasoning on which to consider the merits of alternatives and, although it does not provide all the answers, it points the way. In doing so, the framework reduces the influence of personal views and biases, as well as political pressures in making accounting judgments. The framework also helps the Board and its constituents communicate using a common frame of reference during the due process by which standards are

[3] The G4+1 (a group of standard setters originally consisting of standard setters from Australia, Canada, the U.K., and the U.S., plus the IASC) came into being in 1993 largely because all of its members share the view that the objective of financial reporting is to provide decision-useful information. Therefore, it was fruitful for group members to meet to discuss common conceptual and standard-setting issues. With the reorganization of the IASC into the new IASB, which has direct liaison relationships with those standard setters, the G4+1 had served its purpose and was disbanded.

developed. For those reasons, it has proven to be an indispensable part of the FASB's standard-setting process.

Others also are beneficiaries of the framework. The use of objectives and concepts to help develop standards enhances the credibility of financial reporting by producing a body of standards that is more internally consistent and less ad hoc. That structure helps users of financial reporting information to better understand that information and its limitations. Moreover, it provides a frame of reference for understanding standards, which is useful to preparers who apply those standards and auditors who examine the resulting reports. That frame of reference also is helpful to faculty who teach accounting and students who study it.

How Does the Framework Affect Practice?

Concepts Statements do not affect practice directly. They do not require a change in GAAP, amend, modify, or interpret existing accounting or disclosure standards, require changes in accounting procedures, or require disclosure of practices that might be in conflict with the concepts. Concepts Statements are not intended to invoke application of Rule 203 or 204 of the AICPA's Rules of Conduct of the Code of Professional Ethics. The framework affects practice only by means of its influence in the development of new accounting standards.

How Does the FASB Use the Framework?

The FASB staff considers pertinent concepts that might provide guidance in developing its analysis of issues for consideration by the Board, as well as in making its recommendations to the Board. Similarly, the Board considers applicable concepts in discussing those issues and in making its decisions about a specific standard. In fact, a discussion of the concepts used in developing a standard is included in the basis for conclusions of each standard.

What Are Some Key Components of the Framework?

The framework consists of objectives and concepts.

The objectives of financial reporting flow from the more general to the specific. The objectives begin with a broad focus: providing *information that is useful in* *investment, credit, and similar decisions* being made by external parties who generally lack the authority to prescribe the information they want. That objective is broader than just providing a report to shareholders on management's stewardship. The intended audience is broader than just management or other insiders; instead, the audience includes present and prospective investors, lenders, suppliers, customers, employees, and others who make decisions about establishing or continuing their relationships with the entity and need broadly similar financial information to make those resource allocation decisions. That broad objective for general-purpose external financial reporting is also the same for smaller, privately held companies as for larger, public companies.[4]

That broad focus then narrows to investors' and creditors' primary interest in *the prospect of receiving cash from their investments in or loans to reporting entities*, and the relationship of that prospect to those entities' prospective net cash flows from their business activities. Finally, the objectives focus on providing *information about an entity's economic resources, the claims to those resources, and changes in them* (including measures of the entity's performance), which is useful to investors and creditors in assessing the entity's cash flow prospects.[5]

The concepts flow from the objectives. Because the objectives focus on an entity's economic resources, the claims to those resources, and the changes in them, it follows that some of the key concepts address the definitions of assets and liabilities. Since the APB's framework also included definitions of assets and liabilities, it is instructive to compare those definitions with the ones in the FASB's framework.

The APB defined assets and liabilities in APB Statement 4 (paragraph 132) as follows:

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[4] The FASB considered whether that broad objective should be different for smaller, privately held companies but found little basis for differences, either in its consideration of objectives in the 1970s or in its consideration of almost 1,000 responses to a 1981 Invitation to Comment, *Financial Reporting by Private and Small Public Companies*.

[5] It has been said that the golden rule is the message of the Bible and the rest is elaboration. Similarly, decision usefulness is the message of the conceptual framework and the rest is elaboration.

> *Assets*—economic resources of an enterprise that are recognized and measured in conformity with generally accepted accounting principles. Assets also include certain deferred charges that are not resources but that are recognized and measured in conformity with generally accepted accounting principles.
>
> *Liabilities*—economic obligations of an enterprise that are recognized and measured in conformity with generally accepted accounting principles. Liabilities also include certain deferred credits that are not obligations but that are recognized and measured in conformity with generally accepted accounting principles.

Those definitions are consistent with the approach that was taken in APB Statement 4, that is, by inferring principles from existing practice. In doing so, however, the APB produced definitions that are circular in nature. In effect, the APB's definition of assets states that an asset is anything with a debit balance once the books are closed.

Defining assets (liabilities) as anything that GAAP treats as assets (liabilities) confuses the *accounting representations* on the balance sheet with the *economic phenomena that are to be represented*. Such circular definitions do not provide guidance in making standard-setting decisions about which items qualify to be represented on balance sheets as assets and liabilities, because such definitions do not rule out anything.

In contrast, the FASB defines assets and liabilities in terms of the items to be represented (that is, real-world economic phenomena) rather than the representations of those items on balance sheets. Concepts Statement No. 6, *Elements of Financial Statements,* defines them as follows:

> Assets are probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events. [paragraph 25]
>
> Liabilities are probable sacrifices of future economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events. [paragraph 35]

Each of those definitions identifies three essential characteristics needed for an item to qualify for representation in the balance sheet as an asset or liability. The three essential characteristics of an asset are:

(a) It embodies a probable future benefit that involves a capacity, singly or in combination with other assets, to contribute directly or indirectly to future net cash inflows.

(b) A particular entity can obtain the benefit and control others' access to it.

(c) The transaction or other event giving rise to the entity's right to or control of the benefit has already occurred.

Any item that possesses all three of those characteristics meets the definition; if it fails to possess any one of those characteristics, it does not meet the definition of an asset.

The three essential characteristics of a liability are:

(a) It embodies a present duty or responsibility to one or more other entities that entails settlement by probable transfer or use of assets at a specified or determinable date, on occurrence of a specified event, or on demand.

(b) The duty or responsibility obligates a particular entity, leaving it little or no discretion to avoid the future sacrifice.

(c) The transaction or other event obligating the entity has already happened.

Any item that possesses all three of those characteristics meets the definition; if it fails to possess any one of those characteristics, it does not meet the definition of a liability.

All of the other definitions flow from those basic definitions. For example, *equity* is defined as the residual interest in an entity's assets that remains after deducting its liabilities. Similarly, changes in equity—*investments by owners, distributions to owners, revenues, expenses, gains, losses,* and *comprehensive income*—are all defined in terms of changes in assets and liabilities (that is, as inflows, outflows, or other increases or decreases in assets or liabilities).

Thus, assets and (to a lesser extent) liabilities have conceptual primacy, while income and its components—revenues, expenses, gains, and losses—do not. That is not because information about assets and liabilities is the most important information, but rather because the definitions of the elements that make up a fully articulated, internally consistent system of financial statements have to start somewhere. Former FASB Board member (and former APB member) Oscar Gellein, expressed it succinctly:

> Every conceptual structure builds on a concept that has primacy. That is simply another way of saying some element must be given meaning before meaning can be attached to others. I contend that assets have that primacy. I have not been able to define income without using a term like asset, resources, source of benefits, and so on. In short, meaning can be given to assets without first defining income, but the reverse is not true. That is what I mean by conceptual primacy of assets. No one has ever been successful in giving meaning to income without first giving meaning to assets.[6]

That conceptual hierarchy provides the necessary discipline that APB Statement 4 lacked. It helps the Board identify the items that qualify for inclusion in financial statements as well as the ones that do not qualify. For example, deferred charges and deferred credits (that result from conventional practices such as "matching" revenues and expenses) that do not possess the characteristics of assets and liabilities do not meet the definitions and do not qualify for admission to the financial statements. As an example at the standards level, those concepts led the Board to adopt the "liability method" of income tax accounting in Statement 109, in place of the earlier "deferral method" of APB Opinion 11.

With that hierarchy, the conceptual framework provides guidance on the right questions to ask in standard setting and the order in which they should be asked. Reed K. Storey, a principal architect of the framework, described those questions as follows:

> What is the asset?
>
> What is the liability?
>
> Did an asset or liability or its value change?
>
> > Increase or decrease?
> >
> > By how much?
> >
> > Did the change result from:

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[6] Oscar S. Gellein, "Primacy: Assets or Income?" in *Research in Accounting Regulation,* vol. 6, edited by Gary John Previts, page 198.

An investment by owners?

A distribution to owners?

Comprehensive income?

Was the source of comprehensive income:

Revenue?

Expense?

Gain?

Loss?[7]

Starting at the bottom of the list and working up simply does not work because it results in reporting items in the balance sheet as assets and liabilities even though they do not meet either the technical definitions of those terms or what the person on the street would think of as assets and liabilities.

The Need to Revisit the Framework

The Board has found the framework useful in setting standards. For example, the definitions of assets and liabilities that exclude deferred charges and deferred credits led the Board to adopt the 'liability method' of income tax accounting in Statement 109, in place of the 'deferral method' formerly used under APB Opinion 11. The inclusion under the liability definition of equitable and constructive obligations led the Board to require recognition of liabilities for post-employment health care in Statement 106. The definitions helped the Board decide (in Statement 133) that derivative instruments result in assets or liabilities that should be recognized. More recently, the definitions also led the Board to conclude in Statement 150 that mandatorily redeemable preferred shares are liabilities, and, much more controversially and now under reconsideration, that common shares of private companies mandatorily redeemable on retirement or death are liabilities.

The Board continues to utilize the framework in making decisions in its current agenda projects, such as liability and equity, purchase method procedures, and revenue recognition. However, as noted previously, most of the framework was

[7] Reed K. Storey and Sylvia Storey, FASB Special Report, *The Framework of Financial Accounting Concepts and Standards,* page 87.

developed 20 or more years ago. Because the framework has not kept up with changing times and changing business practices, it needs updating and refining. Moreover, certain aspects of the framework are inconsistent with others, and those inconsistencies need to be eliminated. Furthermore, some parts of the framework that originally were planned were not ultimately completed, even though the need for conceptual guidance in those areas continues to be evidenced in the Board's agenda projects.

Faced with insufficient, outdated, or inconsistent concepts, individual Board members must resort to their own internal (and unstated) conceptual frameworks, which may not be consistent with those of other Board members. That can complicate Board decision-making, confuse constituents during due process, or produce unsatisfactory standards. For example, the Board has had to suspend and reconsider its conclusion in Statement 150 that common shares of private companies mandatorily redeemable on retirement or death are liabilities, a decision based on the Board's interpretations of conceptual definitions of liability and equity that proved insufficient to resolve that issue satisfactorily. Also, decisions resulting from Board members' individual frameworks may not be durable, since they are susceptible to change with Board member turnover. For those reasons, the framework is gradually becoming less helpful in providing guidance to the Board for making standard-setting decisions.

That is not just an American problem. The International Accounting Standards Board's framework, issued in the late 1980s, is similar in many respects to the FASB concepts statements, though they differ in some ways. The IASB has found their framework useful in setting international accounting standards, but the IASB also has found it somewhat out of date, inconsistent in some respects, and incomplete. Furthermore, the FASB and IASB have committed themselves to converging their standards, and that would be less difficult if the two Boards had a common framework. Seeing a common interest in improving frameworks, the Boards discussed the possibility of a joint project at their April 2004 joint meeting.

The Joint Conceptual Framework Project

At the October 2004 joint IASB-FASB meeting, the Boards added to their respective agendas a joint project to develop a common conceptual framework—a single framework that both converges and improves upon the existing frameworks of the two Boards.

The planned approach will identify troublesome issues that seem to reappear time and time again in a variety of standard-setting projects and often in a variety of guises. That is, the focus will be on issues that cut across a number of different projects, or "crosscutting issues." Because of the inability to address those issues comprehensively in the context of a standards-level project, the Boards are limited to developing standards-level guidance that is less than optimal. The planned approach aims to identify and resolve those crosscutting issues in advance of when the conceptual guidance is needed in standards-level projects.

There are numerous crosscutting issues. One example is the matter of the term *probable,* which is part of the definition of asset and of liability in the FASB framework is used in a different way as part of the recognition criteria in the IASB framework. Another relates to other aspects of the liability definition, which is not as clear and as effective as it needs to be to distinguish some liabilities from equity instruments and other liabilities from revenues. Yet another relates to the accounting for contractual rights and obligations. Still another concerns the "unit of account," which involves consideration of both aggregation (including linkage) of apparently separate items and disaggregation of complex items. There are many other candidates.

Once the crosscutting issues have been identified, they will be prioritized. One consideration will be how frequently and how soon those issues would be likely to arise in standards-level projects. Another consideration will be the interdependencies between crosscutting issues, so that higher priority would be assigned to issues on which the resolution of other issues depend. Still another consideration in setting priorities will be whether resolving the issue would foster convergence of the FASB's and IASB's frameworks. The Boards began work on identifying and prioritizing the cross-cutting issues in November.

After that, joint deliberations will focus on each crosscutting issue and work towards improved concepts. The initial goal is one converged and improved concepts of objectives, qualitative characteristics, elements, recognition, and measurement, with work also needed on display and disclosure. The project will likely involve one or more initial discussion documents and an exposure draft before a final Statement is issued, several years from now.

Discussion Questions

1. The objectives of financial reporting begin with providing *information that is useful in investment, credit, and similar decisions* being made by *external parti*es who generally lack the authority to prescribe the information they want. That objective is broader than just providing a report to shareholders on management's stewardship, and the intended audience is broader than just management or other insiders. That broad objective is also the same for smaller, privately held companies as for larger, public companies.

   That overriding objective, controversial in the 1970s, seems to be widely accepted today. Does the Board need to revisit it?

2. The staff has suggested several possible examples of conceptual issues that might be prioritized because they cut across several standards-level projects, including the meaning and role of *reliability*; the definition of *liability*; the meaning of *probable*; the effect of conditions, contingencies or other uncertainties; the unit of account; and accounting for contractual rights and obligations.

   a. Do those issues merit priority?

   b. What other cross-cutting issues deserve priority also, or instead?

Assessing the Benefits and Costs of a Proposed change to Accounting and Reporting standards

Since the Board began setting accounting standards in the 1970s, its constituents have asked and continue to ask:

- How do Board members assess and weigh the potential benefits and costs of a proposed change to accounting and reporting standards?
- What procedures does the FASB use to assist Board members in assessing whether the expected benefits justify the anticipated costs?

Who Asks and Why?

Those interested in the FASB's standard-setting process and some of their concerns about the benefits and costs of a new standard include:

- *CEOs, CFOs, controllers, directors and trustees, and others* who have significant responsibilities in preparing and issuing an entity's financial statements and concerns about potential detrimental economic consequences of a new standard. Those concerns include, for example, disclosing new information that could (1) harm the entity's competitiveness, (2) diminish its access to or increase its cost of capital, and (3) require out-of-pocket costs to implement systems to gather and audit the new information.
- *Investors, creditors, suppliers, employees, and others* who use an entity's financial statements in making investment and other economic decisions and have concerns about the quality of and access to financial information. Those concerns include the potential costs (economic risks) that they bear when making investment decisions without information that is decision useful and of the highest quality possible.
- *Analysts, rating agencies, regulators, and others* who evaluate and opine or provide oversight on the investment quality, creditworthiness, and financial soundness of issuers of financial statements. They have similar concerns about the quality of and access to financial information that they need and the potential costs that they and investors, creditors, and others who rely on them may bear if information is not of the highest quality possible.
- *Auditors* who, in fulfilling a public responsibility, attest to and opine on the fairness of an entity's financial statements in accordance with generally accepted accounting principles. They also have concerns about their access to financial information and the potential costs that they and investors, creditors, and others who rely on them may bear if information is not of the highest quality possible. They also have concerns about the out-of-pocket costs to audit new information.

The FASB's constituents sometimes agree about the potential benefits and costs of a new standard, but they often have very different views about how those benefits and costs ought to be weighed.

THE FASB's Perspectives and Process

Background

Assessing the benefits and costs of a new or different method of accounting is a well-established and integral part of the Board's decision-making process. As noted in its mission statement, one of the precepts that the FASB follows is to "promulgate standards only when the expected benefits exceed the perceived costs."

Former Board member Victor Brown shared his perspectives on this subject in his September 1990 article, "Accounting Standards: Their Economic and Social Consequences" (*Accounting Horizons*, pages 89–97).[8] He noted that there is widespread agreement that:

- Standards of financial accounting and reporting are needed, as is some mechanism for setting standards.
- Changes to accounting standards will have consequential effects.
- Most interested parties accept the notion that considerations about the cost and benefits should enter into the process of setting accounting standards.

Ten years earlier, the Board shared its thinking about costs and benefits in paragraphs 133–144 of FASB Concepts Statement No. 2, *Qualitative Characteristics of Accounting Information* (see the Appendix). Among other things, Concepts Statement 2 notes that:

- To be useful accounting information must attain some minimum level of both relevance and reliability, but beyond those minimum levels, sometimes users of financial information may gain by sacrificing some degree of relevance for added reliability or some degree of reliability for added relevance (paragraph 133).
- A standard-setting body has to do its best to meet the needs of society as a whole when it promulgates a standard that sacrifices one of those qualities for

[8] A copy of Mr. Brown's article is available by contacting Roberta Small at rssmall@F-A-F.org.

the other; and it must also be aware constantly of the calculus of costs and benefits (paragraph 133).

- The Board cannot cease to be concerned about the cost-effectiveness of its standards. To do so would be a dereliction of its duty and a disservice to its constituents (paragraph 144).

The remainder of this paper describes (a) the meanings of the terms *benefits* and *costs* in the context of the FASB's standard setting, (b) the procedures that the Board uses to identify and assess the potential benefits and costs from the pre-agenda phase of a project through issuance of a final standard, and (c) some examples of past cost-benefit considerations.

What Are the Benefits and Costs?

The principal benefit of a new accounting standard is the potential improvement in the dissemination and quality of financial information that is useful in making business and economic decisions. Companies and their managers that prepare and issue financial statements (preparers) and investors and creditors that use financial statements (users) in making business or economic decisions are among the primary beneficiaries of improvements in financial information. Society, at large, also reaps benefits from such improvements. The benefits of such improvements include gains in the:

- Utility and credibility of an entity's financial statements, which is critical to increasing investor confidence in its financial information and ultimately increasing the entity's access to capital and potentially lowering its cost of capital
- Knowledge of an entity's financial position and results, which is helpful to directors and managers that are accountable to an entity's shareholders, lenders, and others
- Functioning of the economy through more efficient business and economic decisions, particularly those relating to the allocation of capital
- Comparability and understandability of financial information through the elimination of alternative methods of accounting, which also may reduce complexity and costs of systems for preparing and analyzing financial statements.

The Board's assessment of a standard's benefit to preparers, investors, creditors, and other users is unavoidably subjective. In making that assessment, the Board also considers the costs of *not* issuing a standard (for example, investor, creditor, and societal losses associated with incomplete or lower quality information).

The incremental costs of a new standard generally fall initially on preparers of financial statements; however, certain costs fall on users, auditors, and society as well. The types of costs associated with providing new financial information vary. Some are one-time costs, while others are ongoing costs. Among others, Concepts Statement 2 identifies:

- Costs to the preparer of collecting, processing, and disseminating the information
- Costs to the preparer and the auditor of understanding the new requirements
- Costs of auditing the information
- Costs of disclosure in the form of a loss of competitive advantages vis-à-vis trade competitors, labor unions (with a consequent effect on wage demands), or foreign enterprises
- Costs to the user of analyzing and interpreting the new information (including costs of developing new or modified forecasting models, and adjusting databases and other long-term trended information)
- Costs passed on to consumers and society in the form of higher prices for goods and services.

Some of the above costs can be quantified, albeit imprecisely and with difficulty. However, most of the benefits and costs of adopting a new accounting standard cannot be quantified.[9]

[9] To quantify potential benefits and costs one would need to estimate the economic consequences, both positive and negative, of activities and decisions that have not occurred. Those future activities include the gathering, processing, disseminating, and interpreting the new information. The future decisions related to using the new information include business decisions of preparers (for example, in adjusting production levels and prices for their goods and services) and economic decisions of present and prospective investors and creditors (for example, in determining whether to reallocate capital among particular entities).

What are the Procedures Used to Identify and Assess Benefits and Costs?

The following are among the internal procedures that the Board and its staff use to identify potential benefits and costs of proposed improvements in accounting and reporting standards and ultimately in assessing those benefits and costs.

1. All pre-agenda materials related to potential projects and Board agenda decisions are to describe the types of benefits expected to be achieved by addressing the issues associated with the project and the possible types of costs associated with potential solutions. Prior to seeking a Board agenda decision for potential major projects, the FASB often uses a Prospectus to gain further insights from a cross-section of its constituents.
2. The project plan is to address the activities necessary to validate the expected benefits and costs with preparers, users, and others during the course of the project and the timing of those activities. Examples of such activities include field visits, questionnaires, and discussions and meetings with constituents, including members of FASAC, SBAC, UAC and the project resource group.
3. Staff memorandums seeking Board decisions on potential solutions to an issue are to describe the relative types of benefits and costs associated with alternative solutions, including those potential benefits and costs identified by members of the project resource group and their insights.
4. Whenever possible, speeches and other discussions with constituents[10] related to the Board's tentative decisions (whether only a subset of or the entire package of decisions) are to be used to:
   a) Identify and discuss the types of benefits that the Board expects can be achieved by applying a proposed approach.
   b) Elicit constituents' views about whether those benefits will be achieved and, if not, how they might be achieved and learn of other types of benefits that constituents expect to realize.
   c) Identify and discuss the types of costs that the Board expects constituents would incur (1) during the transition and initial application period and (2) in subsequent periods.
   d) Identify and discuss ways in which those costs might be reduced without reducing the related benefit (alternative ways of reducing costs that would result in a slight reduction in benefits also should be entertained).
   e) Learn other potential consequences that have yet to be identified.

[10] Examples of other discussion forums include public roundtables and educational meetings, public or private liaison meetings with constituent groups, public meetings of FASAC, SBAC, or UAC, and public or private meetings with the project resource group or individual companies, auditors, or users.

5. Undertake *field visits*[11] for all projects that are expected to introduce one or more significant changes and involve significant costs. A field visit generally involves two or three Board members and project staff members meeting with key representatives of individual companies or firms to engage in a confidential and in-depth discussion of a proposed approach, its potential consequences, and potential alternatives. The participants generally encompass a cross section of affected constituents (size and industry) and where feasible include preparers, auditors, and users. Field visits generally are used *prior* to the release of an Exposure Draft but they may be used at other stages of a project, as well.
6. The notice for recipients in each Exposure Draft generally asks for input on how the Board could further reduce the related costs without reducing the benefits. If a public roundtable meeting is held on a proposed Statement, suggestions on reducing costs also are discussed with the roundtable participants.
7. Prior to giving the "go ahead" to draft a proposed or final Statement, the Board discusses at a public Board meeting the steps it took to consider and balance the benefits and costs of applying the Statement, including the benefit and cost issues addressed in field visits or comment letters and those associated with alternative approaches that were considered but rejected. The basis for conclusions of the proposed or final Statement also should capture that discussion—that is, adequately describe the steps the Board took to consider and balance the benefits and costs of that Statement and the Board's analysis of those benefits and costs. The basis for conclusions also explains in qualitative terms how the anticipated benefits of that Statement are expected to outweigh the costs.

Keep in mind that the procedures the Board uses are *not* aimed at quantifying the benefits and costs of a proposed change to an accounting standard. (Reliable quantitative cost-benefit calculations are seldom possible.) Rather, the procedures are designed to engage the Board's constituents in that cost-benefit analysis and, thus, help Board members individually and collectively achieve a full understanding of and appreciation for the types of benefits and costs that various parties might obtain or incur through a new accounting standard.

Ultimately, the Board's goal is to use a qualitative analysis to assess whether a proposed standard (compared with possible alternatives) will sufficiently improve financial reporting to justify the costs it will impose *on the financial reporting*

[11] It differs from a *field test*, which usually involves participants actually applying a proposed approach or Statement and submitting the results of their testing.

system as a whole. That overall assessment goes beyond assessing the costs to particular groups of constituents or sectors of the economy (for example, preparers, auditors, or users of financial information; entities operating in the manufacturing or banking, insurance, and other financial services sectors; large or small, public or private, for-profit or nonprofit, and so forth). However, that does not preclude making accommodations if the Board believes potential costs may be excessive on a particular group.

Are There Classic Examples of Past Cost-Benefit Considerations?

There are many examples of standards in which the Board faced difficult judgments in striving to strike the right balance in its consideration of the expected benefits of new information and the potential costs that it or other alternatives might impose. In his article, Mr. Brown noted the complex cost-benefit concerns that were raised surrounding proposals to address the deficiencies that existed in accounting for postretirement benefits prior to the Board's issuance of FASB Statement No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions* (December 1990). He said:

> . . . it has been argued that a required change from a cash to an accrual basis in accounting for postretirement health care costs will cause enterprises to curtail their retiree health care plans so as to avoid higher recorded expenses and liabilities. Aggregate employer actions in this direction, it is argued, would have adverse economic and societal consequences. Many employees would find themselves without adequate health care coverage, perhaps forcing governmental action to compensate in some fashion. . . .
>
> Assessing these derivative kinds of consequences is very difficult, calling for initially predicting the nature and extent of enterprise behavioral changes in response to changed methods of reporting financial results. Subsequent judgments would then be required of the macroeconomic impact of this modified enterprise behavior. [pages 91–92]

As discussed in paragraphs 118–132 of Statement 106, many, if not most, preparers had argued that the expected benefits of the new information would not justify the costs. Despite the difficult cost-benefit calculus and its sensitivity to the consequences that were likely to occur as a result of the new information, including the perceived costs to companies and their employees, as noted in paragraph 132, the Board concluded:

> Both the benefits and costs of the information provided pursuant to this Statement will be recognized over time and will affect many parties differently. Those parties and the contracts they enter into will benefit from more relevant and reliable information about the incidence of postretirement benefit costs. But improved financial information comes at a cost, and while some of those parties may not pay directly for the benefits they derive from that information, they are likely to bear indirectly some of its cost.

More than a decade later, Statement 106 continues to be held up by many constituents, including former nonbelievers, as one of the clearest examples of new information that has benefited preparers as well as users well beyond the anticipated costs that were perceived at the time of its issuance.

In its consideration of the benefits and costs of a new standard the Board also must remain mindful of its mission by establishing standards that are neutral.[12] Such standards emphasize fundamental principles and strive to avoid exceptions, particularly those that add undo complexities and costs. For example, page vii of the August 5, 2004, staff draft of tentative decisions on business combinations says:

> In developing this proposed Statement, some of the Board's constituents again suggested that the pooling method be retained for mutual enterprises for public policy reasons. For example, some mutual enterprises have argued that eliminating their application of that method would impede consolidation within certain industries and, perhaps, misrepresent the financial soundness and regulatory capital of certain mutual enterprises. Concepts Statement 2 states that a necessary and important characteristic of accounting information is neutrality. In the context of business combinations, neutrality means that the accounting standards should neither encourage nor discourage business combinations but, rather, provide information about those combinations that is fair and evenhanded.

[12] The FASB's mission statement notes that the Board "is committed to following an open, orderly process for standard setting that precludes placing any particular interest above the interests of the many who rely on financial information [and] believes that this broad public interest is best served by developing neutral standards that result in accounting for similar transactions and circumstances similarly and for different transactions and circumstances differently."

> The Board strives to issue accounting standards that result in neutral and representationally faithful financial information. Eliminating the pooling method is consistent with that goal. The Board noted that requiring a single method of accounting and financial reporting for business combinations of all enterprises is evenhanded and results in comparable reporting of the financial soundness and capital of those enterprises, regardless of whether they are organized as public or private entities, investor-owned or mutual enterprises, or for-profit or tax-exempt entities.

Nonetheless, in many instances the Board decided to permit certain exceptions or make accommodations for cost-effectiveness reasons. Examples include:

1. The decisions in the forthcoming Statement, *Share-Based Payment*, to mitigate the incremental costs of complying with the Statement. For example, a nonpublic entity would not be required to estimate the fair value of its liability awards; instead, such an entity may elect to account for its liabilities based on their intrinsic value. An alternative measurement method also is provided for equity options and similar instruments granted by a nonpublic entity if it is not practicable to estimate the expected volatility of its share price. Also, transition costs for public entities have been minimized by requiring that compensation cost for the nonvested portion of awards granted before the issuance of this Statement be based on the grant-date fair values previously estimated for recognition or pro forma disclosure purposes under Statement 123.
2. The decision to encourage rather than require entities to report major classes of gross cash receipts and gross cash payments from operating activities in a statement of cash flows (*direct method*, Statement 95). The Board noted that it believes that *both* the direct method and the indirect method provide potentially important information and that the more useful approach would be to report under both methods. Nonetheless, the Board decided not to require the direct method at that time, in part because most preparers and users of financial statements had little or no experience and only limited familiarity with the direct method and because of questions about the ability of enterprises to determine gross amount of cash flows (paragraph 119). Instead the Board opted for a voluntary and evolutionary approach that would allow (encourage) entities to provide such information when it is (becomes) available.[13]

[13] Some constituents advocate that the Board make greater use of this voluntary approach toward providing new information. Arguments advanced for such views include (a) if the information is relevant users will demand it and, thus, enterprises will provide it, and (b) most important users (major institutional investors, creditors, credit rating agencies) can get whatever information they want, thus, information need not be required. However, the experience with voluntary disclosures under Statement 95 does not support such arguments as many users continue to suggest that the Board require the direct method of reporting cash flows from operations.

3. The exception provided by Statement 126 to the Statement 107 fair value disclosure requirements for financial instruments. The Board decided to make the requirement optional for nonpublic entities that have (a) total assets below $100 million and (b) not held or issued any derivative financial instruments, other than loan commitments. Accommodations for nonpublic or small entities also can be found in Statements 87, 106, 107, and 116, which provide deferred effective dates, and Statements 109, 128, 129, 131, 132, and 141, among others.
4. Similarly, in Statement 141, which requires the purchase method of accounting for all business combinations (and rejects the pooling-of-interest method), the Board decided to delay its effective date for mutual enterprises. The Board concluded that a neutral (principles-based) standard for business combinations ought to apply to all enterprises, including mutual entities. However, for cost-benefit reasons the Board decided not to make Statement 141 effective for combinations of two or more mutual entities until the Board issued interpretative guidance for the application of the purchase method for those transactions. That guidance is forthcoming as part of the second phase of the Board's project on business combinations.

In addition to those examples, the Board issued numerous standards in which cost-benefit considerations were especially important in selecting among available transition alternatives (for example, retroactive application versus prospective application).

Questions for discussion

1. Are SBAC members aware of improved means of measuring benefits or costs that have developed since the issuance of Concepts Statement 2?[14]
2. Do SBAC members have suggestions for improving the procedures currently used to engage constituents in the process of identifying the benefits and costs of proposed standards and alternative solutions?
3. Are SBAC members aware of other types of costs that they incur to implement a new standard in addition to those identified on page 4?
4. What aspects of new standards cause the most costs to be incurred?

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[14] Paragraph 144 of Concepts Statement 2 says that although "it is unlikely that significantly improved means of measuring benefits will become available in the foreseeable future, it seems possible that better ways of quantifying the incremental costs of regulations of all kinds may gradually be developed, and the Board will watch any such developments carefully to see whether they can be applied to financial accounting standards."

Excerpts from FASB Concepts Statement No. 2, *Qualitative Characteristics of Accounting Information* (May 1980, footnotes omitted)

COSTS AND BENEFITS

133. Accounting information must attain some minimum level of relevance and also some minimum level of reliability if it is to be useful. Beyond those minimum levels, sometimes users may gain by sacrificing relevance for added reliability or by sacrificing reliability for added relevance; and some accounting policy changes will bring gains in both. Each user will uniquely perceive the relative value to be attached to each quality. Ultimately, a standard-setting body has to do its best to meet the needs of society as a whole when it promulgates a standard that sacrifices one of those qualities for the other; and it must also be aware constantly of the calculus of costs and benefits.

134. Unless the benefits to be derived from a commodity or service exceed the costs associated with it, it will not be sought after. When a decision to acquire a commodity is being considered, the prospective buyer will compare the costs of acquisition and maintenance with the benefits of owning the commodity. Once the purchase has been made, the owner must decide—continually, from day to day—whether the opportunity cost of ownership, the sacrifice of the sale price that cannot be realized so long as ownership continues, is less than the benefits of continued ownership. Thus, both before and after acquisition, costs and benefits must be compared, though the comparison takes a somewhat different form according to whether the acquisition has or has not been consummated.

135. Financial information is unlike other commodities in certain important respects. While, in general, it will not be desired unless its benefits exceed its costs, what makes it different from other commodities, or at least from those that are traded in the marketplace, is that whereas those other commodities are private goods, to be enjoyed only by the buyer and those with whom the buyer chooses to share them, the benefits of information cannot always be confined to those who pay for it. If the whole government and private system by which the flow of financial information is regulated could now be dismantled, if information could be traded between buyers and sellers like other commodities and could be kept from those who did not pay for it, and if consumers of information were willing to rely on their own inquiries, the balance of costs and benefits could be left to the market. But in the real world the market for information is less complete than most other markets, and a standard-setting authority must concern itself

with the perceived costs and benefits of the standards it sets—costs and benefits to both users and preparers of such information, to others, like auditors, who are also concerned with it, and to anyone else in society who may be affected.

136. Most of the costs of providing financial information fall initially on the preparers, while the benefits are reaped by both preparers and users. Ultimately, the costs and benefits are diffused quite widely. The costs are mostly passed on to the users of information and to the consumers of goods and services. The benefits also are presumably passed on to consumers by assuring a steady supply of goods and services and more efficient functioning of the marketplace. But, even if the costs and benefits are not traced beyond the preparers and users of information, to say anything precise about their incidence is difficult. There are costs of using information as well as of preparing it; and much published information would be compiled for the preparer's own use even if providing it to stockholders and others were not required. The preparer enjoys other benefits also, such as improved access to capital markets, favorable impact on the enterprise's public relations, and so on.

137. The costs of providing information are of several kinds, including costs of collecting and processing the information, costs of audit if it is subject to audit, costs of disseminating it to those who must receive it, costs associated with the dangers of litigation, and in some instances costs of disclosure in the form of a loss of competitive advantages vis-a-vis trade competitors, labor unions (with a consequent effect on wage demands), or foreign enterprises. The costs to the users of information, over and above those costs that preparers pass on to them, are mainly the costs of analysis and interpretation and may include costs of rejecting information that is redundant, for the diagnosis of redundancy is not without its cost.

138. Society needs information to help allocate resources efficiently, but the benefit to any individual or company from that source is not measurable. Nor is the spur to efficiency that comes from making managers account to stockholders capable of evaluation, either at the level of the enterprise or the economy. It is impossible to imagine a highly developed economy without most of the financial information that it now generates and, for the most part, consumes; yet it is also impossible to place a value on that information.

139. From the point of view of society, the loss of competitive advantage that is said to result from some disclosure requirements is clearly in a different category from the other costs involved. Although the loss to one business enterprise may be a gain to

another, the Board is aware of and concerned about the economic effects of the possible discouragement of initiative, innovation, and willingness to take risks if a reward to risk taking is denied. That is another cost that is impossible to begin to quantify.

140. The burden of the costs and the incidence of benefits fall quite unevenly throughout the economy, and it has been rightly observed that "... the matter of establishing disclosure requirements becomes not only a matter of judgment but also a complex balancing of many factors so that all costs and benefits receive the consideration they merit. For example, a simple rule that any information useful in making investment decisions should be disclosed fails as completely as a rule that says disclosure should not be required if competitive disadvantage results." The problem is to know how to accomplish that "complex balancing."

141. The Board has watched with sympathetic interest the efforts of the Cost Accounting Standards Board (CASB) to come to grips with the task of comparing the costs and benefits of its standards. The Report of the special group of consultants who were asked by the CASB to examine this matter was submitted on November 13, 1978. The conclusions were quite negative.

> Our conclusion is that no objective cost benefit calculation in aggregate quantitative terms is possible for CASB standards as a whole or for any of them individually. Reasonable people, with some experience in such matters, acting responsibly in a spirit of compromise, using such reliable information as can be gathered together, will make a "calculation," as they must if anything is to be done. But the calculation will be in ordinal rather than cardinal terms; it will be rough rather than precise; it will always be subject to revision, rather than fixed in stone. The situation is not different from that concerning the merits of many other laws, rules, regulations, and administrative decisions. Nor is our conclusion different from the conclusion reached by those concerned with the cost-benefit problem confronting the Paperwork Commission, for example.

142. As the CASB's consultants point out, the reasons for that negative conclusion can be simply stated. The costs and benefits of a standard are both direct and indirect, immediate and deferred. They may be affected by a change in circumstances not foreseen when the standard was promulgated. There are wide variations in the estimates that different people make about the dollar values involved and the rate of discount to be used in reducing them to a present value. "For these reasons," the consultants conclude, "the merits of any Standard, or of the Standards as a whole, can be

decided finally only by judgments that are largely subjective. They cannot be decided by scientific test."

143. Despite the difficulties, the Board does not conclude that it should turn its back on the matter, for there are some things that it can do to safeguard the cost-effectiveness of its standards. Before a decision is made to develop a standard, the Board needs to satisfy itself that the matter to be ruled on represents a significant problem and that a standard that is promulgated will not impose costs on the many for the benefit of a few. If the proposal passes that first test, a second test may subsequently be useful. There are usually alternative ways of handling an issue. Is one of them less costly and only slightly less effective? Even if absolute magnitudes cannot be attached to costs and benefits, a comparison between alternatives may yet be possible and useful.

144. Though it is unlikely that significantly improved means of measuring benefits will become available in the foreseeable future, it seems possible that better ways of quantifying the incremental costs of regulations of all kinds may gradually be developed, and the Board will watch any such developments carefully to see whether they can be applied to financial accounting standards. Even if that hope proves to be a vain one, however, the Board cannot cease to be concerned about the cost-effectiveness of its standards. To do so would be a dereliction of its duty and a disservice to its constituents.

LIABILITIES AND EQUITY

Introduction

The Board has been considering approaches for distinguishing liabilities from equity for single component instruments before it tackles classification and measurement issues for complex instruments. The Board has tentatively chosen an approach that combines two principles: (1) the relationship between the issuer and the counterparty that is established by an instrument (ownership relationship) and (2) the issuer’s settlement obligation. The following is a description of that approach.

Ownership/Settlement Approach in Distinguishing Liabilities from Equity for Single-Component Instruments

The Board has decided that a single-component instrument is classified as a liability or equity as follows (words in *italics* are defined as described below):

1. An instrument that does not embody a *settlement obligation* is equity (unless it is an asset). An example is a share (common or preferred) that is not subject to redemption requirements.
2. An instrument that establishes a *direct ownership relationship* between the issuer and the holder is equity, even if it embodies a settlement obligation. An example is a common share that is mandatorily redeemable at its proportionate share of an entity's fair value.
3. An instrument that establishes an *indirect ownership relationship* that would be settled or ultimately settled by issuing an instrument that establishes a direct ownership relationship is equity (such as a physically settled written call option). Otherwise, the instrument is a liability (such as a net cash-settled written call option).
4. An instrument that embodies a settlement obligation and does not establish either a direct ownership relationship or an indirect ownership relationship is a liability. An example is a written put option.

The Board also agreed on the following definitions in applying the approach:

1. A *settlement obligation* is a present obligation of an entity settled prior to liquidation to:
    a. Transfer or provide use of assets
    b. Use assets to provide services
    c. Stand ready to use assets to provide services or transfer or provide use of assets
    d. Issue shares or other instruments (fixed or variable number).

2. A *direct ownership relationship* is established by an instrument of an entity or consolidated subsidiary (reference instrument) that:

   a. Is (or together with other instruments is) the most subordinated interest(s) issued by the entity or consolidated subsidiary, and

   b. Shares pro rata in the earnings and losses of the entity with other instruments meeting characteristic 2(a).

3. An *indirect ownership relationship* is established by an instrument of an entity in which the counterparty's payoff at settlement is based on and varies in the same direction as the fair value of the reference instrument and does not contain a contingency provision that is based on an external market or index.

Tables, Flowcharts, and Examples

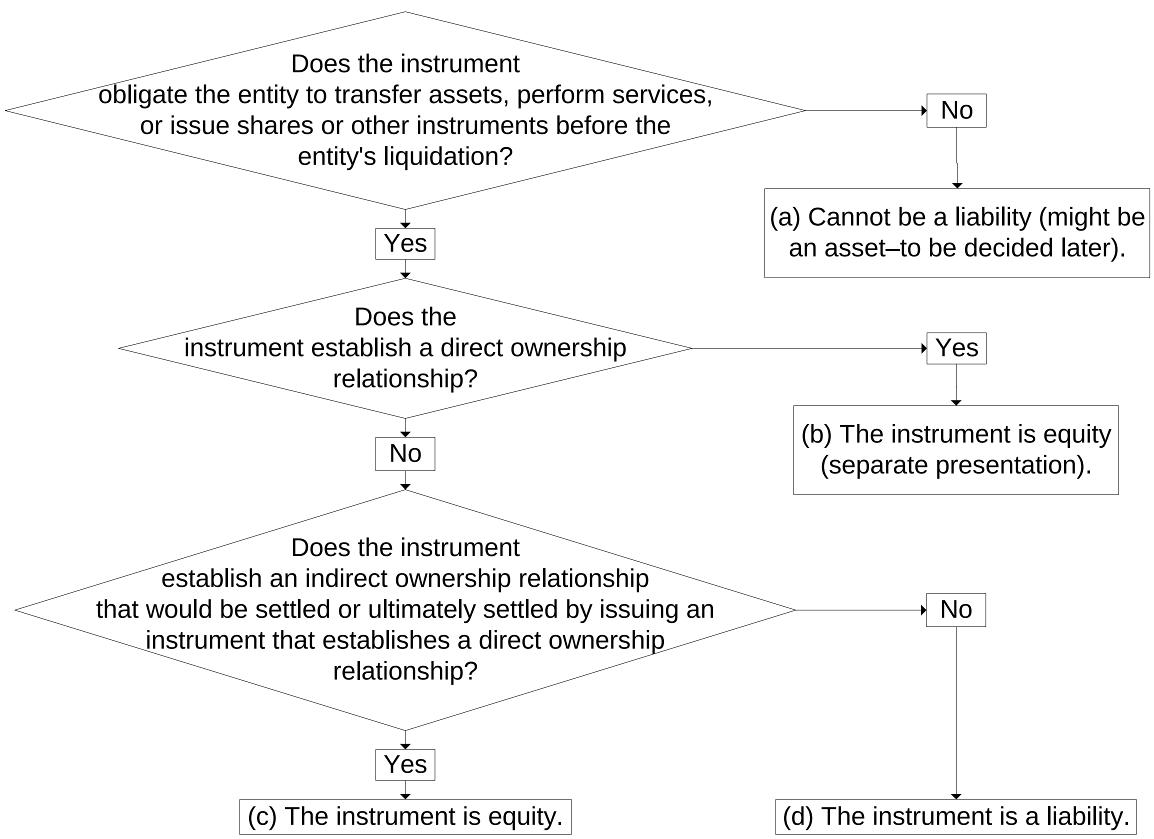
The table, flowchart, and examples found on the following pages further illustrate the Ownership/Settlement Approach. Following those illustrations are some issues the Board will consider next and questions for Council members.

Ownership/Settlement Table

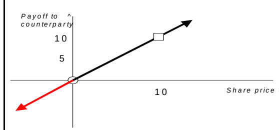
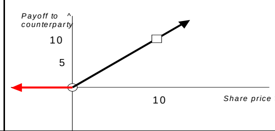
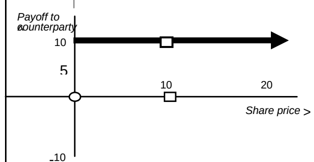
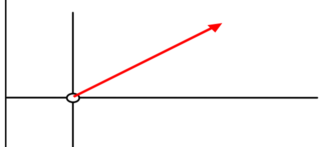
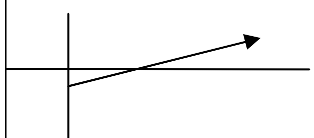
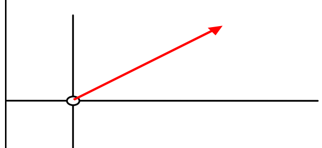
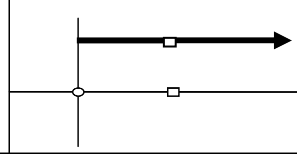
	Settlement Criterion Met?		
Ownership Criterion Met?	**Yes—Ultimate Settlement Does Not Establish Direct Ownership**	**Yes—Ultimate Settlement Establishes Direct Ownership**	**No**
No	Liability (d)	Liability (d)	Equity (a)
Yes—Indirectly (indexation to reference instrument)	Liability (d)	Equity (c)	Equity (a)
Yes—Directly (reference instrument)	Equity (b)	Equity (b)	Equity (a)

*Lettered annotations indicate the classification in the flowchart.

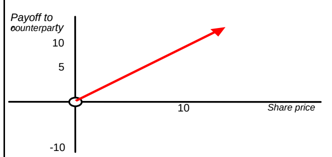
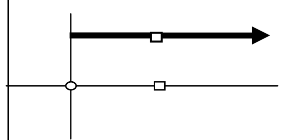
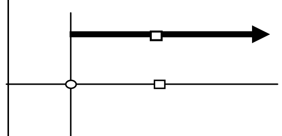
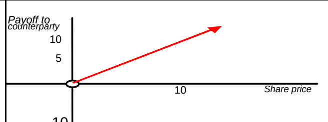
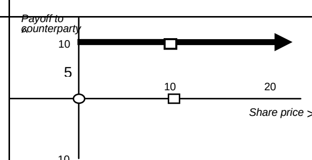
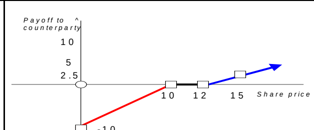
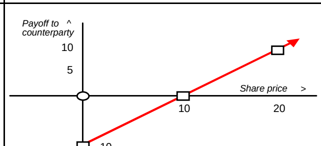
Ownership/Settlement Flowchart



*Lettered annotations indicate the classification in the table.

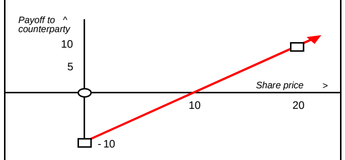
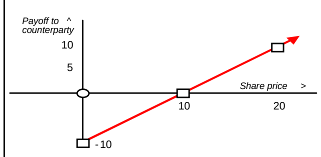
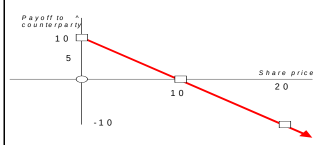
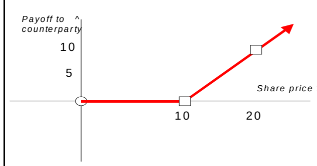
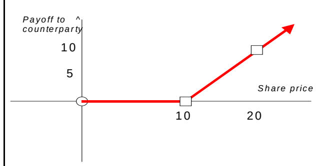
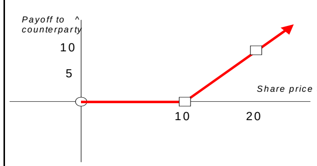
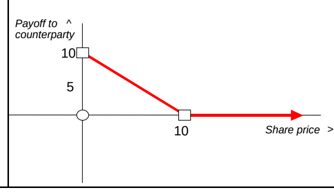
Instrument	**Counterparty Payoff Profile**	**Ownership /Settlement Approach**	**Current GAAP[15]**
1. Proprietorship interest		Equity	Equity
2. Common share		Equity	Equity
3. Mandatorily redeemable share at a fixed price settled with assets		Liability	Liability
4. Most subordinated interest that is mandatorily redeemable at fair value settled with assets		Equity—separate	Liability*
5. Most subordinated interest that is mandatorily redeemable at book value or a formula highly correlated to fair value settled with assets		Equity—separate	Liability*
6. Mandatorily redeemable share at fair value (not most subordinated interest) or indexed debt settled with assets		Liability	Liability*
7. Mandatorily redeemable noncontrolling interests at a fixed price settled with assets		Liability	Liability

[15] Current GAAP includes the requirements of FASB Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*, before the deferral under FSP FAS 150-3, "Effective Date, Disclosures, and Transition for Mandatorily Redeemable Financial Instruments of Certain Nonpublic Entities and Certain Mandatorily Redeemable Noncontrolling Interests under FASB Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*." Instruments denoted by a * indicate those that might have been subject to an indefinite deferral.

Instrument	Counterparty Payoff Profile	Ownership /Settlement Approach	Current GAAP[15]
8. Mandatorily redeemable noncontrolling interests at fair value (of the subsidiary shares, most subordinate) settled with assets		Equity—separate	Liability*
9. Perpetual preferred stock		Equity	Equity
10. Note payable cash or share settled (variable number of shares)		Liability	Liability
11. Mandatorily converting instrument into a fixed number of shares[16]		Equity	Liability (debt host with an embedded equity derivative)?
12. Mandatorily converting instrument into a variable number of shares		Liability	Liability
13. Variable share forward sale contract[17]		Equity	Generally Equity
14. Physically settled forward sale contract for a fixed amount		Equity	Equity

[16] This assumes that an instrument that mandatorily converts into a fixed number of shares (same as a prepaid forward sale) is not a compound instrument. The staff understands that there are mixed views about how this is accounted for under current GAAP.

[17] This assumes that a variable share forward sale contract is not considered a compound instrument.

Instrument	**Counterparty Payoff Profile**	**Ownership /Settlement Approach**	**Current GAAP[15]**
15. Net cash-settled forward sale contract (fixed sale price)		Liability	Liability
16. Net share-settled forward sale contract (fixed sale price)		Equity	Equity
17. Physically or net-settled forward purchase contract (at a fixed price)		Liability	Liability
18. Treasury stock purchase	Not applicable	Equity	Equity
19. Physically settled written call option (stock option)		Equity	Equity
20. Net cash-settled written call option (cash SAR)		Liability	Liability
21. Net share-settled written call option (stock SAR)		Equity	Equity
22. Written put option (physically or net settled)		Liability	Liability

Some Issues the Board Will Consider Next

1. How the approach should apply in distinguishing assets from equity.
2. What form of settlement should be assumed if there are multiple settlement alternatives.
3. Refining what is meant by the phrases *most subordinated* and *sharing pro rata in the earnings and losses of an entity* in determining a direct ownership relationship.
4. Measurement and presentation for single component instruments.

Discussion Questions

1. Do you have any questions or concerns about the Ownership/Settlement Approach?
2. In addition to the issues that the Board will consider next, what other issues do you believe that the Board should consider?

Equity-Based Compensation

Background

The Committee discussed certain issues relating to the Exposure Draft of the proposed Statement, *Share-Based Payment,* at its previous meeting on May 11, 2004, and Committee members are referred to the papers for that meeting for the background to the issuance of the Exposure Draft and a summary of the key proposals contained in it. A brief summary of the due process procedures related to the consideration of nonpublic entity and small business issues that the Board has performed since the issuance of the Exposure Draft at the end of March is provided as Appendix 1.

The Board began its redeliberation of the Exposure Draft on August 4 and has, so far, held 11 public meetings to discuss constituents' comments and to reconsider the decisions that were reached in developing the proposals contained in the

Exposure Draft. As a result of its redeliberations, the Board has tentatively decided to make a number of changes to the Exposure Draft. Many of the changes that the Board has decided to make involve providing additional implementation guidance or clarifying certain aspects of the proposed Statement; however, the Board also has decided to make some more substantive changes. Some of those changes specifically affect small businesses and nonpublic entities and these are set out in more detail below.

1. Measurement of Equity Awards Issued by Nonpublic Entities

The Board proposed in the Exposure Draft that a nonpublic entity choose whether to account for its equity share options and similar instruments based on either (a) their fair value at the grant date or (b) their intrinsic value, remeasured at each reporting date until settlement.

During its redeliberations, the Board has tentatively decided that a nonpublic entity should measure equity awards using the same method as a public entity,[18] unless it is not practicable for a nonpublic entity to make a reasonable estimate of the expected volatility of its own share price. In that case, a nonpublic entity would use the historical volatility of an appropriate index, rather than the expected volatility of its own stock price, as an assumption in an option pricing model to arrive at a *calculated value*. The draft implementation guidance on the application of the calculated value method is set out in Appendix 2.

2. Measurement of Liability Awards Issued by Nonpublic Entities

In the Exposure Draft the Board proposed that nonpublic entities be allowed to make a policy decision whether to measure liabilities incurred under share-based payment arrangements with employees at (a) fair value or (b) intrinsic value.

During its redeliberations the Board has tentatively decided to retain this policy choice for a nonpublic entity's liability awards. In addition, the Board has tentatively decided that a nonpublic entity that makes a policy choice to measure

[18] Based on the fair value at grant date unless the unusual features of a particular equity award prevent use of that measure when an entity would measure it at intrinsic value, remeasured each reporting date until settlement.

its liability awards at fair value should do so using *calculated value* if it is not practicable for it to make a reasonable estimate of the expected volatility of its own share price. Under each method, the liability would be remeasured at the end of each reporting period until settlement.

3. Effective Date and Transition for Public Entities That Are Small Business Issuers

In the Exposure Draft the Board proposed that all public entities would apply the final Statement for interim or annual accounting periods beginning after December 15, 2004, using a modified prospective transition method.

In its redeliberations, the Board has tentatively decided that public entities that are small business issuers would be required to apply the final Statement for interim or annual reporting periods beginning after December 15, 2005, using the same transition provisions that apply to other public entities. The Board has also tentatively decided to permit all entities that had adopted the Statement 123 fair-value-based method of accounting for either recognition or pro forma disclosures to use a modified retrospective transition method utilizing their existing Statement 123 fair-value-based cost information.

4. Effective Date and Transition for Nonpublic Entities

In the Exposure Draft the Board proposed that:

a. Nonpublic entities that had adopted the Statement 123 fair-value-based method of accounting for either recognition or pro forma disclosures would use the same effective date and transition provisions as public entities.

b. All other nonpublic entities would apply the final Statement prospectively for fiscal years beginning after December 15, 2005.

In its redeliberations the Board has tentatively decided that:

a. *All* nonpublic entities would be required to apply the final Statement for fiscal years beginning after December 15, 2005.

b. Nonpublic entities that had adopted the Statement 123 fair-value-based method of accounting for either recognition or pro forma disclosures would use the same transition provisions as public entities.

c. All other nonpublic entities would apply the final Statement prospectively.

Questions for Committee Members

1. Do you believe that the changes to the proposed requirements are responsive to cost-benefit issues faced by small businesses and nonpublic entities?

2. What types of implementation issues or questions do Committee members foresee?

Appendix 1

Steps Taken to Further Address Small Business and Nonpublic Entity Issues since the Issuance of the Exposure Draft

- Small business and nonpublic entity issues were discussed at two public roundtable meetings on June 24, 2004, in Palo Alto, California, and at two public roundtable meetings on June 29, 2004, in Norwalk, Connecticut.
- Over 13,500 comment letters have been received and analyzed for comments that addressed issues relating to small business and nonpublic entities.
- Additional interviews with nonpublic entity constituents, including preparers, users, and auditors of financial statements, were conducted in August and September 2004. These additional interviews concentrated on confirming information regarding measurement difficulties and cost concerns provided by respondents in comment letters.
- Staff and Board members have discussed small business and nonpublic entity issues with other interested constituents including the Technical Issues Committee of the Private Companies Practice Section of the AICPA and the National Venture Capital Association.

In addition, Board members have also participated in the following Congressional hearings, which addressed issues affecting small businesses, including nonpublic entities:

- On April 20, 2004, FASB Chairman Robert H. Herz testified before the U.S. Senate Subcommittee on Financial Management, the Budget, and International Security of the Committee on Governmental Affairs "Oversight Hearing on Expensing Stock Options: Supporting and Strengthening the Independence of the Financial Accounting Standards Board."
- On April 28, 2004, FASB Chairman Robert H. Herz and Board Member George J. Batavick testified before the U.S. Senate Committee on Small Business and Entrepreneurship hearing on "The FASB Stock Options Proposal: Its Effect on the U.S. Economy and Jobs."
- On May 4, 2004, FASB Chairman Robert H. Herz and Board Member George J. Batavick testified before the U.S. House of Representatives Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises of the Committee on Financial Services hearing on the "Impact of Stock Option Expensing on Small Businesses."

Appendix 2

Extract from draft Appendix A of the final Statement

CALCULATED VALUE METHOD FOR CERTAIN NONPUBLIC ENTITIES

A40. Nonpublic entities may have sufficient information available on which to base a reasonable and supportable estimate of the expected volatility of their share prices. For example, a nonpublic entity that (a) has an internal market for its shares, has private transactions in its shares, or issues new equity or convertible debt instruments may be able to consider the historical volatility, or implied volatility, of its shares in estimating expected volatility or (b) can identify similar public companies[19] for which share or option price information is available may be able to consider the historical, expected, or implied volatility of those entities shares in estimating expected volatility.

A41. This Statement generally requires all entities to use the fair-value-based method to account for share-based payment arrangements that are classified as equity instruments. However, the calculated value method is used if it is not practicable for a nonpublic entity to reasonably estimate the expected volatility of its share price.[20]

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[19]A nonpublic entity may have identified similar public companies that it uses to estimate the fair value of its shares or to benchmark various aspects of its performance. Refer to paragraph A19, footnote 15.

[20]It may not be possible for a nonpublic entity to reasonably estimate the fair value of its equity share options and similar instruments at the date they are granted because the complexity of the terms of the award prevents it from doing so. In that case, paragraphs 21 and 22 of this Statement require that the nonpublic entity account for its equity instruments at their intrinsic value, as remeasured at each reporting date through the date of exercise or other settlement.

A42. For purposes of this Statement, it is not practicable for a nonpublic entity to estimate the expected volatility of its share price if it is unable to obtain, without undue cost or effort, sufficient historical information about past volatility, or other information such as that noted in paragraph A40, on which to base a reasonable and supportable estimate of expected volatility at the grant date of the award. In that situation, this Statement requires a nonpublic entity to estimate a value for its equity share options and similar instruments by substituting the historical volatility of an appropriate industry sector index for the expected volatility of its share price as an assumption in its valuation model. All other inputs to a nonpublic entity's valuation model should be determined in accordance with the guidance in paragraphs A2–A39.

A43. There are many different indices available to consider in selecting an appropriate industry sector index.[21] An appropriate industry sector index is one that is representative of the industry sector in which the nonpublic entity operates and that also reflects, if possible, the size of the entity. If a nonpublic entity operates in a variety of different industry sectors, then it might select a number of different industry sector indices and weight them according to the nature of its operations; alternatively, it might select an index for the industry sector that is most representative of its operations. If a nonpublic entity operates in an industry sector in which no public entities operate, then it should select an index for the industry sector that is most closely related to the nature of its operations. However, in no circumstances shall a nonpublic entity use a broad-based market index like the S&P 500, Russell 3000®, or Dow Jones Wilshire 5000 because those indices are too diversified and, therefore, will not be representative of the industry sector, or sectors, in which the nonpublic entity operates.

A44. A nonpublic entity shall use the selected index consistently in applying the calculated value method (a) across all of its equity share options or similar instruments and (b) in each accounting period, unless the nature of the entity's operations changes such that another index is more appropriate.

A45. The calculation of the historic volatility of an appropriate industry sector index should be made using the daily historical closing values[22] of the index selected for the period of time prior to the grant date (or service inception date) of the equity share option or similar instrument that is equal in length to the expected term of the equity share option or similar instrument. If historical closing values of the index selected are not available for the entire expected term, then a nonpublic entity shall use the closing values for the longest period of time available. The method used shall be consistently applied (paragraph A20). Illustration 11(b) (paragraphs A129–A134) provides an example of a share option award granted by a nonpublic entity that uses the calculated value method.

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[21]For example, Dow Jones Indexes maintain a global series of stock market indices with industry sector splits available for many countries, including the United States, the historic values of which are easily obtainable from its website.

[22]If daily values are not readily available, then an entity shall use the most frequent available observations of the historical closing values of the selected index.

RESULTS OF THE SURVEY ON THE PRIORITIES OF THE FASB

Introduction

Each year, the Board has solicited the views of the Financial Accounting Standards Advisory Council (FASAC) on a variety of matters through the annual survey. In 2004, with the creation of the Small Business Advisory Committee (SBAC), the Board decided that it would be appropriate to ask for the views of SBAC members on several of the questions included in the 2004 annual FASAC survey. Those questions requested input on the Board's current priorities, future financial reporting issues, and differential accounting standards for certain entities.

Presentation of Results

The results are presented in three sections, with each section representing a set of related questions. Individual responses from SBAC members follow. Fourteen members of the SBAC responded to the survey. However, not every SBAC member answered every question.

[Note: FASAC members and Board members responded to the same questions in the 2004 FASAC survey. For those individual responses, please see the *Summary of Responses to the Annual FASAC Survey*, October 2004, previously distributed to SBAC members and others. That summary also is available on the FASB website, www.fasb.org.]

Highlights

Key observations and conclusions from SBAC members' responses to the survey are:

- The issue of differential accounting standards for certain entities topped the list of issues that SBAC members believe should be the Board's priority.
- Other important issues for the Board to consider include codification and simplification, fair value issues, revenue recognition, and business combinations.
- With respect to future financial reporting issues, several SBAC members believe that fair value issues will continue to require the Board's attention. Other issues mentioned include lease accounting, revenue recognition, derivatives, and consolidation issues, among others.
- SBAC members overwhelmingly believe that the Board should issue differential standards for certain entities, at least to some extent. Some would limit differential standards to disclosure requirements only.

♦ ♦ ♦ ♦ ♦

Section A—The FASB's Priorities
Views of Respondents

The first question of Section A asked respondents to consider the accounting and financial reporting issues that are the most challenging for entities, boards of directors, and investors in the current environment and to name the five most important issues that the Board should address.

The table below displays the five topics mentioned most often in responses from SBAC members. For comparative purposes, the top five topics of FASAC members and Board members also are shown. Individual responses from SBAC members appear below the table.

SBAC Members	**FASAC Members**	**Board Members**
Differential Accounting Standards	Revenue Recognition	Liabilities and Equity
Codification and Simplification[1]	Financial Performance Reporting by Business Enterprises	Revenue Recognition
Fair Value Measurement/ Fair Value[1]	Fair Value Measurement/ Fair Value	Consolidations[2]
Revenue Recognition	Codification and Simplification	Financial Performance Reporting by Business Enterprises[2]
Business Combinations	International Convergence	Equity-Based Compensation

[1] These items received the same number of "votes" and are presented in alphabetical order.

[2] These items received the same number of "votes" and are presented in alphabetical order.

Individual Committee Member Responses

Dyson

Revenue Recognition
Fair Value Measurement of Financial Instruments with No Active Market
Control for Purposes of Consolidation
Simplification and Codification

Revenue Recognition. Currently, the criteria of SAB 104 is not GAAP except in limited circumstances, such as the sales of software. The adoption of criteria similar to that in SAB 104 for revenue recognition in general would reduce diversity in practice.

Fair Value Measurement of Financial Instruments with No Active Market. See response to Section B, Question 1. A valuation that is confirmed by a subsequent cash/asset exchange is necessary to prevent financial statement manipulation.

Control for Purposes of Consolidation. The concept of control, pertaining both to voting ownership, as discussed in ARB 51, and influence, as discussed in Interpretation 46(R), is not clearly understood by both preparers and auditors. This concept is supported in the amended SBAC agenda, in which many competent accountants report that they do not understand Interpretation 46(R).

Simplification and Codification. The standards, as currently written, are difficult to understand and apply. The chances of not correctly presenting financial information because of misunderstandings are enhanced if the basic rules are not clearly understood. In my experience, any system will fail if it is too complex for those who operate in it.

Ellis

Educational Efforts on Principles-Based Standards
Principles-Based Standards
Equity-Based Compensation
Differential Accounting Standards

Educational Efforts on Principles-Based Standards. Focus on how to educate the financial community (investors, companies, regulators, accounting firms) on the change in focus from rules-based to principles-based standards. I applaud the Board's decision to develop future standards around defined principles but believe it will take a lot of education to have users of those standards move to principles-based thinking.

Principles-Based Standards. Focus on providing principles that are applicable and should be followed in respect of each of the current standards. I believe much of the problem we face today in applying standards comes from the fact that they were rules-based. In order to move forward, I believe we need to take our current standards and provide guidance on principles to go with them. The review of the conceptual framework walks us down that path, but this is a major and long journey that needs to be committed to and planned.

Equity-Based Compensation. The FASB is on the right track here and needs to stand firm. If you are giving someone compensation, it should be reflected as a cost to the company in the financial statements.

Differential Accounting Standards. Perform a review of current standards and determine whether for nonpublic companies of a certain size there is an alternative (for example, a disclosure note) that could be used instead of the GAAP requirements that justifiably are required for publicly held companies. Private companies that are closely held and of a certain size may have issues that are the same as public companies, but the users (primarily lenders and inside investors) of their financial statements are much more able to assess the effect if they are prompted by a note in the financial statements because they can directly ask for more information or are already aware of it. The shareholder in a public company with its size and multiple businesses needs full accounting and disclosure to be fully informed.

Hall

Codification and Simplification
Differential Accounting Standards
Cash Flow Statement

<u>Codification and Simplification</u>. In my view, there is no more important issue than the Board taking on the fundamental project of codifying all U.S. GAAP in one source. Taking on this project would be time-consuming and expensive but critical to the future of a self-regulated accounting environment. Those that say "the material is available to knowledgeable researchers" just do not understand the risks of not having one consistent and understandable set of rules. In the franchise industry we have complaints of different interpretations of the rules by the Big Four accounting firms on issues. If the Big Four cannot agree on what is proper, what about the mid-size and smaller firms that handle many of the small-business clients? The authoritative literature and rules need to be put into one place. Many entrepreneurs, management executives, accounting personnel, lenders, investors, and others in the business community have the intellect to understand the "rules of accounting" but the evolution of our standards has made it so complicated that most have to rely upon the "accounting experts" to understand the rules. The auditors want to say "the financial statement is the clients' responsibility," yet we make the rules so complicated that management does not have the knowledge to make the financial statement decisions.

Taking on this project would deflect efforts in Congress to override or get involved in setting accounting regulations. Lobbying efforts are under way on the stock option issue and that could just be the start. Imagine testifying before a Congressional committee and answering the question, "Where do the folks in my district go to find the rules for GAAP?"

Finally, I think completion of this project could include incorporation of other changes currently on the Board's agenda. This would be such a comprehensive effort that there would be the opportunity for a "fresh start" on some fundamental issues.

<u>Differential Accounting Standards</u>. If the Board does not take on the codification and simplification project, then the next best thing for small business owners would be to develop differential standards for SMEs. More and more small business owners are moving away from GAAP because of the implementation costs. Many community lenders do not understand GAAP and continue to waive audit requirements because of the perceived lack of value of GAAP statements. This trend will

continue as long as the rules remain in so many different places and are so costly to implement.

Cash Flow Statement. From the small business perspective, the development of a consistent and understandable cash flow statement to take a more prominent place in the financial statement line up. The income statement and the disclosure of noncash items are critical, but a new cash flow statement would be a fundamental change in reporting that would be of benefit to the small business community. It would seem that investors in larger companies would benefit as well, since the valuation of many entities is cash flow related.

Hoffman

Differential Accounting Standards
FASB Processes for Cost-Benefit Analyses
Improving Stakeholder Processes

Differential Accounting Standards. The focus should be on differential standards for businesses with ownership and capital structures that diverge from traditional, investor-owned, publicly traded entities. (See comments in Section C.)

The following recommendations address procedural issues that the FASB should address as priorities before it advances major new projects.

FASB Processes for Cost-Benefit Analyses. Given the significant impact of FASB standards on SMEs, it is critical that the FASB evaluate the processes it uses to determine the relative costs and benefits of the standards it issues. The FASB has not clearly articulated these processes and provides little substantive or quantitative information in its Exposure Drafts or final standards articulating how it arrived at the conclusion that the benefits of a standard exceed its costs. As a quasi-regulatory body, the FASB has an obligation to carefully evaluate costs and benefits for businesses of different sizes. The FASB may look to U.S. federal government processes for conducting such analyses. The FASB should make an effort to quantify both costs and benefits, even if the latter intangibles may be difficult to measure. An effort should be made to do so.

Improving Stakeholder Processes. The FASB should evaluate its stakeholder input processes to ensure they are sufficient for truly assessing stakeholder viewpoints and gathering sufficient information on which to base its decisions, as well as to ensure that the FASB decision-making processes are open and transparent. The FASB should evaluate how it appoints representatives to advisory committees and ensure that stakeholders of a variety sizes and with varying viewpoints are represented. The FASB may look to the Federal Advisory Committee Act for guidance on ensuring appropriate representation of stakeholders on such committees. In addition, the FASB should evaluate its systems for stakeholder input, including whether it should provide an opportunity for public comment at Board meetings and meetings of advisory committees; conducting true stakeholder input sessions in the field on a periodic basis; and conducting roundtable sessions to gather input before, not after, Exposure Drafts are issued.

The FASB should evaluate the appropriateness of its current practice of issuing tentative Board decisions long before Exposure Drafts are issued. The current practice suggests the development of intractable Board decisions prior to receiving input from stakeholders.

The FASB should also carefully consider how it evaluates comments it receives. The FASB states clearly that it does not conduct a "nose count" of comments but rather looks to the substantive arguments when evaluating comments. However, the FASB should consider the volume of comments from concerned stakeholders as an indicator of the degree of concern and the need to reevaluate standards based on that concern. Moreover, the FASB needs to address how it refutes arguments and concerns raised by commenting parties in standards it issues, providing substantive reasons for its disagreements with commenters.

Joseph

Financial Performance Reporting by Business Enterprises
International Convergence
Business Combinations
Pro Forma Reporting, Capital Expenditures, and
Cash Flow Reporting

Financial Performance Reporting by Business Enterprises. A crucial area from an investor's perspective would be financial performance reporting by business enterprises. This would help us get more clarity into the divisions of a business and ensure greater comparability with other stocks in the same industry.

International Convergence. This helps significantly, especially if there is a large quantitative element to the investing process. By ensuring consistent accounting, alphas can be scaled across different investing universes. R&D and income tax treatment are two areas that have significant differences.

Business Combinations. International treatment and GAAP treatment are different. This might, however, be part of the convergence project. Companies should disclose the pro forma effect of acquisitions, not just on the revenue and earnings-per-share line but on operating income and also for the past three years. It would also be useful to get details on the intangible valuation assumptions used for tax and book purposes. We find it difficult, from a database perspective, to capture stock issued for acquisitions without laborious computations that involve stock prices on the date of settlement, etc. I would like to see all money spent on acquisitions (whether paid for in cash or stock) shown in the investing activities section. Otherwise, it is difficult to analyze the cost of growth.

Pro Forma Reporting, Capital Expenditures, and Cash Flow Reporting. Assuming the projects on equity-based compensation and consolidation of variable entities are completed, other “nice to haves” would be some ruling on what is allowable in “pro forma” type reporting, an allocation of capital expenditures into maintenance and growth capital expenditures, mandating a reclass of tax benefit of stock options from operating cash flow to financing cash flows, and mandating the use of the direct method of cash flow statements.

Jumonville

Fair Value Measurement
Revenue Recognition
International Convergence
Codification and Simplification
Equity-Based Compensation

Fair Value Measurement. A very complex question, with far-reaching implications and consequences.

Revenue Recognition. A critical measurement for investors and financial institutions.

International Convergence. It is truly a global economy.

Codification and Simplification. For all the obvious reasons.

Equity-Based Compensation. A fascinating subject, which inspires great passion, and without an easy answer.

Meyers

Financial Instruments
Financial Performance Reporting by Business Enterprises
Business Combinations
Codification and Simplification
Differential Accounting Standards

Financial Instruments. Particularly getting Statement 150 wrapped up. The folks out there with mandatorily redeemable shares need some planning guidance for clients needing to structure succession plans.

Financial Performance Reporting by Business Enterprises. We need to look ahead and figure out what needs to be reported—then we can figure out what basket of rules we need to control the reporting.

Business Combinations. Let’s put this one to bed. The not-for-profit guidance is very much needed in practice.

Simplification and Codification. Well worth the time and effort.

Differential Accounting Standards. I am not a fan of multiple sets of standards. The FASB needs to decide what role it wants to play in setting standards for small businesses and not-for-profit organizations. I would like to see the FASB take responsibility for all accounting standards and control any differential applications. My fear is that someone else, the AICPA or one of the other players, will come in and offer easy political alternatives. However, with the FASB's current funding structure, I think that it may be hard for the FASB to devote substantial resources in the long run to the needs of non-SEC entities. If that happens, they will look for guidance elsewhere and the FASB may be marginalized.

Nusbaum

Equity-Based Compensation
Revenue Recognition
Fair Value Measurement
Financial Instruments
Business Combinations

<u>Equity-Based Compensation</u>. This is a controversial and widely recognized accounting issue that must be resolved. Equity-based compensation is prevalent in nearly all public companies' compensation practices. The Board must move forward on its proposal to expense options and resolve valuation and implementation issues. Of particular interest is the impact of volatility on the valuation and other issues that affect small- and mid-cap public companies as well as private companies that have options.

<u>Revenue Recognition</u>. The literature for this topic is extensive, disjointed, and in many areas industry specific. Even within certain industries the literature can be considered inconsistent. Issues with revenue recognition often cause public mistrust of financial statements. It is critical that revenue recognition be addressed in the near-term and a more universal standard emerge. The Board should evaluate the impact of various alternatives in this important area.

<u>Fair Value Measurement</u>. So many elements of today's standards require fair value measurements. There is considerable need for a consistent and comprehensive standard to address the topic.

<u>Financial Instruments</u>. Issues surrounding definition of assets and liabilities, particularly Statement 150, need timely resolution given the amount of confusion in the market today regarding identification and reporting of financial instruments.

<u>Business Combinations</u>. The entire "arena" of literature addressing business combinations requires better definition and clarity. Particularly, Interpretation 46(R) is extremely difficult to interpret and apply. Literature addressing new basis, bankruptcy, and fresh-start accounting should be more robust. In today's business climate, these issues are prevalent and the standards in place do not allow sufficient clarity and definition for proper measurement and reporting.

Thrower

Fair Value Measurement
Conceptual Framework
Codification

Business Combinations
Revenue Recognition

Fair Value Measurement. Finish the Exposure Draft and issue the standard. This fair value Statement is the foundation for completing the transition to the concept of recognizing that the balance sheet embodies the most fundamental elements of accounting theory. This project should be completed in order to be able to proceed with the additional priorities listed below.

Conceptual Framework. Rewrite the Concepts Statements incorporating the *complete* transition to principles-based and fair value accounting for *all* balance sheet elements, eliminating entirely both the mixed attribute model and the earnings-matching income statement concept. Elevate the Concepts Statements to a GAAP hierarchy level of 2.

Codification. Codify all authoritative U.S. GAAP into one source, all of which would become level one of the GAAP hierarchy. (The new Concepts Statements would be level two and there would not be any other levels.) Include the existing implementation guidelines and develop and incorporate full implementation guidelines with examples in each and every section of the codification.

Business Combinations. Complete and issue the final business combination standards as the first implementation (and demonstration) of how the fair value measurement standard is to be applied.

Revenue Recognition. Complete and issue the revenue recognition standard as the first new standard to be released under the new balance-sheet-focused Concepts Statements demonstrating how all existing and future income statement elements will be defined as new or revised standards are issued.

Waite

Financial Performance Reporting by Business Enterprises
Differential Accounting Standards
Business Combinations—Purchase Method Procedures
Accounting for Transfers and Servicing of Financial Assets
  and Extinguishment of Liabilities—Loan Participations
Conceptual Framework
Codification and Simplification
Fair Value Measurement
Short-Term International Convergence

Financial Performance Reporting by Business Enterprises. The impact on enterprises regarding numerous and frequent changes in accounting standards should have some balance in the goal of transparency and neutrality in financial reporting.

Differential Accounting Standards. “Big GAAP” versus “little GAAP” should be thoroughly discussed and a consensus reached. Although

I'm not promoting a division in accounting standards, I'm suggesting that the small business community continue to achieve and sustain an important voice in the deliberations of the FASB Board.

Business Combinations—Purchase Method Procedures. Although I cannot disagree with this change in accounting treatment for merged enterprises, I am concerned about the neutralities of the issue. I believe that this change will have an effect on my industry that is far from neutral. Many credit unions that are trying to survive in a consolidating industry will be facing a regulatory quandary. I fully realize that this is a different challenge to overcome but want the FASB Board to note that this accounting change does have implications far beyond the transparency of financial statements objective. In this case, a Congressional action is required to remedy the regulatory capital treatment and recognition.

Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities—Loan Participations. Loan participations are a predominant business opportunity for many financial institutions. They also increase the safety and soundness of the financial services industry by providing diversification of risk. I think that the FASB Board needs to keep in mind the magnitude of suggested changes. I am confident that through the Board's very thorough due process, it will.

Conceptual Framework. This work can never be finished. It is the very fabric that should keep everything else focused.

Willey — Differential Accounting Standards. Refer to comments in Section C.

Wright — Fair Value Measurements
Revenue Recognition
Liabilities and Equity
Differential Accounting Standards
Codification

Fair Value Measurements. These measurements are becoming more frequent in nonpublic company financial statements and the guidance that is in the standards is written for more sophisticated companies, and it assumes access to information, which most nonpublic companies do not have.

Revenue Recognition. The concepts surrounding revenue recognition need further clarification and guidance. Clients always have questions, and the guidance in this area is thin.

Liabilities and Equity. The question surrounding liabilities and equity as it relates to nonpublic companies needs to be resolved. There is much speculation about the outcome since Statement 150 has been deferred.

Differential Accounting Standards. Differential accounting standards for nonpublic companies should be addressed. There is current momentum for these standards, and I believe the FASB should issue its thoughts on the topic, similar to what the IASB did in its Preliminary Views document.

Codification. Codification of pronouncements should be a top priority. With all of the changes in the current literature, it is getting extremely difficult for small CPA firms and small companies to keep up with the technical literature.

Wysham

Differential Accounting Standards
Loan Participations
EITF 03-01
Revenue Recognition
Fair Value Measurement/Fair Value

Differential Accounting Standards. I do not think there should be different accounting standards for small business entities but I would like the FASB to pursue differences in disclosure requirements and transition periods. Is it possible for the FASB to work with the SEC to change the definition of an accelerated filer ($75MM is too low) and the shareholder base of 500? The burden of accelerated filing on a small company is tremendous as is the filing of full 10Qs and 10Ks for a company with less than $500MM in assets and a shareholder base of 500 to 1500 shareholders.

Loan Participations. Resolve this issue so banks (especially community banks) can continue to use sales treatment for loan participations. The community banking industry would be severely impacted if this long-time business practice was taken away. Community banks do not have the expertise to form SPEs, and they cannot afford the expense to do so.

EITF 03-01. Resolve this issue through clear guidance to take care of the current problems with interpretation by some accounting firms.

Revenue Recognition. A comprehensive solution is needed to provide consistent guidance. Industry-specific guidance should be considered.

Fair Value Measurement/Fair Value. A complex issue with broad implications to different industries. I do not have a clear picture on how to value loans and deposits for a small community bank. I think the average individual investor will be confused unless properly educated. A framework for measurement, application, and disclosure should be developed. This issue needs to be carefully and fully studied with consideration as to its impact on the small business community and different industries.

Considering the priorities you have identified above, are there projects currently on the Board's agenda that should be removed so that the Board can devote resources to your identified priorities? If so, please identify the project (or projects) that you believe should be removed from the Board's agenda.

Dyson	The guidance presented in the tentative summaries of conclusions regarding the accounting for business combinations and noncontrolling interests is quite complex. Based on similar circumstances, I believe the complexity would result in the need to issue supplemental guidance in the form of EITF Issues, FSPs, Interpretations, and other pronouncements. The Board should compare the benefits from these preliminary proposals with the use of resources to provide supplemental guidance that may be better used elsewhere.
Ellis	I have tremendous respect for the work the Board is doing and its focus on moving us to principles-based standards. I understand that the Board needs to react to the issues of the day and believe it is on track with all current initiatives. However, I do believe that with the complexity of the standards to deal with the increased complexity of business transactions, time should be spent evaluating if there can be simplified disclosure and reporting requirements for nonpublic companies under a certain size.
Hall	Projects to be removed in my opinion would be everything except the codification of U.S. GAAP. That project would be all consuming, although you could incorporate many of the existing projects into the codification effort.
Hoffman	The FASB should address the procedural issues identified above concomitant or in advance of other standard-setting priorities.
Joseph	Projects like fair value accounting and revenue recognition, while theoretically attractive, will probably have zero impact on stock prices and can only serve to confuse return on capital calculations. These are complex projects, and I am not sure the cost-benefit is attractive.
Jumonville	No.
Meyers	Revenue Recognition Liability Extinguishment A noble and valiant effort—let's take care of the current practical issues first.
Nusbaum	Financial performance reporting by business enterprises could potentially be removed, or scaled back. This would make sense to the extent the FASB could leverage the efforts of the AICPA's enhanced business reporting initiative.

Saeman — Fair Value Measurement

Thrower — All major projects should be frozen until priorities one and two [fair value measurement and conceptual framework] are completed (except for share-based payments, which should be completed by the end of this year). However, the EITF should continue its work throughout this time. The convergence project should be limited only to the development of convergence on the new set of Concepts Statements.

Waite — As a result of a very impressive due process, the Board members of the FASB have a great sense of the importance of issues. I fully respect the process of analyzing the input that they receive and the fact that they evaluate many considerations before reaching any decision. I believe that the current agenda reflects the important issues in a fully adequate manner. Although some of my prior comments are not on the current agenda, I have full confidence that the priorities are being aligned with the most important issues as expressed by the community at large.

Wright — I understand why the FASB would like to see international convergence. However, for my type of client base, this would be of no benefit to them. I also understand that the Board cannot remove this project from its agenda.

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Section B—Future Financial Reporting Issues
Views of Respondents

In the previous section, the survey asked for views on the most important accounting and financial reporting issues that the Board should have on its agenda now. The Board also wants to look to the future and become aware of potential financial reporting issues before practices become entrenched. Section B of the survey asked for respondents' views on the following two questions:

In what specific areas do you foresee potential accounting and financial reporting issues?

Individual Committee Member Responses

Dyson — Accounting for Derivatives. Currently, derivatives are measured at fair value, which many interpret as the future value of the characteristics discussed in paragraphs 6-9 of Statement 133. This view appears consistent with the concept of fair value in that the recorded assets or liabilities represent the amounts that would theoretically be exchanged to terminate the derivative instrument. The future values of these characteristics used in measuring derivatives are based on the holder's expectations, as opposed to substantial evidence. The problem is that the recorded derivative asset or liability, absent the termination of the instrument, is not verifiable by either the auditor or senior management of the financial statement issuer. The lack of verifiability raises a significant risk of financial statement manipulation.

Ellis — I have none in our business that I see as potential issues.

Hall — Some small business reporting issues that I see will be cash flow reporting, fair value, and revenue recognition. There will be more pressure from equity sources, lenders, and investors to report real economic substance of financial statements. The franchise industry strongly felt Interpretation 46 did not reflect the true nature of the consolidated entities and this issue was addressed in Interpretation 46(R).

Hoffman — The National Cooperative Business Association is surveying its members on emerging accounting and reporting issues and will provide that input to the FASB as it is gathered.

Joseph — Cannot think of a major area. A minor, probably too small a sample to focus on, is the issue of tracking stocks. While this may be more an area for the SEC, sometimes a company can have multiple tracking stocks but a set of financial statements where corporate overhead is not allocated or improperly allocated. Thus, Perkin Elmer has a stock that does not trade but has two tracking stocks for two of its three divisions that do trade. The company reports financial statements before corporate overhead for each tracking stock, but investors have no way of identifying how much of the corporate overhead is allocated to each division. This is probably too arcane an area for the FASB to focus on.

Jumonville — Fair value accounting.

Meyers — The reporting structure—financial performance reporting. The needs of the users are becoming more sophisticated and we need to be able to provide reporting flexibility and guidance.

Nusbaum — Consolidations (or business combinations)—many companies may decide to “structure around” the standards in place to avoid the spirit of the guidance.

Lease accounting, Statement 13, is too formula-driven in allowing agreements to be accounted for off-balance-sheet.

Saeman	I believe that fair value measurement standards will create substantial difficulties for certain industries and for certain sized organizations without a corresponding benefit to users or preparers of financial statements.
Thrower	Numerous issues will arise on fair value measurements. The Board should continue to do what it can to educate users of this fundamental change in concept.
Waite	The ability for enterprises of many different sizes and scales to digest the amount of accounting changes. The magnitude of these changes versus the available resources required to carry out such change must always be part of the deliberation process.
Wright	None that I am aware of.
Wysham	Public education. Burden on small business entities.

Are there specific business, industry, or economic trends that might give rise to financial reporting issues? What are they?

Dyson	No major issue.
Ellis	A move to high inflation presents a whole number of questions when it comes to fair value accounting.
Hall	Economic trends giving rise to reporting issues include increased international activity by U.S. companies, increased regulation by federal government (Sarbanes-Oxley), and cost of providing accounting services because of complex and litigation-protection audit procedures versus value of services to companies.
Joseph	The one type of stock that persistently hurts investors is the "roll-up." This is the case of a serial acquirer and it is very difficult to say what the true, nonacquisition growth rate is. While anyone investing in these types of stocks deserves to get burnt, it might be worthwhile, as part of the business combinations project, to specify how the underlying organic growth rate should be calculated and reported.
Meyers	Technology and communications issues that shorten the time horizon. The relevance versus reliability issue.
Nusbaum	The drive for consolidation and the desire of many companies to move liabilities off the balance sheet are the driving forces behind

the comments immediately preceding this question.

Saeman — Yes. Smaller organizations with lower market capitalization or shareholder numbers will likely be burdened unduly by fair value measurement standards as currently proposed. I also think that the financial services industry will be negatively impacted based on the unique nature of their balance sheets.

Thrower — Not sure.

Waite — For financial institutions, economic uncertainties about interest rates play a larger part in their strategic planning. The valuing of AFS portfolio investments, as referred to in Issue 03-01 for example, makes for major concerns from your constituents. I am very pleased to see that the Board has rearranged its upcoming meeting agenda to provide clarity on this issue. As an industry that is forbidden to invest excess liquidity in equity securities, any adverse treatment for debt securities has major implications.

Wright — None that I am aware of.

Wysham — The regulatory and accounting burden on small community banks continues to grow and with it the overhead cost. It is getting harder and harder to compete with our limited resources (which includes staff). The definition of a small filer should be changed. For a public $250MM bank with over 500 shareholders to be dealing with CRA, SOX 404, SEC filings, FDIC Call Report, and FRY 9s—well, it certainly has taken up valuable resources, which hurt our small communities and our small community investor. Many of us are not traded publicly but have reached the much “dreaded” 500 shareholder bright line and/or the $250MM in assets.

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Section C—Differential Accounting Standards for Certain Entities
Views of Respondents

In June 2004, the IASB issued a Discussion Paper, *Preliminary Views on Accounting Standards for Small and Medium-sized Entities*. That Discussion Paper asked for comments on issues relating to whether small and medium-sized entities (SMEs) should be required to follow IFRS as they exist today or whether the IASB should develop separate standards for those entities.

Similarly, the AICPA developed a discussion paper on private company financial reporting. In June, the AICPA posted a survey to its website seeking input on whether general-purpose GAAP financial statements of privately held for-profit entities meet the needs of stakeholders of privately owned companies.

Section D of the survey asked four questions about differential accounting standards for certain entities.

Do you believe it would be appropriate for the FASB to issue differential accounting and financial reporting standards for certain entities, such as privately held entities or SMEs? Why or why not?

Individual Committee Member Responses

Dyson	Standards regarding measurement should be the same for all entities, regardless of size. Financial statement users, such as lenders or investors, would probably discount the usefulness of “little GAAP” and pressure many SMEs to adopt “big GAAP.” Also, problems in determining fair value affect all entities and need to be addressed. Certain disclosures are not really necessary for SMEs. The classic example is the limitation of segment reporting to publicly traded companies; segment information would not increase the usefulness of small or nonpublic company financial reporting.
Ellis	Yes, because the users of these statements generally have access and are aware of the effect of issues within the business, especially if alerted to it by disclosure. In a public company, due to its size and complexity, full GAAP reporting is needed to provide shareholders with complete information and its effect.
Hall	If the Board does not take on the codification and simplification of U.S. GAAP, then I think it would be appropriate for the FASB to issue differential accounting and reporting standards for SMEs. My opinion is that economics will drive this issue. As smaller and privately held companies see the cost of compliance with GAAP increase, they will put increasing pressure on lenders and equity partners to depart from GAAP. In the community banking business, we are seeing many customers opting out of audits now and, as costs rise and audit firms become more difficult to deal with, that will increase. Many community banks now do not see the benefit of GAAP compliance because they feel they have an understanding of the cash flow of the operating business and that drives the lending decision. So while it would be better to have the same rules for everyone, the economic reality is that if you make the cost to comply so high, then the small and privately held businesses will find a way to avoid the cost.

Hoffman Yes. The FASB should consider issuing differential accounting and reporting standards for SMEs as well as businesses with unique capital and ownership structures that differ from conventional publicly traded firms.

The FASB has long served as the standard setter for publicly traded companies—those regulated by the SEC. As a result, the FASB tends to look at standard setting through a lens of investor-ownership. Indeed, the FASB presents itself as "serving the investing public."

Among the recent controversies that FASB standards have generated, several relate directly to the appropriateness of those standards for SMEs and cooperatives—businesses with an ownership and capital structure that differs significantly from publicly traded firms.

The FASB has already recognized that structural issues may necessitate different standards or different applications of standards for nonprofit entities.

Similarly, for SMEs and cooperatives, FASB standards may not be appropriate for those business structures. Nor may they be relevant from the standpoint of users, given that such businesses may have different relationships with users relative to investor-owned firms. Moreover, FASB cost-benefit analyses for SMEs and cooperatives may determine some standards do not meet the FASB's cost-benefit test.

Joseph I believe there should be a minimum market capitalization, or revenue or borrowing level, for implementing GAAP. Smaller firms (say less than $100 million market cap) have thinly traded stock, large family ownerships usually, and low widespread shareholder ownership. Caveat emptor should be the watchword here. This is even more true for private companies. However, above a certain cap, say $200 million (or express it as a decile of NYSE/AMEX cap), there should be no differential accounting.

Jumonville Yes, as accounting has evolved, the time for differential standards is now. Compliance with GAAP can be cost prohibitive for SMEs, resulting in non-GAAP financials and, even worse, acceptance of these non-GAAP financials by users.

Meyers I am not a fan of differential reporting; however, I can see the need for limited differences. Earnings per share, for example.

Nusbaum Recognition and measurement standards should be the same for all companies. The only possible exception might be in the definition of equity for private companies, and any exception should be limited. It may also be appropriate for SMEs to have reduced disclosure requirements, as users of their financial statements have different means of acquiring information than users of public company financial statements. Research should be conducted to determine if reducing disclosure benefits these entities.

GAAP is the highest standard of accounting and, while not perfect, it is the best methodology we have for financial reporting. It should be utilized for all companies. The burden on the profession, industry, and users in understanding more than one standard of accounting is too great.

Saeman

Absolutely. The answer is itself embedded in your background information when you state “significant costs of compliance, those costs tend to fall disproportionately on smaller entities….” This, of course, should not be the result of standard changes. Therefore, I believe it is appropriate for there to be differential accounting.

Thrower

I do not believe that it is appropriate for the Board or the IASB to issue separate, standalone standards for SMEs. Nor do I believe that any other body should be setting SME accounting standards. However, I believe the Board should continue—but greatly expand—its efforts to incorporate reduced disclosure requirements where cost considerations or complexity considerations unreasonably impact SMEs. In addition, I believe that the Board should allow less stringent valuation measurement <u>methods</u>—but conceptually the same—for SMEs but only where cost versus benefit is at issue. (Example: a level three measurement of fair value of a less-than-liquid investment instead of a level two valuation where the cost of obtaining a level two value is excessive for an SME.) However, these reduced disclosure standards should be incorporated into the standards as needed and not issued in a separate set of SME standards. In summary there should not be differential measurement standards, but only differential disclosure standards, as there are now, but with more careful consideration given to SMEs.

Waite

In some fashion, yes. I’m not advocating a parallel accounting standards system for small and medium-sized businesses, but rather, modifications to future standards to accommodate special characteristics of some enterprises or industries. As a representative of an industry of mutual enterprises, I believe that there is uniqueness to mutuals, for example, that should be evaluated and addressed.

Willey

I am going to differ with many of the Board members and responders as it relates to differential accounting standards for various entities. I am in favor of the Big GAAP/Small GAAP separation. The recent pronouncements have become increasingly complex and convoluted that they have rendered the financial statements for many small businesses useless for the purposes of managing and reporting on their businesses. The owners cannot understand them and their creditors usually cannot understand them. Many of the adjustments for comprehensive income and some of the required adjustments for long-term liabilities have rendered the income statements useless. Derivative calculations, Statement 150, and the requirements to consolidate certain entities or capitalize certain agreements have rendered the balance sheets useless. The response of one of the Board members that companies should be using the cash flow statements anyway was not helpful. There was an old joke in which a man was in a balloon and was lost. He called down to someone on the ground and asked him where he was. The response was that he was in a balloon, 200 feet off of the ground drifting in a 10-mile-an-hour southerly wind. The punch line was you must be an accountant because you told me something that was factually correct and precise, but totally useless to solving the problem at hand.

As a CPA firm that services only small to medium-sized nonpublic business, we have been seriously discussing converting many of our reporting entities from GAAP to OCBOA statements, such as tax basis or modified tax basis, to provide an understandable financial statement that is meaningful to the reader. It usually makes no sense for a small business to go through gyrations to calculate certain numbers and make convoluted entries to meet GAAP requirements that have no material impact on the financial condition of the company. Other alternatives are just to agree to qualified opinions that are satisfactory to the owners and the creditors.

I am also not sure that the Board understands the unintended consequences of many of its decisions. Let's take Statement 150, which would require the recording of the ultimate liability of a buy-sell agreement between shareholders. It is a good business practice to have such agreements in place for a variety of reasons, from estate planning to succession planning for the business. To require recording of that obligation currently will effectively wipe out all of the equity in these companies. This would severely impact their ability to obtain financing and basically render their balance sheet useless. The unintended consequences could be that these agreements would no longer be used, which would leave these companies open to disputes and litigation at the time of a death or departure. This is a classic case of where the liability should not be recorded but should be disclosed in the notes.

In summary, I would favor a simplified small business GAAP with appropriate disclosures.

Wright — I believe that the FASB should be included in the discussion. I also believe that the users of nonpublic statements are different from those of public companies, and, therefore, one size does not fit all. I understand that, conceptually, it will be difficult for the FASB to decide that a different set of measurement standards is appropriate for a particular group of entities. However, due to the complexity of accounting standards and the limited resources of nonpublic companies, it may be the only answer to continue to have a set of standards that apply to these entities, without numerous exceptions on a case-by-case basis.

Wysham — See response in Section A.

If you believe it would be appropriate for the Board to issue differential standards, what type or types of entities should be eligible to apply such standards? For example, should all privately held entities be eligible to apply differential standards? Should the size of an entity be a factor in determining eligibility?

Ellis — I believe the key here is who the user is. If a private company has external shareholders that are not involved in the operation of the business, then for their protection, full standards should apply. Other users, internal shareholders, banks, other lenders, and regulatory bodies have the business knowledge to be able to ask more questions if a simplified note disclosure is used to note the issue as opposed to complex accounting for it. I also believe that companies over a certain size do have a public responsibility to follow the full standards and believe sales of $250 million is a good cut-off.

Hall — I think the differential standards should be a private verses public issue. The difficulty in using size of an entity is comparing industries. A bank with $40,000,000 in assets is a small bank but a fast food restaurant company with the same assets would be large. If an entity is public, it has chosen to raise capital from public investors.

Hoffman — The FASB should consider, at a minimum, differential standards for businesses with unique capital and ownership characteristics, such as cooperatives and other mutual enterprises, and may wish to consider the relative size of the entity as well.

The FASB should address the appropriateness of differential accounting standards on a standard-by-standard basis and evaluate whether size or ownership and capital structure necessitates a differential standard. In some cases, differential standards may not be necessary, whereas in other cases, they will be essential in order to ensure transparent and accurate financial statements.

Jumonville — Public/nonpublic. I am aware that, due to the large size of certain nonpublic companies, comparability issues with smaller public companies may arise.

Meyers — I like the cut between SEC and non-SEC. On difficult applications I like a phased-in approach based on asset/revenue size.

Nusbaum — It is appropriate for SMEs to have more time than larger companies to implement new standards. Given that the cost of implementation is often considered to disproportionately burden the SMEs, delaying implementation of new standards allows these entities more time to effectively plan how they will comply with newly issued guidance and even, to some extent, leverage work of others in the accounting profession and industry that have addressed new standards before them. Reduced disclosure requirements and alternative equity definitions could be based on private versus public company characteristics, but additional research is required.

Saeman — It may be necessary and appropriate to review standards and to have more than one criterion for differentiation. However, consider that private and public but not publicly (actively) traded entities could and perhaps should benefit from some form of differentiation.

Thrower — The determination of differential disclosure standards should be applied strictly on public versus nonpublic entity lines, and not be applied based on any other set of rules or tests. Nonpublic entities should have the option of electing the full disclosure standards, but only in total, not piecemeal, and once elected, the decision is irrevocable except in very limited circumstances. The election by a nonpublic entity to use or not use full disclosure standards should be made by agreement among the users of the entity's financial statements, and not by an accounting or auditing standards body.

Waite — As mentioned above, public versus private enterprises, for-profit versus not-for-profit, and larger versus small enterprises should be factors. Again, as opposed to advocating multiple standards in all cases, I believe that each standard, on a case-by-case basis, should be evaluated on the technical issues and effects on different classes of businesses.

Wright — Size is definitely one criterion. I also believe access to company information is another factor that must be considered.

If the FASB issued differential standards for certain entities, should the standards differ only in disclosure requirements, or should the standards differ in terms of recognition and measurement criteria for those entities?

Ellis — If it is recognized that the recognition and measurement criteria require a significant amount of additional work that may be considered unnecessary when all parties involved are aware of the approximate effect, I believe disclosure of the departure from GAAP should be acceptable instead of going through the required accounting. The justification for this is that the users are either internal owners or professionals.

Hall — I would prefer standards to differ in disclosure rather than in terms of recognition and measurement.

Hoffman — Differential standards should be considered for both recognition and measurement and disclosure.

Joseph — I believe only disclosure should be different. Underlying economic reality is the same irrespective of size.

Jumonville — Recognition, measurement, and disclosure.

Meyers — Mostly in the disclosure area. However, I can see small business measurement issues in the equity section related to equity (?) instruments for succession planning. In not-for-profits, I can see the need to measure items differently in investments, service efforts, and the various classes of net assets.

Nusbaum — The standards should differ for disclosure requirements only, with the possible exception of equity definitions.

Saeman — That may need to be discussed on a more specific and detailed level based on the particular standard.

Thrower — There should be disclosure requirements only. The recognition and measurement criteria, and therefore the underlying Concepts Statements, should be the same for all for-profit entities regardless of size. The only exception would be where the ability to apply full measurement procedures would be limited due to unreasonable costs to an SME, who would then apply a less stringent method, but not resulting in measuring a different attribute.

Waite — Recognition and measurement criteria should be included in the scope of the standard.

Wright — I believe that a conceptual framework that considers the two criteria above [size and access to company information] should be developed. The concept of fair value is just not that relevant to the nonpublic enterprise that is just preparing financial statements to satisfy a loan covenant.

Wysham — Disclosure requirements only.

Should the FASB devote staff resources to further study of this issue?

Ellis — There are millions of private businesses that are the foundation of our economy. They deserve to be served by the FASB and this issue should be further studied.

Hall — I do see many problems with implementing a “Big GAAP” and “Little GAAP” approach, and for that reason I prefer to see a principles-based codification and simplification that could be applied to all companies. If the Board does not take that approach, consideration should be given to devoting staff resources to differential accounting because regardless of how much everyone wants one standard for accounting, the small business community will move away from GAAP because of the cost to implement and the perception by that community and its lenders that it is not necessary.

Hoffman — Absolutely.

Joseph — This is something the Small Business Advisory Committee should consider.

Jumonville	Yes.
Meyers	Yes.
Nusbaum	Devoting FASB staff resources to implementation guidelines on some of the more complex matters would be most appropriate. Companies may be more willing to endorse new standards if they felt that there were clear and concise guidelines offered by the FASB to help them implement the new rules. These implementation issues are particularly more difficult for small and mid-cap public companies and private companies, which often believe that the Board is only concerned about the large-cap public companies. The staff should also devote limited resources to address the disclosure and equity issues of private companies. In addition, members of Congress have expressed concerns about the issues facing small businesses, and the Board must be sensitive to these concerns. The Board should use all of its resources, and possibly add resources, to ensure that Congress does not enter into the standard-setting process on any issue.
Saeman	Absolutely yes.
Thrower	Yes. The FASB should devote specific resources to study the issue. More importantly, the FASB should use resources to work with SMEs to help determine implementation issues of the SMEs. Equally important, the FASB or FAF should use its resources to help educate SMEs as to the reasons behind standards. This is important because SMEs generally do not have the resources to follow the events that drive the development of accounting standards. The FASB should be doing more to actively educate (or at least attempt to educate) the SME constituents. I believe that the Board should engage in a long and healthy dialog with SMEs and their constituencies on this subject, and that it is a major mistake for the IASB, AICPA, state boards, or any other body to begin to undertake creating a separate set of accounting standards.
Waite	Most definitely. Through the establishment of the Small Business Advisory Committee, particular focus by staff to study this issue should be on the Board's agenda.
Wright	I would think the FASB should be able to use the information that the AICPA has gathered, to at least begin the discussion. I believe that there is current momentum for differential standards, and I believe the FASB should be a part of the ultimate decision.
Wysham	Yes, and work with the SEC to change the definition of an

accelerated filer and the definition of "public" relative to the 500 shareholder issue.

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Identification of Individuals Who Provided Comments That Are Included in This Summary of Responses

Committee Members	Affiliation
Robert A. Dyson	American Express Tax & Business Services
Mark Ellis	Chief Financial Officer Michael C. Fina
William G. Hall	Chairman and Chief Executive Officer William G. Hall & Company
Jane A. Hoffman	Chief Financial Officer National Cooperative Business Association
Joe Joseph	Managing Director Putnam Investments
Francis C. Jumonville, Jr.	Chief Financial Officer and Secretary Treasurer Airtrol, Inc.
Russell V. Meyers	Member of the Firm PKF Witt Mares
Edward E. Nusbaum	Executive Partner & Chief Executive Officer Grant Thornton LLP
Charles L. Saeman	President and Chief Executive Officer State Bank of Cross Plains
Edgar A. (Andy) Thrower	Chief Financial Officer Contec, Inc

Scott M. Waite	Senior Vice President and Chief Financial Officer Patelco Credit Union
Grafton (Cap) H. Willey, IV	Shareholder Tofias PC
Candace Wright	Audit Director Postlethwaite & Netterville
Lark E. Wysham	Executive Vice President and Chief Financial Officer Citizens Bank/Citizens Bancorp