Testimony of
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Chairman
Financial Accounting Standards Board
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Subcommittee on Securities and Investment of the Committee on Banking, Housing, and Urban Affairs
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Full Text of Testimony

Chairman Enzi, Ranking Member Dodd, and Members of the Subcommittee:

I am pleased to appear before you today on behalf of the Financial Accounting Standards Board ("FASB" or "Board"). Sitting behind me is Manuel H. Johnson, the President and Chairman of the Financial Accounting Foundation ("FAF"). The FAF's responsibilities include exercising general oversight of the FASB's due process procedures to ensure that our process is open, fair, and thorough.[1] My testimony this afternoon includes a brief overview of the FASB, including the importance of our independence and due process to our mission of developing high-quality financial accounting and reporting standards for both public and private enterprises. My testimony also includes the FASB's past and ongoing efforts, consistent with our mission and Rules of Procedure, to solicit input from, and carefully consider the views of, our constituents that are users, auditors, and preparers of the financial reports of our nation's small businesses.

The FASB

The FASB is an independent private-sector organization.[2] Our independence from enterprises, auditors, and other constituents is fundamental to achieving our mission—to establish and improve general-purpose standards of financial accounting and reporting for both public and private enterprises.[3] Those standards are essential to the efficient functioning of the United States ("US") economy because investors, creditors, and other

[1] See Attachment 1 for additional information about the Financial Accounting Foundation.
[2] See Attachment 1 for additional information about the Financial Accounting Standards Board.
[3] See Attachment 2 for recent materials commenting on the importance of the FASB's independence.

users of financial reports rely heavily on credible, transparent, comparable, and unbiased financial information to make rational resource allocation decisions.

The FASB's independence, the importance of which was recently reaffirmed by the Sarbanes-Oxley Act of 2002 ("Act"),[4] is fundamental to our mission because our work is technical in nature, designed to provide preparers the guidance necessary to report information about their economic activities. The guidance creates the yardstick to measure and report on the underlying economic transactions of business enterprises. Like investors and creditors, Congress and other policy makers need an independent FASB to maintain the integrity of a properly designed yardstick in order to obtain the financial information necessary to appropriately assess and implement the public policies they favor. While bending the yardstick to favor a particular outcome may seem attractive to some in the short run, in the long run an inaccurate yardstick (or a biased accounting standard) is harmful to investors, creditors, and the US economy.

The FASB's authority with respect to public enterprises comes from the US Securities and Exchange Commission ("SEC"). The SEC has the statutory authority to establish financial accounting and reporting standards for publicly held enterprises. For 30 years, the SEC has looked to the FASB for leadership in establishing and improving those standards. The SEC recently issued a Policy Statement reaffirming this longstanding relationship.[5]

[4] Sarbanes-Oxley Act of 2002, Public Law Number 107-204, Sections 108-109 (July 30, 2002).
[5] Policy Statement: Reaffirming the Status of the FASB as a Designated Private-Sector Standard Setter, Exchange Act Release Nos. 33-8221; 34-47743; IC-26028; FR-70 (April 28, 2003).

The Policy Statement, consistent with the language and intent of the Act,[6] also reemphasizes the importance of the FASB's independence described earlier. It states:

> By virtue of today's Commission determination, the FASB will continue its role as the preeminent accounting standard setter in the private sector. In performing this role, the FASB must use independent judgment in setting standards and should not be constrained in its exploration and discussion of issues. This is necessary to ensure that the standards developed are free from bias and have the maximum credibility in the business and investing communities.[7]

The SEC, together with the private-sector FAF, as noted earlier, is responsible for maintaining active oversight of the FASB's activities.

The FASB has no power to enforce its standards. Responsibility for ensuring that financial reports comply with accounting standards rests with the officers and directors of the reporting enterprise, with the auditors of the financial statements, and for public enterprises, the Public Company Accounting Oversight Board, and ultimately the SEC.

What Process Does the FASB Follow in Developing Accounting Standards?

Because the actions of the FASB affect so many organizations, its decision-making process must be fair and as objective as possible. The FASB carefully considers the views of all interested parties, including users, auditors, and preparers of financial

[6] Sections 108-109; the legislative history of the Sarbanes-Oxley Act of 2002 ("Act") is clear that the provisions of the Act relating to the FASB were intended to "strengthen the independence of the FASB . . . from . . . companies whose financial statements must conform to FASB's rules." Senate Report 107-205, 107th Congress, 2d Session (July 3, 2002), page 13.

[7] Page 5 of 8.

Information. Our Rules of Procedure require an extensive due process. That process involves public meetings, public hearings or roundtables, field visits or field tests, liaison meetings and presentations to interested parties, and exposure of our proposed standards to external scrutiny and public comment. The FASB members and staff also regularly meet informally with interested constituents to obtain their input and better our understanding of their views.

The Board makes final decisions only after carefully considering and analyzing the input of all parties. While our process is similar to the Administrative Procedure Act process used for federal agency rule making, it provides far greater opportunities for interaction with the Board by all interested parties. It is also focused on making technical, rather than policy or legal, judgments. In making those judgments, the FASB's mission and Rules of Procedure require that the Board must balance the often conflicting perspectives of our various constituents and make independent, objective decisions guided by the fundamental concepts and key qualitative characteristics of financial reporting set forth in our conceptual framework.

The FASB and the FAF, in consultation with the Board's constituents, periodically review the FASB's due process procedures to ensure that the process is working efficiently and effectively for all constituents. In recent months, the FASB and the FAF have undertaken a significant number of actions to improve the Board's due process procedures.[8] Some of those actions were intended to increase the quality and breadth of constituent input to our process. Those particular actions include the following:

- Establishing a User Advisory Council ("UAC") in order to obtain more active user involvement in our process.[9] The UAC consists of representatives of individual and institutional investors, investment and commercial banks, rating agencies, and other groups that represent investors and other key users. Several of the members of the UAC are primarily users of financial reports of small businesses.

- Making our public Board meeting announcements available to constituents more broadly through an email subscription service.

- Making our public Board meetings available to constituents for monitoring via the telephone.[10]

- Making our proposals for public comment and the full text of all of our standards available on our website.

Are Small Businesses Required to Comply with FASB Standards?

The US federal securities laws generally require that any enterprise, including any small business, that lists its shares on a national securities exchange or has $10 million or more in assets and 500 or more owners of any class of equity securities be deemed a

[8] Full text of testimony of Robert H. Herz, Chairman, FASB, before the Subcommittee on Commerce, Trade and Consumer Protection of the Committee on Energy and Commerce, March 4, 2003, pages 18-32.
[9] See Attachment 3 for a listing of the members of the User Advisory Council.
[10] Constituents may monitor open Board meetings by telephone live or up to 48 hours following the meeting. The FASB charges $.75 per minute to recover the costs of the service.

"registrant."[11] All registrants generally are required to file periodic reports with the SEC.[12] As indicated above, the SEC has required, since the FASB's inception in 1973, that the preparation of the financial statements contained in the periodic reports comply with generally accepted accounting principles ("GAAP"), including FASB standards.[13] Also as indicated above, the SEC recently reevaluated and reaffirmed that requirement as a result of the provisions of the Act.[14]

Excluding those small businesses that are SEC registrants, there is generally no federal law requiring that small businesses file financial reports or comply with GAAP. Thus, for most small businesses, the use of FASB standards is a private choice.

Some small businesses may choose to comply with GAAP at the request or demand of current or potential lenders, suppliers, customers, or other contracting parties. The decision by one or more of those parties to require that the financial reports of a small business comply with GAAP instead of another basis of accounting, is, again, a private choice presumably dictated by the quality of FASB standards versus the other available alternatives.

How Does the FASB Identify the Concerns of Small Businesses about FASB Activities?

As indicated above, the FASB actively solicits the views of all of its various constituencies, including the views of those users, auditors, and preparers of financial

[11] 15 U.S.C. Section 781(g).
[12] 17 C.F.R. Section 249.310.
[13] Policy Statement, page 2 of 8.
[14] *Id*.

reports of small businesses. Some of the ways in which the FASB currently attempts to identify the concerns of small businesses include the following:

- Including representatives of small businesses on the UAC, the Financial Accounting Standards Advisory Council ("FASAC"),[15] the Emerging Issues Task Force ("EITF"),[16] and other project task forces and working groups. Both the UAC and FASAC are formal parts of our independent structure and have responsibility for consulting with the FASB as to technical issues on the Board's agenda, project priorities, and other matters as may be requested by the FASB. The mission of the EITF is to assist the Board in improving financial reporting through the timely identification, discussion, and resolution of financial accounting issues within the framework of existing authoritative literature. Several current members of the UAC, FASAC, and EITF are primarily users, auditors, or preparers of the financial reports of small businesses.

- Participating in liaison meetings with representatives of small businesses. Since January of this year, the FASB has held liaison meetings with several such organizations, including the Technical Issues Committee of the American Institute of Certified Public Accountants ("AICPA") Private Companies Practice Section, and the Accounting Practices Committee of the Risk

[15] See Attachment 1 for information about the Financial Accounting Standards Advisory Council and Attachment 4 for a listing of the members of the FASAC.

[16] See Attachment 1 for information about the Emerging Issues Task Force ("EITF") and Attachment 5 for a listing of the members of the EITF.

Management Association.[17] FASB members or staff also frequently meet less formally with other organizations and individual constituents, including representatives of small businesses, upon request or at the initiation of the FASB members or staff.

- Participating at conferences and other speaking engagements that are sponsored by or primarily attended by representatives of small businesses. Examples include the Technical Issues Committee of the AICPA Private Companies Practice Section and the various State CPA societies. Since January of this year, FASB members or staff has participated in over 20 such events.[18]

How Does the FASB Evaluate the Input from Small Businesses as Part of Its Due Process Procedures?

The FASB's conceptual framework guides the Board in its development of financial accounting and reporting standards. That framework states that the objectives of financial reporting are to provide information (1) that is useful to present and potential users, i.e., investors and creditors, in making investment and credit decisions; (2) to help the users to assess amounts, timing, and uncertainties of prospective cash flows from their investments; and (3) about the economic resources of and claims against enterprises, and the effects of transactions changing such resources and claims.[19]

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[17] See Attachment 6 for a listing of FASB liaison meetings since January 2003.
[18] See Attachment 7 for a listing of FASB speaking engagements since January 2003.
[19] Statement of Financial Accounting Concepts No. 1, *Objectives of Financial Reporting by Business Enterprises*, November 1978, paragraphs 32-54.

The Board has long recognized that those objectives are not static and that since the reporting by nonpublic or small businesses caters to a different set of users, the same objectives, defined identically, may mean different things. For many small businesses, the relevant financial statement users include both current and potential lenders, suppliers, and customers. Some of those users may focus more heavily on an enterprise's ability to meet its debt or performance obligations. Their needs may vary in some respects from the needs of other users of financial reports.

The Board's conceptual framework also describes the qualitative characteristics of accounting information.[20] In the hierarchy of accounting qualities, the FASB conceptual framework rates "decision usefulness" as the most important quality, and "relevance" and reliability" as the two primary qualities necessary to provide such usefulness, subject always to the constraints of a cost-benefit evaluation.[21]

In applying the above concepts to the financial accounting and reporting of nonpublic or small businesses, the Board has generally differentiated between financial information appearing on the face of the financial statements and the additional, analytical, and collateral information appearing in the footnotes to those statements.[22] With respect to the former, the Board has generally concluded that all enterprises, including nonpublic

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[20] Statement of Financial Accounting Concepts No. 2, *Qualitative Characteristics of Accounting Information,* May 1980.

[21] *Id*. paragraphs 32-110, 133-44. The Board has long acknowledged that the cost of any accounting requirement falls disproportionately on small entities because of their limited accounting resources and need to rely on outside professionals. "FASB Analyzes Small Business Concerns about Accounting Standards," FASB *Status Report,* No. 181, November 3, 1986.

[22] See Statement of Financial Accounting Standards No. 126, *Exemption from Certain Required Disclosures about Financial Instruments for Certain Nonpublic Entities*, December 1996, paragraph 10 (stating that in considering the costs and benefits of a new standard the Board has a commitment to consider potential *disclosure* differences between small and large companies on a case-by-case basis).

and small businesses, should be subject to the same recognition and measurement requirements.[23] That conclusion has been generally supported by the stated needs of users of financial reports of nonpublic or small businesses. The Board, however, has on a number of occasions provided deferred effective dates for nonpublic enterprises to alleviate the costs and other burdens that may be associated with the more rapid implementation of new requirements.[24] Examples include the Board's two most recent pronouncements—FASB Interpretation No. 46, *Consolidation of Variable Interest Entities* ("FIN 46"), and Statement of Financial Accounting Standards No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity* ("Statement 150"), discussed later in more detail.

With respect to the latter information disclosed in the financial statement footnotes, the FASB has on a case-by-case basis decided in some circumstances to reduce[25] or

[23] FASB *Status Report*, No. 181, page 4. There have been some limited exceptions. For example, in our November 2002 Interpretation to improve the accounting and disclosure for guarantees, the Board provided a scope exception for the initial recognition and measurement of guarantees issued between parents and subsidiaries and certain other related parties (FASB Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others,* November 2002, paragraph 7). One of the reasons given for the scope exception was to alleviate nonpublic entities' concerns about the cost of complying with the new requirement. *Id.* paragraph A29.

[24] See Statement of Financial Accounting Standards No. 107, *Disclosures about Fair Value of Financial Instruments*, December 1991, paragraph 79 (concluding that allowing smaller entities additional time to comply with the provisions of the Statement will reduce their costs of compliance). Compare Emerging Issues Task Force Topic No. D-1, "Implications and Implementation of an EITF Consensus," May 15, 2003, page 4965A, footnote 2 (establishing operating procedures that provide nonpublic entities a later effective date than public entities).

[25] See, e.g., Statement of Financial Accounting Standards No. 132, *Employers' Disclosures about Pensions and Other Retirement Benefits*, February 1998, paragraphs 57-59 (concluding that a reduced disclosure set would be appropriate for nonpublic entities as a result of comments by users of financial statements of nonpublic entities about the usefulness of the disclosures).

eliminate[26] the disclosure requirements for nonpublic or small businesses. Those decisions have generally been the result of input from users, auditors, or preparers of financial reports of nonpublic or small businesses indicating that the users of those reports did not need some or all of the disclosures[27] or that the cost of preparing the disclosures outweighed the usefulness of the information to those users.[28]

The FASB and its constituents have over the years periodically examined the issue of whether financial accounting and reporting standards should be different for small businesses.[29] Some of the reasons frequently cited in opposition to a so-called Big GAAP/Little GAAP approach to financial accounting and reporting include:

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[26] See Statement of Financial Accounting Standards No. 141, *Business Combinations*, June 2001, paragraph B201 (concluding that nonpublic entities should continue to be exempt from pro forma disclosure requirements because of arguments by preparers and auditors that costs of information exceed the benefits); Statement of Financial Accounting Standards No. 131, *Disclosures about Segments of an Enterprise and Related Information*, June 1997, paragraph 115 (concluding to continue to exempt nonpublic enterprises from the requirement to report segment information because few users of nonpublic enterprises' financial statements have requested that those enterprises provide segment information); Statement 126, paragraph 14 (concluding that certain nonpublic entities should be exempt from fair value disclosure requirements because of the likely limited utility of the disclosures to certain users).

[27] See, e.g., Statement 132, paragraphs 57-59.

[28] See Statement 141, paragraph B201; Statement 131, paragraph 115; and Statement 126, paragraph 14.

[29] See Status Report, No. 181, page 4 (concluding that the most constructive effort to alleviate the concerns of small business regarding GAAP is to ensure that the views of privately held companies and smaller CPA firms are adequately included in the Board's consideration of specific accounting issues); FASB Research Report, A. Rashad Abdel-khalik, *Financial Reporting by Private Companies: Analysis and Diagnosis*, August 1983, page 1 (stating that surveyed bankers that are users of the financial reports of private companies do not believe that a special set of GAAP would be beneficial for private companies considered to be small in size); FASB Invitation to Comment, *Financial Reporting by Private and Small Public Companies*, November 20, 1981 (soliciting input on several concerns about the existing financial reporting by private and small public companies); "Report of Task Force on GAAP Requirement of Concern to Small or Closely Held Businesses, to Small Business Advisory Committee, Financial Accounting Advisory Council," December 1978, page 3 (finding that most individuals surveyed reported that there were no areas of particular concern to them with respect to current reporting requirements of small or closely held businesses); See also Abraham M. Stanger & Samuel P. Gunther, Article, "'Big GAAP—Little GAAP'": Should There Be Different Financial Reporting For Small Business? N.Y.U. L. Rev. 1209 (Nov. – Dec. 1981) (concluding that different disclosure requirements, but not recognition and measurement standards, should apply to small businesses, but that there should remain a unitary system of GAAP); Compare Eric P. Wallace & Richard E. Wortmann (summarizing the arguments for and against an alternative to GAAP for nonregistrants).

- Similar economic transactions and events should be reported consistently regardless of the size of the reporting enterprise.

- Differential standards for enterprises of different sizes would reduce the benefits to users of financial reports by impairing comparability more than they would reduce the costs of financial statement preparation.

- It would be virtually impossible for an accounting standards-setting body to decide which economic transactions and events should be permitted to be recognized and measured differently by large versus small businesses.

- Dual standards would represent additional costs to preparers, accountants, advisors, and others in the areas of continuing education, authoritative resources, and quality control systems.[30]

Significantly, the users of small business financial reports have historically been generally supportive of uniform accounting standards for both nonpublic or small businesses and larger public enterprises.[31]

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[30] See Eric P. Wallace & Richard E. Wortmann; J. E. McCahey & A. L. Ramsay, "Differential Reporting: Nature of the Accounting Standards Overload Problem and a Proposal for its Resolution," Australian Accounting Research Foundation, June 26, 1989, 10-11, 12-13.

[31] See, e.g., A. Rashad Abdel-khalik, page 1. Of note, the FASB's counterpart internationally, the International Accounting Standards Board ("IASB") recently added a project to its agenda to develop IASB accounting standards for small or medium-sized entities ("SME"). Under the IASB planned approach there would be a rebuttable presumption that no modifications would be made to the recognition and measurement principles of International Financial Reporting Standards for SME standards. Similar to the general approach taken by the FASB, the IASB approach would generally be limited to disclosure modifications. As part of its international convergence efforts, the FASB will be closely monitoring the IASB project.

The FASB's two most recent pronouncements, FIN 46 and Statement 150 illustrate the Board's solicitation and consideration of the input of users, auditors, and preparers of the financial reports of small businesses. The following is a brief description of our due process with respect to those two standards.

FIN 46

The project that resulted in FIN 46 began in early 2002 in response to concerns raised by a broad range of constituents about the need to improve the application of consolidation policies. Many of those constituents believed that the existing accounting requirements governing consolidations impeded the quality and comparability of financial reports of enterprises engaged in similar activities when some of those activities were conducted through certain off-balance-sheet or variable interest entities ("VIEs").

After several months of Board deliberations at public meetings, the Board issued a proposed Interpretation, *Consolidation of Certain Special-Purpose Entities*, in June 2002. The Board received over 140 letters of comment from a broad range of constituents.

On September 30, 2002, the Board held 2 public roundtable meetings at which approximately 40 respondents and other interested parties discussed the provisions of the proposed Interpretation with the Board. FIN 46, issued in January 2003, was the result of the Board's public redeliberations of all of the issues raised in light of the comments received on the proposal.

The objective of FIN 46 was not to restrict the use of VIEs but to improve financial reporting by all enterprises involved with those entities. Consistent with that objective, FIN 46 establishes a general principle that if control over another enterprise cannot be determined through an analysis of who holds the majority voting interest of the enterprise, a further analysis is required. That further analysis provides that if an enterprise absorbs a majority of the expected losses, a majority of the expected returns, or both, as result of holding financial interests in VIEs, the assets, liabilities, and results of the activities of VIEs are required to be included in the financial statements of the controlling enterprise.

Given the broad concern with the financial accounting and reporting in this area, the Board concluded that the requirements of FIN 46 should be made effective as soon as reasonably possible. The Board, however, also recognized that some enterprises were involved with a large numbers of VIEs and that their analysis of those entities would require significant data gathering and qualitative and quantitative analysis. The Board, therefore, deferred the required application date of FIN 46 to existing VIEs to three months later than originally proposed.

The Board found no basis for providing different recognition, measurement, or disclosure requirements for nonpublic or small businesses. Users of the financial reports of those enterprises, including creditors who raised concerns about the off-balance-sheet activities of small business debtors, generally supported the Board’s decision. In recognition, however, of the disproportionate cost incurred by some nonpublic or small businesses in implementing the new requirements as compared to some public enterprises, the Board provided that nonpublic enterprises would not be required to apply the requirements of

FIN 46 to existing VIEs until more than 12 months after the provisions would be applicable to public enterprises.

Since the issuance of FIN 46, the FASB has received input from many constituents, including users, auditors, and preparers of the financial reports of small businesses, about implementation issues relating to the application of the provisions of FIN 46. In response to that input the FASB has issued nine FASB Staff Positions[32] and a proposed modification to FIN 46 to address certain technical corrections and implementation issues that have been raised.[33] The FASB continues to monitor the application of FIN 46 and will consider the issuance of additional guidance to assist constituents, including small businesses, in implementing the requirements of the Interpretation.

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[32] FASB Staff Position No. FIN 46-1, "Applicability of FASB Interpretation No. 46, *Consolidation of Variable Interest Entities*, to Entities Subject to the AICPA Audit and Accounting Guide, *Health Care Organizations*," July 24, 2003; FASB Staff Position No. FIN 46-2, "Reporting Variable Interests in Specified Assets of Variable Interest Entities as Separate Variable Interest Entities under Paragraph 13 of FASB Interpretation No. 46, *Consolidation of Variable Interest Entities*," July 24, 2003; FASB Staff Position No. FIN 46-3, "Application of Paragraph 5 of FASB Interpretation No. 46, *Consolidation of Variable Interest Entities*, When Variable Interests in Specified Assets of a Variable Interest Entity Are Not Considered Interests in the Entity under Paragraph 12 of Interpretation 46," July 24, 2003; FASB Staff Position No. FIN 46-4, "Transition Requirements for Initial Application of FASB Interpretation No. 46, *Consolidation of Variable Interest Entities*," July 24, 2003; FASB Staff Position No. FIN 46-5, "Calculation of Expected Losses under FASB Interpretation No. 46, *Consolidation of Variable Interest Entities*," July 24, 2003; Proposed FASB Staff Position No. FIN 46-b, "Effective Date of FASB Interpretation No. 46, *Consolidation of Variable Interest Entities*, for Certain Decision Makers"; Proposed FASB Staff Position No. FIN 46-c, "Impact of Kick-Out Rights Associated with the Decision Maker on the Computation of Expected Residual Returns under Paragraph 8(c) of FASB Interpretation No. 46, *Consolidation of Variable Interest Entities*"; Proposed FASB Staff Position No. 46-d, "Treatment of Fees Paid to Decision Makers and Guarantors as Described in Paragraph 8 in Determining Expected Losses and Expected Residual Returns of a Variable Interest Entity under FASB Interpretation No. 46, *Consolidation of Variable Interest Entities.*"

[33] FASB Proposed Interpretation, *Consolidations of Variable Interest Entities*, October 21, 2003.

Statement 150

Statement 150 was the result of the Board's broad project on financial instruments that was added to the Board's agenda in 1986. The purpose of the project was to address financial reporting issues that were arising, or were given a new sense of urgency, as a result of financial innovation. In 1990, the Board issued a Discussion Memorandum for public comment that elicited views on issues about the distinction between liabilities and equity. The Board received 104 comment letters in response to the Discussion Memorandum.

The Board held 2 days of public hearings on the 1990 Discussion Memorandum in March 1991, at which representatives from 13 organizations testified. In 1992, after two public meetings to discuss the issues raised, the Board decided to suspend work on the liabilities and equity project to devote its resources to financial instrument issues that were deemed more urgent. The project was inactive until 1996, at which time the Board's Financial Instruments Task Force discussed it. Based on the discussion at that task force meeting, work on the project began anew.

After discussing issues related to the project at 30 public Board meetings, as well as additional task force meetings, the Board issued on October 27, 2000, an Exposure Draft of a proposed Statement of Accounting Standards, *Accounting for Financial Instruments with Characteristics of Liabilities, Equity, or Both.* On the same day, the Board issued another related Exposure Draft, *Proposed Amendment to FASB Concepts Statement No. 6 to Revise the Definition of Liabilities.* The Board received 71 letters commenting on those Exposure Drafts.

During May, June, and July 2001, Board members and staff met with 7 different companies that volunteered to participate in field visits pertaining to the Exposure Drafts. Board members and staff also met in field visits in November 2001 with various users of financial statements to discuss, from their perspective, the usefulness of the reporting that would result from the proposed change to the definition of liabilities.

On October 16, 2001, 18 constituents participated in a roundtable discussion focusing on several issues raised in comment letters on the Exposure Drafts. At 16 public meetings during 2001 and 2002, the Board redeliberated the issues raised in the Exposure Drafts, comment letters, field visits, and the roundtable discussion. During four further meetings during 2003, the Board decided that issuance of a limited-scope Statement, even though issues effecting certain instruments within the scope of the project had not yet been resolved, was needed to provide timely and necessary guidance for certain troublesome instruments for which the practice problems were both clear and resolvable without necessarily addressing more complex separation and conceptual issues. The Board is currently in the process of redeliberating those and other remaining issues raised and plans to issue another proposal for public comment at a future date.

The objective of Statement 150 is to improve the usefulness, relevance, and reliability of financial reports by providing a more complete depiction of an enterprise’s liabilities and equity. Statement 150 establishes a general principle that an enterprise’s obligations to transfer cash or other assets or issue shares to settle an obligation should generally be accounted for as liabilities. That principle is generally consistent with the FASB’s conceptual framework and international accounting standards.

Statement 150 describes three types of instruments and concludes that, consistent with the general principle, those types of instruments should be classified, measured, and reported as liabilities. One of those three types is an instrument issued in the form of shares that is mandatorily redeemable—that embodies an unconditional obligation requiring the issuer to redeem it by transferring its assets at a specified or determinable date (or dates) or upon an event that is certain to occur. Under the general principle, those shares are liabilities. Constituents, including lenders to small businesses, supported that conclusion.

The proposal that resulted in Statement 150 indicated that shares issued by some privately held enterprises that must be sold back to the enterprise, for example, upon the holder's termination of his or her employment, are liabilities because they are mandatorily redeemable upon an event certain to occur. Accounting for those financial instruments in the legal form of shares as liabilities would reduce or eliminate the equity of those companies with mandatory buy-back arrangements. Some small business commentators to the proposal suggested that an exception be made to allow such arrangements to continue to be reported as equity. Others suggested that while those instruments were appropriately classified as liabilities, some sort of special reporting was merited, that disclosure about those arrangements was necessary for other investors and creditors, and that affected companies needed more time to revise debt covenants or make other changes in response to the change in classification.

The Board initially concluded that those kinds of arrangements met the definition of mandatorily redeemable financial instruments, that the definition should not be changed to classify them differently from other mandatorily redeemable financial instruments, and that there was no adequate basis for any exception. However, the Board acknowledged the need for special reporting in the most often cited circumstance in which no equity would be reported. Therefore, the Board concluded in Statement 150 that entities that have no equity instruments outstanding but have financial instruments in the form of shares, all of which are mandatorily redeemable financial instruments required to be classified as liabilities, should describe those instruments as *shares subject to mandatory redemption* to distinguish them from other liabilities and should separately present payments to and interest due to creditors in statements of cash flows and income.

For entities that have financial instruments in the form of shares that are all mandatorily redeemable, the Board also decided that, in addition to separate presentation, a related disclosure was needed that displays the nature and composition of the mandatorily redeemable instruments. For example, such an entity would disclose the event triggering the redemption, the number of shares issued and outstanding, the value associated with those financial instruments, and any retained earnings or accumulated other comprehensive income that would be distributed on redemption (the items that those entities have previously displayed in equity). The Board concluded that for those entities that have financial instruments in the form of shares that are all mandatorily redeemable, disclosure would assist financial statement users in assessing the amount and timing of redemptions.

In addition, the Board concluded that private companies needed more time to adapt to liability classification, in part because many of them are affected significantly by the requirements on mandatorily redeemable shares, and decided to delay the effective date for mandatorily redeemable instruments of a nonpublic enterprises until fiscal periods beginning after December 15, 2003.

Following the issuance of Statement 150, the Board received additional input from some nonpublic and small businesses expressing concerns about the implications of applying the mandatorily redeemable provisions of Statement 150 and requesting that the provisions be either changed or delayed to allow enterprises to adapt to those provisions and educate financial statement users.

At its August 27, 2003 public meeting, the Board directed the FASB staff to issue a proposed FASB Staff Position for public comment deferring the effective date of Statement 150 for mandatorily redeemable financial instruments of certain nonpublic entities until fiscal periods beginning after December 15, 2004. In comments in response to the proposal and in several meetings with representatives of small businesses, the FASB obtained additional input about implementation issues related to the mandatorily redeemable provisions of Statement 150 that had not been previously raised.[34]

[34] The additional input included information from small businesses in the construction and engineering industry about certain issues relating to the mandatorily redeemable provisions of Statement 150 that will require additional time and efforts to communicate with and educate the relevant parties.

At its November 5, 2003 public meeting, the Board discussed the input received and decided to direct the FASB staff to issue a final FASB Staff Position that defers indefinitely the effective date for applying the provisions of Statement 150 for mandatorily redeemable instruments of nonpublic enterprises pending further Board action.[35] During that indefinite deferral, the Board plans to reconsider implementation issues and, perhaps, classification or measurement guidance for those instruments in conjunction with the Board's ongoing project on liabilities and equity.[36]

The FASB also has issued three additional FASB Staff Positions to address certain technical implementation issues that have been raised by constituents in connection with the provisions of Statement 150.[37] The FASB continues to monitor the application of Statement 150 and will consider the issuance of additional guidance to assist constituents, including small businesses, in the application of the requirements of the standard.

In addition, the Board has begun embarking on Phase 2 of the liabilities and equity project. The objectives of Phase 2 include:

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[35] FASB Staff Position No. 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*," November 7, 2003.

[36] *Id*. at page 2.

[37] FASB Staff Position No. FAS 150-1, "Issuer's Accounting for Freestanding Financial Instruments Composed of More Than One Option or Forward Embodying Obligations under FASB Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*," October 16, 2003; FASB Staff Position No. FAS 150-2, "Accounting for Mandatorily Redeemable Shares Requiring Redemption by Payment of an Amount That Differs from the Book Value of Those Shares, under FASB Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*," October 16, 2003; FASB Staff Position No. FAS 150-4, "Issuers' Accounting for Employee Stock Ownership Plans under FASB Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*," November 7, 2003.

1. To improve the accounting and reporting by issuers for financial instruments that contains characteristics of equity and liabilities, assets, or both.

2. Amend and improve on the definitions of liability, equity, and perhaps assets in the FASB's conceptual framework, such that decisions made in Statement 150 and in Phase 2 are consistent with those definitions.

In conclusion, we are aware of the significant focus over the past year on the financial accounting and reporting of public enterprises, in part because of the many activities relating to the Act and the increased attention on the movement toward convergence of international accounting standards. We, however, remain committed to serving all of our constituents including private companies, small businesses, and not-for-profit enterprises.

Accordingly, we appreciate the opportunity that this hearing presents to publicly encourage representatives of private companies, small businesses and not-for-profits to more actively participate in our activities. Greater participation by those constituents will be welcomed and will help ensure that, consistent with the FASB's mission and Rules of Procedure, the various perspectives of those constituents are effectively communicated to the Board and receive the careful consideration they deserve.

That concludes my testimony. Thank you, Mr. Chairman. I would be happy to respond to any questions.