Private Company Financial Reporting Committee

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Meeting Highlights April 23-24, 2009

San Antonio, Texas

All Private Company Financial Reporting Committee ("PCFRC" or "Committee") members were in attendance, except Maryann Lawrence.

Financial Accounting Standards Board ("FASB") Staff: Paul Glotzer
American Institute of Certified Public Accountants ("AICPA") Staff: Bob Durak and Dan Noll

Status of Letters Issued to the FASB and FASB Activities
Oil and Gas Disclosures
Loan Loss Disclosures

The PCFRC discussed with FASB staff the status of certain letters issued by the PCFRC to the FASB on various accounting projects (see the PCFRC web site at http://www.pcfr.org/recommendations.html). In addition, FASB staff informed the Committee about recent FASB projects that the PCFRC may have an interest in.

The FASB's project on oil and gas disclosures was discussed. The objective of this limited-scope project is to amend FASB Statement No.19, *Financial Accounting and Reporting by Oil and Gas Producing Companies* to conform to the Securities and Exchange Commission's recently issued Final Rule, *Modernization of the Oil and Gas Reporting Requirements*. Private oil and gas companies may be affected by this project. As such, the PCFRC will reach out to its Resource Group to identify individuals with oil and gas experience and understand how this project will impact them. In addition, Mike Cain of the PCFRC will gather information about the effect of the project on private oil and gas companies from individuals knowledgeable about the industry. AICPA staff will do the same with oil and gas experts on the AICPA's Oil and Gas Audit and Accounting Guide task force.

The PCFRC will monitor the progress of the FASB's project on loan loss disclosures. The objective of this project is to improve disclosures a creditor provides about the allowance for credit losses and the credit risks inherent in its loan and lease portfolio.

FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* ("FIN 48")

In May, the FASB will issue proposed FASB Staff Position ("FSP") FIN 48-d, *Application Guidance for Pass-through Entities and Tax Exempt Not-For-Profit Entities, and Disclosure Modifications for Nonpublic Entities*. The proposed FSP is expected to have a comment period of 30 days. FASB staff reviewed a current draft of the proposed FSP with the PCFRC and solicited feedback. Committee members provided suggestions about clarifying or changing the wording of the proposed FSP in certain areas. Most of these comments were focused in the area of defining a tax position and the attribution of taxes.

The PCFRC will review the proposed FSP when issued in early May and decide about developing a comment letter at that point.

Revenue Recognition Preliminary Views

The FASB's Discussion Paper, *Preliminary Views on Revenue Recognition in Contracts with Customers*, was reviewed and discussed by the PCFRC. Below are the highlights of that discussion:

- The Committee engaged in a lengthy conversation about the notion of "customer control" in the context of determining whether an entity has transferred an asset to a customer (that is, when determining whether the customer has received a promised good or service. This concept of control is key because it determines when an entity satisfies performance obligations and recognizes revenue.
- The PCFRC talked about how the control concept would be operational in the private company sector and how it would apply to transactions involving construction, the development of intellectual property, design engineering, upgrading and maintaining software, providing attorney services, auditing services, and marketing services, among other transactions. Furthermore, the Committee considered the meaning of continuously transferring control of a good to a customer and how that would be implemented at private companies and what affect it would have on their financial reporting. Based on this discussion, the Committee was of the opinion that the Discussion Paper's definition and discussion of control seems to be ambiguous and in need of further clarification and development. Also, the existing construction examples in the Discussion Paper are simplistic and need to be enhanced.
- PCFRC members expressed concern that recognizing revenue based on the concept of control as outlined in the Discussion Paper could have a profound effect on certain private companies' financial statements, and on the analytical processes of the users of those financial statements. Moreover, financial ratios could change a great deal and could vacillate from year to year as a result of the proposed revenue recognition model. This would be an important issue because licensing requirements in many states are partially based on financial ratios as are loan covenants.
- Given the questions and concerns the PCFRC had about the concept of control and its effect on the timing of revenue recognition, the Committee was uncertain about the overall merits and usefulness of the single, contract-based revenue recognition model proposed in the Preliminary Views document.
- The proposed accounting for rights of return in the Preliminary Views document seemed problematical to the PCFRC. Rights of return are part of the cost of doing business and the current approach to accounting for them seems to work

effectively in the private company sector. Measuring a performance obligation associated with a right of return may be difficult.
- The proposed accounting for warranties also appeared problematical to the Committee. The approach proposed in the model may be too onerous and create unnecessary bookkeeping expense. The Committee discussed the idea of only identifying a separate performance obligation for purchased warranties and not for implied or statutory warranties.
- The proposals in the Discussion Paper appear to represent a major improvement to the accounting and reporting for multi-element service contracts. The current ratable approach to accounting and reporting for those contacts can fail to capture the economic reality of the arrangements in some cases. The proposed revenue recognition model would remedy that situation. As such, the proposed model may prove to be a positive development for the software industry and other service areas.
- The creation of an overarching single document on revenue recognition that would eliminate the myriad number of documents and guidance currently existing was recognized by Committee members as a positive outcome of this project. However, some Committee members cautioned that given the complicated nature of revenue recognition across many varied industries, there may be a need for the large amount of revenue recognition guidance that currently exists.
- Other possible positive aspects of the Preliminary Views document discussed by the PCFRC included the simplifying assumptions present in the proposed model and convergence with the International Accounting Standards Board ("IASB") on this key accounting subject.
- The Committee will continue its work and discussion on this topic and reach out to its Resource Group and organizations such as the Association of General Contractors and the Construction Financial Managers Association to gain their input. Also, the Committee will attempt to gather input from representatives of the software industry and retail industry about their reaction to the proposed model.

Lease Accounting Preliminary Views

The FASB's Discussion Paper, *Leases: Preliminary Views*, was reviewed and discussed by the PCFRC. The following tentative opinions were voiced:
- The Committee tends to agree with the approach that would require the lessee to recognize an asset representing its right to use the leased item for the leased term and a liability for its obligation to pay rentals.
- Arrangements in which the most likely term, including renewal clauses, is twelve months or less should be excluded from the scope of the project on the basis of cost-benefit considerations. Such arrangements are normally rentals and not leases and the FASB needs to differentiate between rentals and leases.
- The FASB's decision to measure the lessee's obligation at the present value of the lease payments discounted using the lessee's incremental borrowing rate appears appropriate and simplifies the existing capital lease measurement process. Also, the PCFRC tends to agree with the FASB's decision to initially measure the lessee's right-of-use asset at cost. This approach would keep the asset measurement simple by tying it to the liability measurement.

- Regarding the subsequent measurement of the lease obligation and the right-of-use asset, PCFRC members expressed two viewpoints.
  - Certain members of the Committee disagreed with the FASB's preliminary view to not adopt the linked approach to subsequent measurement. These members believed that not pairing the amortization of the asset and liability would cause distortion in the statement of financial position. This viewpoint holds that the right-of-use asset is a contractual asset and it should be matched with the related contractual lease liability. The physical asset underlying the lease should not determine the amortization of the right-of-use asset. In addition, under the proposed approach a distortion could occur between the income statement and cash flows.
  - Other PCFRC members favored the FASB's approach and did not believe that the amortization of the lease asset and liability should be linked. Although the right-of-use asset and the obligation to pay rentals are linked at the inception of the lease, that is not necessarily the case after inception. For example, the right-of-use asset could be impaired or undergo significant depreciation early in the lease term, but the lessee would still be required to make the same rental payments. Therefore, these members believe that economic reality would be better reflected if the asset and liability were not linked.
- Also related to subsequent measurement, PCFRC members tended to think that the decrease in value of the right-of-use asset should be described as amortization or depreciation and not as rental expense. The Preliminary Views document tentatively proposes to describe the decrease in value as rental expense for some leases. PCFRC members tentatively believe the use of amortization or depreciation expense is consistent with the existing capital lease classification and, therefore, will be more intuitive to private company constituents. The use of rental expense would give the appearance of mixing the attributes of capital leases and operating leases, which could cause confusion. Plus, that could also have the unintended consequence of negatively impacting certain key financial metrics (e.g. debt-to-EBITDA ratio) by increasing liabilities through the recording of previous operating lease obligations while continuing to report rent expense, which reduces EBITDA.
- Committee members tentatively did not support the approach in the Preliminary Views to include amounts payable under contingent rental agreements in the lessee's obligation to pay rentals. Committee members are of the opinion that the lessee's obligation to pay contingent rentals does not exist until the future event requiring the payment occurs. Particularly when payment is linked to usage or performance of the lessee, the obligation to pay rentals should exclude the contingent element.
- Similar to their tentative view about contingent rentals, Committee members were of the opinion that amounts payable under residual value guarantees should only be recognized when payment under the guarantee is probable. This is counter to the proposed approach in the Preliminary Views document. Additionally, PCFRC members disagree with the FASB's preliminary view that changes in the obligation to pay rentals arising from changes in estimated payments under residual value guarantees should be recognized in profit or loss.

- Concerning presentation, PCFRC members tended to agree with the FASB's preliminary views that the lessee's obligation to pay rentals should be presented separately in the statement of financial position because lease obligations are inherently different in nature from other debt obligations. Also, PCFRC members agree with the proposed approach to present the right-of-use asset in the statement of financial position on the basis of the nature of the leased item.
- Of major interest to the PCFRC is how the accounting and reporting for related party variable interest entities ("VIEs") will be affected by the lease accounting project. Frequently, these variable interest entities involve leasing arrangements. It appears to the Committee that the lessor side of lease accounting will also need to be resolved in order to determine the accounting and reporting for these VIEs.

Disclosure of Certain Loss Contingencies

The status of the FASB's project to enhance the disclosure requirements for loss contingencies under FASB Statement No. 5, *Accounting for Contingencies*, was discussed by the Committee. (On August 8, 2008, the PCFRC issued a comment letter (http://www.pcfr.org/downloads/Loss_Contingencies_8-08-08.pdf) to the FASB on the related Exposure Draft.) The PCFRC members who attended the FASB's March roundtable on the project informed the Committee about the viewpoints expressed at the roundtable. Reconciling the different viewpoints expressed about this project appears to be challenging to the FASB staff. The PCFRC will continue to monitor the project.

FASB Interpretation No. 46(R), *Consolidation of Variable Interest Entities*

The Committee has issued three letters (http://www.pcfr.org/recommendations.html) to the FASB about FIN 46(R) and has conducted outreach with its Resource Group. Next steps will include the PCFRC's FIN 46 (R) task force reviewing the recent FASB meetings dealing with FIN 46(R) and determining whether additional input from the PCFRC is needed on this subject.

Also, how the accounting and reporting for related party variable interest entities will be affected by the FASB's lease accounting project is of interest to the PCFRC. See the "Lease Accounting Preliminary Views" section of these highlights.

Applying Fair Value to Interests in Alternative Investments

During its discussion about the FASB's "Credit Crisis" projects, the PCFRC noted that the issue of applying fair value to interests in alternative investments is important in the private equity sector and other areas. As such the Committee will form a task force to monitor this project and decide upon next steps as the project progresses.

Financial Instruments with Characteristics of Equity

The Committee discussed recent developments related to the FASB's Preliminary Views, *Financial Instruments with Characteristics of Equity*. The PCFRC noted that the FASB recently decided that all instruments that have no contractual settlement requirement (perpetual instruments) and entitle the holder to a share of the issuer's net assets in liquidation should be classified as equity. This decision is a positive development for private companies and addresses one of the issues the PCFRC had with the Preliminary Views, which it communicated to the FASB in its May 23, 2008 comment letter (http://www.pcfr.org/downloads/PV_Fin_recommendations.pdf).

Helping Private Companies Keep Updated on New Accounting Standards

Identifying ways to help private company constituents become aware of new accounting standards was discussed by the PCFRC. The main problem noted by the Committee is getting preparers and practitioners to utilize the many informational resources at their disposal. The PCFRC will revisit its prior recommendations (http://www.pcfr.org/downloads/PCFRC_final_letter_to_FASB_about_standards_release_process_2-1-08.pdf) to the FASB and consider issuing another letter on this topic. Possible improvements to the standard setting process include:

a. Limiting the issuance of standards to pre-determined and set dates during the year and keeping those dates to a minimum of one or two dates a year.
b. Granting an automatic effective date extension (for example, twelve months) to private companies for every standard issued.
c. Maintaining "blackout" periods during the year, during which no standards or exposure drafts are released and no standards become effective.

Also, the PCFRC will explore ways that the Committee's web site (www.pcfr.org) can be upgraded to incorporate tools such as blogs and RSS feeds to help private company constituents keep informed about new standards and accounting developments.

Amendments to FASB Statement No. 162 – GAAP Hierarchy and AICPA TIS Section 5100, *Revenue Recognition*

The amendments to FASB Statement No. 162 will recognize the *FASB Accounting Standards Codification*™ as the single source of authoritative U.S. GAAP applicable for all nongovernmental entities. The effective date of the proposed amendments is expected to be July 1, 2009, except for the guidance formerly included in the AICPA Technical Inquiry Service ("TIS") Section 5100, *Revenue Recognition*, paragraphs 38-76. For that guidance, the proposed amendments would be applied prospectively for revenue arrangements entered into or materially modified in fiscal years beginning on or after December 15, 2009, and interim periods within those years. This transition guidance would apply only to nonpublic entities that had not previously applied that guidance. The PCFRC discussed the impact on private companies having to eventually follow the guidance in TIS Section 5100 and did not identify any significant issues.

Financial Statement Presentation Discussion Paper

On April 14, 2009 the PCFRC issued its comment letter (http://www.pcfr.org/downloads/PCFRC_CommentLetter_to_FASB_on_%20FS_PresentationDP_Final041409.pdf) on the FASB's Financial Statement Presentation Discussion Paper. Continuing its work on this project, the PCFRC reviewed financial statements prepared by a Committee member under the model proposed in the Discussion Paper. The changes in structure and format were discussed. The Committee decided that two of its "user" members will have their staffs analyze the new model financial statements. The staffs will conduct a normal analysis of the financial statements as they would in their normal work routine and determine the usefulness and benefits of the proposed model.

Update on IFRS for SMEs and Private Company Accounting Efforts in other Countries

The Committee reviewed the progress of private company accounting efforts in other countries, specifically Canada, Great Britain, Australia, and New Zealand. Also, the status of the International Accounting Standards Board's International Financial Reporting Standards for Small- and Medium-Sized Entities ("IFRS for SMEs") was reviewed. The PCFRC decided to examine in detail IFRS for SMEs when it is issued in the second quarter of 2009. Through its detailed examination of IFRS for SMEs, the Committee intends to assess the suitability of the standard in the U.S. private company sector.

Administrative Matters

New PCFRC member Chris A. Rogers (Infragistics, Inc.) was welcomed by the Committee. The PCFRC looks forward to working with Chris and to his contributions to the Committee.

Next PCFRC Meetings

The PCFRC will hold its next meeting on June 25-26, 2009 in Washington, D.C. Beyond June, the PCFRC has set the following tentative meeting dates and places.

August 6-7, 2009 – Cleveland, Ohio
October 22-23, 2009 – Charlotte, North Carolina
December 3-4, 2009 – Norwalk, Connecticut

These dates and places are subject to change.