The FASB Small Business Advisory Committee met at the FASB office in Norwalk, CT.

Members Present

Michael Cain
Daniel Donoghue
Robert Dyson
Mark Ellis
Richard Forrestel, Jr.
Joseph Graziano
William Hall
Gregory Hanson
Jane Hoffman
W. Stephen Holmes
Francis Jumonville, Jr.
Mauricio Kohn
Steven Mayer
Russell Meyers
Darrel Posegate
Charles Saeman
Edgar Anson Thrower
Scott Waite
Grafton Willey, IV
Deborah Wilson
Candace Wright
Lark Wysham

Members Absent

Michael Hansen
Joe Joseph

Others Attending

Financial Accounting Standards Board:  FASB Staff:
Robert Herz, Chairman  Suzanne Bielstein, Director
George Batavik, Member  Lawrence Smith, Director
G. Michael Crouch, Member  Ronald Bossio, Senior Project Manager
Gary Schieneman, Member  Peter Proestakes, Project Manager
Leslie Seidman, Member  Michael Tovey, Practice Fellow
Edward Trott, Member  Lauren Belot, Postgraduate Technical Assistant

Observers

Greg Edwards, Principal, Accounting Standards, CICA
Gregory Fletcher, Assistant Chief Auditor, PCAOB
Tia Jenkins, Senior Assistant Chief Accountant, SEC
James Leisenring, Member, IASB
Jenifer Minke-Girard, Senior Associate Chief Accountant, SEC
Daniel Noll, Director of Accounting Standards, AICPA
Richard Swift, Chairman, FASAC
Teresa Polley, Executive Director, FASAC
Welcome and Introductions

Mr. Batavick called the meeting to order at 9:30 a.m. and welcomed members of the Committee to the initial Small Business Advisory Committee (SBAC) meeting. He encouraged members of the SBAC to openly discuss any issues with FASB members and staff, including any not on the agenda. After each meeting attendee introduced themselves and briefly described their background and affiliation, Mr. Batavick introduced FASB Chairman, Mr. Herz.

Mr. Herz emphasized that the SBAC will be a key element to the standard setting activities of the FASB. He also thanked Senator Enzi for initiating the idea of the SBAC and referred Committee members to a letter from Senator Enzi that was distributed to each member. Mr. Herz also commented that the selected members of the SBAC represent a cross-section of constituents involved in small businesses. He stated that the Committee’s role is to be a source of essential advice for the FASB’s ongoing activities, both through periodic meetings and participation as members of project resource groups. Finally, he encouraged all members to provide feedback on all types of issues.

FASB Overview

Mr. Batavick presented an overview of the FASB’s standard-setting process and the current board agenda, and invited any questions from Committee members. One Committee member asked what the SEC’s role in interpreting principles-based accounting standards will be. An SEC staff member responded that all parties will have a role in interpreting and exercising judgment of principles-based standards and their application.

Another Committee member expressed concern regarding the FASB’s project to amend FASB Statement No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities, and the right of setoff (the common-law right of debtors and creditors to set off (net) amounts due to one another if one of the parties defaults, becomes insolvent, or enters into bankruptcy or receivership). Mr. Trott explained that the common law right of setoff may have implications for a necessary condition to report a transfer as a sale, and thus may affect the accounting for loan participations. He further explained that the FASB is currently gathering more information on the right of setoff from members of the legal community and other constituencies. Several Committee members concurred that there is diversity in views relating to whether loan participations are sales and also expressed concern that there will be a substantial negative impact if loan participations are not accounted for as sales. Mr. Trott assured Committee members that the FASB is trying to resolve this issue and constituent input on the Board’s proposed solution will be sought through a second Exposure Draft.

Equity-Based Compensation

Mr. Crooch introduced the next agenda topic, equity-based compensation, to the Committee and asked members whether or not their organizations, or their clients’
organizations, have stock compensation plans in place. Committee members indicated that equity-based compensation programs are common among many small, public companies, in particular emerging technologies, financial institutions, and to a lesser extent, insurance enterprises. Use of equity-based compensation programs among the small nonpublic companies represented at the meeting was uncommon, in particular cooperatives, small, closely-held construction companies and credit unions. Only a small percentage of small, nonpublic entities issue stock options, but that behavior would most likely change depending on whether they plan to have an eventual initial public offering.

Most of the concerns expressed by Committee members centered on measurement issues. Many of the commentators stated that they currently follow the requirements of APB No. 25, *Accounting for Stock Issued to Employees*, which requires use of the intrinsic method for expensing stock option plans. Several Committee members expressed a preference to recognize a stock option expense at the exercise date and measure it as the fair value of the stock at that date minus the option’s strike price—similar to the accounting of stock options for tax purposes.

Some members questioned the appropriateness of recognizing an expense relating to stock option programs. They argued that stock options are a cash-free form of compensation, and therefore, should not be recognized as an expense. Committee and Board members discussed the ramifications of cash used for share repurchase plans instituted to offset the dilutive effects of stock options and the rationale for expensing the value of employee services received regardless of whether cash is consumed.

Several Committee members expressed a concern that the complexity of the proposed Statement, if issued as a final Statement would contribute to a trend of smaller entities not implementing certain GAAP guidance and therefore, receiving qualified audit opinions. Those Committee members stated that the increased cost of capital to an entity with a qualified audit opinion would be less than the cost of implementing certain GAAP provisions.

Mr. Crooch then described certain provisions of the proposed Statement that affect nonpublic entities, including the election of either the fair-value-based method or the intrinsic value method, the proposal of the prospective method of transition, and the deferral of the effective date. He asked Committee members to comment on whether those are appropriate provisions for nonpublic entities.

One Committee member expressed concern about the definition of “nonpublic entity” and whether that definition would coincide with the SEC’s definition of a “small business.” Another member expressed concern over the comparability of financial statements of public companies versus nonpublic ones, with respect to stock option accounting.

Several Board members inquired how nonpublic entities currently value their stock options under the intrinsic method. One respondent stated that for many companies, the value of the company is set by its Board of Directors. Another Committee member
indicated use of an earnings multiple approach. Other respondents expressed concern over the costs of having to value their stock under the proposed Statement, especially if it is necessary to hire a valuation expert. Another Committee member suggested use of industry data for setting the rate of expected stock volatility. In addition, one respondent suggested that the FASB conduct field tests to determine the costs involved in stock option valuation. Several Board members responded that research on costs was gathered during the extensive field visits conducted prior to issuing the proposed Statement. They also stated that the new guidance would not require the use of a valuation expert.

One Board member asked the Committee whether small, public companies should be afforded similar provisions to those for the nonpublic entities. Several Committee members responded that small public companies should not receive similar treatment to nonpublic entities, because creating a further distinction between business entities would result in more complexity.

Finally, Mr. Crooch asked the Committee to comment on employee stock purchase plans. Several Committee members responded that they would discontinue their employee stock purchase plans if the accounting for them created volatility in their net income figures.

**Business Combinations**

Mr. Batavick informed the Committee that the discussion on business combinations would have to be postponed due to the lengthy discussion on equity-based compensation. However, he asked Committee members if they had any specific questions relating to the business combination project.

One Committee member, a representative of cooperatives, asked whether information will be provided on how to value member benefits in a business combination of mutual enterprises. That member also expressed concern that sometimes it is unclear in such a combination which party is the acquiror and which party is the acquiree. Some Board members acknowledged that the issue of the need for additional guidance would be considered before the final Statement is issued.

Another Committee member expressed concern that the effective date of the final Statement relating to the business combinations project would not allow an appropriate amount of time for implementation. However, that member was pleased when a Board member remarked that it would not be effective until 2006.

**Current Accounting Environment**

Mr. Batavick then opened the discussion up to the broad topic of the current accounting environment. Some Committee members expressed concern that as GAAP becomes more complex and costly to implement, preparers of financial statement will choose not to adopt certain provisions. Other Committee members noted that GAAP is necessary and beneficial for the economy, and that FASB should be the rule-making organization for GAAP.
Another issue raised is whether or not there should be differential accounting for nonpublic and public entities. One Committee member suggested that the noncomparability that would result from differential accounting could be mitigated through disclosure requirements—while public companies may be required to recognize an amount, nonpublic companies may only be required to disclose that amount. Specifically, some Committee members commented that enhanced disclosures relating to the mandatorily redeemable equity of nonpublic entities might be a suitable alternative to the accounting requirements in FASB Statement No. 150, *Accounting for Certain Instruments with Characteristics of both Liabilities and Equity*. However, several Board members noted that in that case, disclosing certain information in lieu of recognizing it in the financial statements actually reflects different applications of the definitions of liabilities and equity.

Some Committee members also stated that there are very few users of their financial statements, and that users such as sureties are not always aware of new accounting requirements. Therefore, they could be penalized by agencies such as sureties for, in the case of Statement 150, reflecting a higher amount of liabilities on their balance sheets, despite having the same capital structure. Several Board members acknowledged that educating sureties and other similar enterprises on changing accounting requirements is important.

Additional suggestions raised by some Committee members include the following:

1. The Statement of Cash Flows is very useful and would be made more transparent if the direct method was required.
2. The complexity of GAAP is a major concern. To address that concern, the FASB should consider the following:
   a. writing standards in plain English
   b. codifying the guidance into one source
   c. communicating the impact of its guidance on specific industries
   d. providing more implementation guidance, and
   e. indicating how radical each change is from previous accounting requirements.
3. Allow at least a year for smaller entities to implement new guidance and to train and educate their employees.
4. Conduct more field tests in order to evaluate the costs and benefits of proposed guidance and communicate those results to constituents.

Meeting Adjournment

Finally, Mr. Batavick asked Committee members to comment on whether the frequency and length of SBAC meetings is appropriate. Members unanimously agreed that having two meetings per year is appropriate, and they also unanimously agreed with the length of the meeting. Mr. Batavick also encouraged members to consider forming an agenda committee to decide which agenda topics are the most relevant.
Mr. Batavick concluded the meeting by thanking all participants, especially Committee members, and by encouraging members to give feedback on how to make future SBAC meetings even more effective.