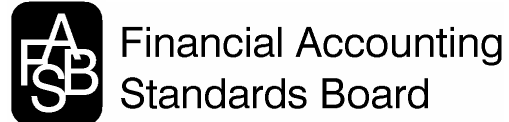


MINUTES



To: Board Members

From: Short-Term Convergence—Balance Sheet Classification Team
(Rohrkemper, ext. 284)

Subject: Revised Minutes of June 16, 2004 Board Meeting **Date:** June 22, 2004

cc: Bielstein, Leisenring, Smith, Swift, Polley, Gabriele, Project Team
(Belot, N. Campbell, Cassel, Gagon, J. Johnson, Rohrkemper, Thomas, Vincent), FASB Intranet (e-mail), McGeachin (IASB, via e-mail)

Topic: Short-Term Convergence: Balance Sheet Classification

Basis for Discussion: Board Memoranda dated June 10, 2004 and June 15, 2004

Length of Discussion: 9:00 a.m. to 9:50 a.m.

Attendance:

Board members present: Herz, Batavick, Crooch, Schieneman, Schipper, Seidman, and Trott

Board members absent: None

Staff in charge of topic: J. Johnson

Other staff at Board table: Bielstein, Cassel, McKenna, Belot, and Rohrkemper

Outside participants: Leisenring, Paul (IASB Staff, by telephone)

Summary of Decisions Reached:

The Board decided not to issue an Exposure Draft of a proposed Statement to replace ARB No. 43, Chapter 3A, “Working Capital—Current Assets and Current Liabilities,” as part of its short-term convergence project, primarily based on the conclusion that the perceived costs of certain proposed changes might outweigh the perceived benefits for some constituents (in particular, smaller or nonpublic entities and the users of the financial statements of those entities).

In making that decision, a majority of the Board expressed the view that the proposed Exposure Draft, which would have adopted the definition of current liabilities used in International Financial Reporting Standards, would have improved financial reporting in the United States. The Board directed the staff to consider whether the changes that would have been proposed in this Exposure Draft should be incorporated into its project on reporting financial performance.

Objective of Meeting:

The objective of the meeting was to:

- (a) Call the Board’s attention to feedback the staff received from constituents and one Board member concerning the tentative requirement in the proposed Exposure Draft on balance sheet classification that would prohibit an entity from giving effect to a covenant violation waiver obtained subsequent to the balance sheet date and
- (b) Determine whether that feedback, which was not available during the Board’s initial deliberations, warrants one of the following courses of action: (1) providing a scope exception for particularly affected groups—such as nonpublic entities, (2) indefinitely deferring the issuance of the Exposure Draft pending further analysis, (3) issuing the Exposure Draft with no alteration to previous Board decisions, or (4) some other form of revising the proposed classification guidance.

Matters Discussed and Decisions Reached:

The staff noted that some of the Board’s small business constituents and one Board member (EWT) are concerned about the proposal to prohibit an entity from giving effect to a waiver of a debt covenant violation that was obtained after the balance sheet date but before the financial statements were issued. The

staff reported that one of those concerns, which was not addressed during the Board's initial deliberations, was that the proposed Exposure Draft could affect the ability of certain licensed contractors to renew licenses or bid on new contracts—that is, because the proposed changes to the definition of current liabilities may make it difficult for some entities to meet regulatory working capital requirements.

Mr. Trott clarified that his primary concern was not related to the economic impact that the Board's decision would have on a certain class of constituents, but rather to the cost associated with educating certain users of licensed contractors' financial statements (that is, regulators that impose working capital requirements for bidding and licensing decisions) as to the impact of the proposed change and associated disclosures. He emphasized that he believes that the proposed change would result in more consistent and comparable financial information.

The staff also announced that since the Board first deliberated the issue of accounting for post-balance-sheet-date covenant violation waivers, the Private Company Practice Section Technical Issues Committee of the AICPA completed a survey of the opinions of some community bankers on this issue and reported the results to the staff. The staff reported that the results of that survey indicate that community bankers do not support the proposed change to the accounting for covenant violation waivers for a variety of reasons.

In light of these newly-expressed concerns and additional information, the staff proposed the following four alternative courses of action for deliberation by the Board.

Alternative 1: Provide an exception for nonpublic entities to the requirements in the proposed Statement as they relate to covenant violations. Effectively, nonpublic entities would continue to apply the requirements of FASB Statement No. 78, *Classification of Obligations That Are Callable by the Creditor*.

Alternative 2: Defer further work on the proposed Exposure Draft until the Board can consider the presentation of information about liquidity and

financial flexibility as part of the Board's project on reporting financial performance.

Alternative 3: Continue the process of drafting and balloting the proposed Exposure Draft without making any changes to address the concerns raised about its effect on nonpublic entities.

Alternative 4: Revise the classification guidance in the proposed Exposure Draft to alleviate the concerns raised by our constituents.

The staff recommended Alternative 2 on the grounds that it does not believe that an exception for nonpublic entities is supportable. Mr. Johnson expressed his belief that the proposed change would be equally appropriate, on both a conceptual basis and a cost-benefit basis, for both public and nonpublic entities and that if the Board were to determine that the costs of the proposed change would outweigh its benefits, then the proposed change should not apply to *either* public or nonpublic entities. He also pointed out that Alternative 2 would alleviate the concerns expressed by many constituents in the short term and allow the Board more time to deliberate the issues surrounding liquidity and financial flexibility more completely in the context of the second phase of the Board's project on reporting financial performance.

Mr. Leisenring pointed out that while liquidity and financial flexibility disclosures were discussed as candidates for inclusion within the scope of the second phase of the FASB's project on reporting financial performance, they were not discussed as potentially within the scope of the IASB's project on reporting financial performance, which is being conducted jointly with the FASB.

Mr. Trott reiterated his belief that the proposed Exposure Draft would result in a higher quality accounting standard than current generally accepted accounting principles (GAAP), including the provisions related to the classification of liabilities subject to a covenant violation waiver. He believes that current GAAP provides for asymmetric treatment of positive and negative subsequent events for purposes of balance sheet classification. For example, under current GAAP, a covenant violation that occurs after the balance sheet date is *not* reflected on the balance sheet, whereas a subsequently obtained waiver for a covenant

violation that exists at the balance sheet date *is* reflected in the classification of the associated liability.

Mr. Trott expressed concern, however, that the costs of the proposed change could outweigh the benefits for certain constituents, particularly nonpublic entities. Because of this concern, Mr. Trott expressed support for either Alternative 2 (delay the issuance of the Exposure Draft for some time until it can be reconsidered under the Board's project on reporting financial performance) or Alternative 1 (exclude nonpublic entities from the scope of the Exposure Draft). He explained that he believes that nonpublic entities have a greater challenge in overcoming the cost-benefit hurdle because, in most cases, nonpublic entities do not prepare interim financial statements with sufficient specificity to anticipate, and initiate discussions with their lenders regarding, potential covenant violations and a potential associated waiver. As a result, nonpublic entities face greater incremental costs in terms of both (a) anticipating covenant violations prior to the balance sheet date and (b) educating their primary users (lenders imposing loan covenants) and other users (for example, customers who have an interest in the ability of the entity to secure sufficient financing to honor a contract) on the impact of the proposed accounting change.

Mr. Trott noted that while he supports both Alternatives 1 and 2 for cost-benefit reasons, he prefers that the Board defer the Exposure Draft in its entirety (not just for nonpublic entities). Additionally, he asked that the staff report their findings and the Board's opinions, particularly as they relate to nonpublic entities and their associated costs and education efforts, to the IASB.

Mr. Schieneman agreed with the staff and Mr. Trott that Alternative 2 is the best course of action, but for different reasons. Unlike Mr. Trott, Mr. Schieneman said he disagrees with the decision to propose a change in balance sheet classification. His view is that the change proposed would give rise to a "static balance sheet" that would provide less relevant information as it relates to subsequent events. For that reason, and to allow more time to examine issues related to the impact of the proposed change on small and nonpublic entities, he expressed support for Alternative 2.

Ms. Schipper expressed two concerns with issuing the Exposure Draft immediately, without alteration. First, she referred to the existence of a class of users of the financial statements of some nonpublic entities that is both (a) dispersed (that is, hard to identify and reach) and (b) more likely to use the financial statement data in question as an input to certain mechanical calculations—for example, the calculation of working capital requirements for contracting decisions—without necessarily scrutinizing the footnotes and other disclosures during analysis. The proposed change in the derivation of the inputs used would require that financial statement preparers undertake significant educational efforts to explain to those users the “new basis” on which their inputs are derived, as well as where to find and how to analyze the appropriate related disclosures. In view of the requisite education effort associated with the proposed change, Ms. Schipper noted that her initial preference is to extend the transition period over a longer-than-usual time period.

Ms. Schipper expressed a second concern with the fact that the Board has discussed, but has not yet adequately addressed, which considerations should be examined in determining whether to provide differential accounting for certain classes of entities. She noted that the Board has discussed the frequency of reporting—that is, the lack of quarterly reporting requirements for nonpublic entities—and the ownership structure of certain classes of entities as possible reasons for providing differential accounting. With respect to the latter, the Board has made exceptions and allowed for differences in application for certain classes of entities with idiosyncratic ownership structures. Specifically, the Board has concluded that not-for-profit entities have an ownership structure that warrants different reporting requirements. Furthermore, the Board has decided that certain investment structures also represent sufficiently different ownership structures to warrant different accounting treatments. Ms. Schipper pointed out that some members of the IASB have considered making exceptions for classes of entities based on the nature of their business in their project on accounting standards for small- and medium-sized entities.

Ms. Schipper noted her support for the conclusions reached in the proposed Exposure Draft because she believes they represent a superior accounting answer to current GAAP. However, she pointed out that the Board has yet to decide, in general, how to display information in financial statements that is forward-looking as of the balance sheet date, but is available as of the date of issuance. Given this, and given that the Board has not yet decided whether, and, if so, on what basis, to provide for differential accounting treatments to entities with idiosyncratic ownership structures, Ms. Schipper supported the staff recommendation to defer further work on the project so that these issues may be more comprehensively considered by the Board during its deliberations on the second phase of its reporting financial performance project.

Mr. Crooch also expressed his belief that the conclusions reached in the proposed Exposure Draft are superior to current GAAP. He did not support an across-the-board deferral of work on the project as the staff recommended. Instead, Mr. Crooch suggested that the Board offer a long transition period, as Ms. Schipper had discussed, but only for certain constituents. Mr. Crooch recognized the difficulty in determining an appropriate definition of “small” or “nonpublic,” but proposed that the Board modify the transition guidance so that nonpublic entities would have a longer period during which they can educate the users of their financial statements on the impact of the proposed change. He also pointed out that this issue would not affect SEC requirements for reconciling items since the proposed change is not something that the SEC would require to be reconciled.

Ms. Seidman expressed support for the staff recommendation. She rejected Alternative 1 because she does not find it supportable to draw a distinction between the definition of a current liability for a public entity and that definition for a nonpublic entity. She rejected Alternative 4 on the grounds that the proposed Exposure Draft, if issued without implementing the Board’s proposed change with respect to the classification of liabilities with covenant violation waivers, would not represent a significant enough change to current practice to reap benefits in excess of its costs to implement. For those reasons and because it represents

the best opportunity for the biggest improvement in current GAAP, Ms. Seidman supported Alternative 2.

Mr. Batavick also agreed with the staff recommendation to defer further work on the subject. He expressed concern with Alternative 1 because of the difficulty in defining “small” or “nonpublic.” He pointed out the existence of a class of small companies with public debt that are not very economically different from small, nonpublic companies but would be treated differently under a standard that delineated between public and nonpublic entities. Furthermore, he pointed out that any such differential accounting treatment between public and nonpublic entities in this project would lead to a (at least temporary) convergence issue with the IASB.

Mr. Herz expressed a preference for the view offered by Mr. Crooch that the Board issue the Exposure Draft but provide a longer transition period for nonpublic entities on the grounds that they would likely require a more extensive education initiative for the benefit of their unique user groups. He also noted that he would not object to the deferral suggested by the staff. Mr. Herz expressed concern, along with Ms. Schipper, with the existence of users who rely on accounting data as a means to carry out certain mechanical calculations but do not scrutinize the basis for the accounting data. Because of the way in which the accounting information is used by some constituents, Mr. Herz noted that the Board sometimes has difficulty justifying a change in the face of high education costs associated with those constituents.

Mr. Herz asked whether any Board members objected to the staff recommendation not to issue the proposed Exposure Draft and to defer further analysis of the changes it would have proposed until they can be examined within the context of the Board’s project on reporting financial performance. No Board members objected.

Follow-up Items:

The Board asked the staff to communicate the Board's views to the IASB as soon as practicable and to determine whether this issue is expected to be as pervasive internationally as it is in the United States.

General Announcements:

None.