

MINUTES



To: Board Members

From: Short-Term Convergence—Bellantoni
(ext. 445)

Subject: Minutes of the April 5, 2006 Board Meeting (Short-Term Convergence, Earnings per Share) **Date:** April 19, 2006

cc: Leisenring, Smith, Bielstein, MacDonald, Polley, Carney, Golden, Project Team, Richards, Carnrick, Singleton (IASB), Sutay, Gabriele, FASB Intranet

The Board meeting minutes are provided for the information and convenience of constituents who want to follow the Board's deliberations. All of the conclusions reported are tentative and may be changed at future Board meetings. Decisions become final only after a formal written ballot to issue a final Statement or Interpretation.

Topic: Earnings per Share

Basis for Discussion: Memorandum dated March 27, 2006

Length of Discussion: 1:04 p.m. to 1:42 p.m.

Attendance:

Board members present:	Herz, Batavick, Schipper, Seidman, Trott, and Young
Board members absent:	Crooch
Staff in charge of topic:	J. Sarno
Other staff at Board table:	Bellantoni, Bielstein, Cassel, and J. Johnson
Outside participants:	None

Summary of Decisions Reached:

The Board made the following decisions after considering (1) comments received from respondents on the FASB Exposure Draft, *Earnings per Share*, and (2) tentative conclusions of the IASB regarding proposed amendments to IAS 33, *Earnings per Share*:

1. The application of the treasury stock method to options, warrants, and their equivalents would be modified as follows:
 - a. The carrying amount of an option or warrant classified as a liability would be considered an assumed proceed (an affirmation of a decision proposed in the Exposure Draft). In a change from the Exposure Draft, the Board decided that the amount of the assumed proceeds should be the average carrying amount of the liability during the period rather than the period end amount.
 - b. The carrying amount of an instrument classified as equity would not be considered an assumed proceed in the treasury stock calculation.
 - c. The average carrying amount of an instrument classified as an asset would be considered a negative assumed proceed.
2. Mandatorily convertible instruments should be reflected in basic earnings per share using the two-class method rather than using the if-converted method as proposed in the Exposure Draft.
3. The application of the reverse treasury stock method to options, warrants, and their equivalents would be modified as follows:
 - a. The average carrying amount of an instrument classified as a liability would be considered an assumed proceed.
 - b. The average carrying amount of an instrument classified as an asset would be considered a negative assumed proceed.
4. The Board was unable to agree on whether the treasury stock method should replace the if-converted method for convertible instruments classified as liabilities (that is, convertible debt instruments).

The Board noted that its views on the earnings per share treatment of (1) options, warrants, and their equivalents classified as equity (Issue 1(b)), (2) mandatorily convertible instruments (Issue 2), and (3) convertible debt (Issue 4) differ from the IASB. The Board directed the staff to further analyze those differences for discussion at a future meeting.

Objective of Meeting:

The objective of the Board meeting was for the Board to consider (1) comments received from respondents during the exposure period of the Exposure Draft and (2) tentative conclusions of the IASB Board regarding proposed amendments to IAS 33. The objective of the meeting was met.

Matters Discussed and Decisions Reached:

1. Mr. Sarno opened the meeting by introducing the issues. He stated that the issues presented were raised by (a) comments received from respondents during the exposure period of the Exposure Draft and (b) tentative conclusions of the IASB regarding proposed amendments to IAS 33. The staff requested that the Board focus its discussion on the technical merits of the issues under existing U.S. GAAP for financial instruments. After the meeting, the staff planned to communicate the Board's views on each of the issues to the IASB staff for consideration by the IASB. To the extent that a lack of convergence remains on certain issues, the staff will report back to the Board for further guidance.

Application of the Treasury Stock Method

2. Mr. Sarno stated that the first set of issues for the Board to consider focused on application of the treasury stock method. In the Exposure Draft, the Board concluded that the carrying amount of an option or warrant classified as a liability should be considered an assumed proceed in the treasury stock calculation. Generally, the respondents agreed with the proposed amendment to FASB Statement No. 128, *Earnings per Share*. Mr. Sarno noted that the staff believes the economic substance of extinguishing an obligation by issuing equity shares without further sacrifice of an entity's assets is the equivalent of cash proceeds received in exchange for equity shares. Therefore, the staff recommended that the Board reaffirm its prior conclusion to include the carrying amount of an option or warrant accounted for as a liability as assumed proceeds in the treasury stock calculation. The Board agreed to reaffirm its prior conclusion.

3. Mr. Sarno stated that the second issue for the Board to consider was whether to apply the treasury stock method to convertible instruments classified as liabilities (that is, convertible debt instruments). The respondents' views on the Exposure Draft were mixed on whether to extend the treasury stock method to include convertible debt instruments. While some of the respondents simply agreed or disagreed, others cited convergence as the basis for their answer. Additionally, the IASB has reached a tentative conclusion to apply the treasury stock method to convertible instruments classified as liabilities. However, the staff noted that the IASB approach to the treasury stock method may differ from the FASB approach. Therefore, if the Board concluded that the treasury stock method should apply to convertible debt instruments, the two staffs would need to highlight the differences in their respective approaches in applying the treasury stock method for both Boards to consider at future Board meetings. The staff noted two potential alternatives for the issue:
 - a. **View A**—Apply the if-converted method to convertible instruments classified as liabilities.
 - b. **View B**—Apply the treasury stock method to convertible instruments classified as liabilities.
4. Mr. Sarno stated that the majority of the staff supported View B because it achieves convergence with the tentative conclusions of the IASB regarding proposed amendments to IAS 33 and eliminates what some perceive as an arbitrary line between (a) options and warrants and (b) convertible debt instruments. Mr. Sarno also noted that a minority of the staff supported View A due to the lack of convergence between U.S. GAAP and International Financial Reporting Standards on the accounting for a conversion option (that is, because the conversion option is not separately accounted for under U.S. GAAP, the debt cannot be considered tendered as payment for the exercise price of the option). By including the carrying amount of a convertible debt instrument as assumed proceeds, it is an acknowledgment that the conversion option is being accounted for separately. A minority of staff members also believed that elimination of the if-converted method would foster further structuring of transactions so as to reduce or eliminate the periodic reflection of the cost of issuing debt in the basic financial statements or earnings per share (EPS) calculations.

5. Mr. Trott noted that the IASB's proposed calculation of the treasury stock method (including convertible debt) double counted the assumed proceeds from the liability extinguishment of the convertible debt. He stated that he would prefer a solution that extended the treasury stock method to include convertible debt in a manner that counted the assumed proceeds from the liability extinguishment a single time. Mr. Sarno clarified that the staff's proposal involved applying the treasury stock method to include convertible debt as it currently exists under U.S. GAAP
6. Ms. Seidman noted that extending the treasury stock method to include convertible debt instruments would not be a fully convergent solution due to the lack of convergence on the accounting for a conversion option (see paragraph 4). She stated that if the Board intended to focus on obtaining complete convergence for the topic of EPS, she would support View B. However, if the Board was not able to converge on the remaining outstanding issues, she would have reservations about extending the treasury stock method to include convertible debt as a necessary change. Mr. Batavick and Mr. Trott agreed with Ms. Seidman.
7. Ms. Bielstein clarified that the meeting was intended to determine Board members' preferences for the proper accounting treatment of EPS in the context of current U.S. GAAP. She informed the Board that, once those preferences are established, the FASB and IASB staffs had agreed to take each Board's preferences and move forward in a way that will satisfactorily improve convergence.
8. Ms. Schipper preferred View A and stated that she agreed with the reasoning provided by the minority staff view (see paragraph 4). Mr. Herz and Mr. Young agreed with Ms. Schipper. Therefore, the Board was not able to reach a decision on this issue. The Board directed the staff to further analyze this issue for discussion at a future meeting.
9. Mr. Sarno stated that the next issue for the Board to consider was whether to extend the treasury stock method to include equity instruments that may be settled by issuing an entity's common equity. He noted that the staff did not believe the same principle that supports including the carrying amount of a liability as assumed proceeds (that is, extinguishment of an obligation without further sacrifice of an entity's assets) existed

for an instrument classified as equity. Therefore, the staff did not recommend including the carrying amount of an instrument classified as equity as assumed proceeds of the treasury stock calculation.

10. Mr. Trott noted that extending the treasury stock method to include equity instruments also would result in double counting the assumed proceeds. He stated that upon issuance of an equity instrument, the net assets of the entity are increased and those assets are immediately available to earn a return. Therefore, including an equity instrument as assumed proceeds in the treasury stock method would double count the proceeds received from the initial issuance. The Board unanimously agreed not to extend the treasury stock method to include equity instruments that may be settled by issuing an entity's common equity.
11. Mr. Sarno stated that the final issue for the Board to consider in relation to the application of the treasury stock method was whether the amount of the extinguished liability that is considered assumed proceeds should be the carrying amount at the end of the period or the average carrying amount during the period for which EPS is being measured. The respondents strongly supported the use of the average carrying amount of the liability as assumed proceeds. Most respondents cited consistency with the use of the average stock price in the treasury stock calculation as their reason for supporting the use of the average carrying amount. Mr. Sarno noted that the staff agreed with the respondents and that the use of the average carrying amount is consistent with the proposed amendments to IAS 33. Therefore, the staff recommended using the average carrying amount of the liability during the period in which EPS is being measured in computing the assumed proceeds in the treasury stock calculation. The Board agreed with the staff recommendation.

Mandatorily Convertible Instruments

12. Mr. Sarno stated that the next issue for the Board to consider was whether a mandatorily convertible instrument should be included in basic EPS using the if-converted method or the two-class method. A few of the respondents raised concerns about the inclusion of mandatorily convertible instruments in basic EPS and at least one of those respondents raised a potential concern regarding the interaction with the

two-class method. Having analyzed both the use of the if-converted method and the two-class method, the staff recommended that the two-class method be applied. Mr. Sarno noted the staff's reasoning was that the two-class method is a more faithful representation of the economics of EPS, rather than assume that a mandatorily convertible instrument is equivalent to a currently outstanding common share. The Board agreed with the staff recommendation.

Other Comments Received

13. Mr. Sarno stated that the final set of issues for the Board to consider involved other comments made by respondents. More than one respondent commented that the requirement to include the carrying amount of a liability in the computation of the treasury stock method also should apply to the reverse treasury stock method. He noted that the staff agreed with those respondents and recommended that the carrying value of a liability also should be considered an assumed proceed in performing the reverse treasury stock calculation. The Board agreed with the staff recommendation.

14. Mr. Sarno stated that the last issue for the Board to consider was whether an instrument that requires or may require share settlement and is classified as an asset would be included as negative assumed proceeds (for example, a forward contract to sell an entity's own equity shares that does not meet the requirements for equity classification). Based on the rationale for including the carrying amount of a liability as assumed proceeds, the staff recommended that the carrying amount of an asset should be included as negative assumed proceeds. The Board agreed with the staff recommendation.

Follow-up Items:

15. The Board noted that its views on the EPS treatment of (a) options, warrants, and their equivalents classified as equity (Issue 1(b)), (b) mandatorily convertible instruments (Issue 2), and (c) convertible debt (Issue 4) differ from the IASB. The Board directed the staff to further analyze those differences for discussion at a future meeting.

General Announcements:

16. None.