



## Board Meeting Handout

### Short Term Convergence—Accounting Changes March 2, 2005

At today's meeting, the Board will be asked the following questions:

QUESTION 1: Should retrospective application consider only the direct effects and related income tax effects of a change in accounting principle, or should it also consider other nondiscretionary adjustments?

QUESTION 2: Should additional disclosure regarding the indirect effects of an accounting change be required?

QUESTION 3: Should the final Statement require that changes in the method of amortization and depletion be treated as changes in accounting estimates effected by a change in accounting principle?

QUESTION 4: Should the final Statement include an impracticability exception to the retrospective restatement requirement for correction of an error in prior period financial statements?

### **QUESTION 1: SHOULD RETROSPECTIVE APPLICATION CONSIDER ONLY THE DIRECT EFFECTS AND RELATED INCOME TAX EFFECTS OF A CHANGE IN ACCOUNTING PRINCIPLE, OR SHOULD IT ALSO CONSIDER OTHER NONDISCRETIONARY ADJUSTMENTS?**

#### **Alternatives**

1. Retrospective application should consider only the direct effects and the related income tax effects of a change in accounting principle.
2. Retrospective application should consider the direct effects and the related income tax effects of a change in accounting principle as well as any nondiscretionary adjustments actually recognized.

***Staff Recommendation***

The staff recommends including the following clarifying language, which is based upon the language in footnote 6 of Opinion 20, to paragraph 7 of the proposed Statement:

Retrospective application shall consider the direct effects of a change in accounting principle and the related income tax effects of the change. Indirect effects on items based on income before taxes or net income, such as profit sharing expense and certain royalties, that would have been recognized if the newly adopted accounting principle had been followed in prior periods, shall not be included in the retrospective application. Indirect effects shall be recorded in the period of change.

***Alternate Staff View—Indirect Effects Should Be Included If Nondiscretionary***

If the Board agrees with the alternate staff view, the staff recommends including the following clarifying language, which is based upon the language in footnote 6 of Opinion 20, in paragraph 7 of the proposed Statement:

Retrospective application shall consider the direct effects of a change in accounting principle and the related income tax effects of the change. Indirect effects on items based on income before taxes or net income, such as profit sharing expense and certain royalties, that would have been recognized if the newly adopted accounting principle had been followed in prior periods, shall not be considered in the retrospective application *unless the indirect effects of the prior periods are actually recognized.*

**QUESTION 2: SHOULD ADDITIONAL DISCLOSURE REGARDING THE INDIRECT EFFECTS OF AN ACCOUNTING CHANGE BE REQUIRED?**

**Alternatives**

1. Include additional disclosure requirements regarding the impact of indirect effects on interperiod consistency.
2. Limit disclosure requirements to those included in the Exposure Draft.

***Staff Recommendation***

The staff recommends that additional disclosure requirements not be included in the final Statement.

**QUESTION 3: SHOULD THE FINAL STATEMENT REQUIRE THAT CHANGES IN THE METHOD OF AMORTIZATION AND DEPLETION BE TREATED AS CHANGES IN ACCOUNTING ESTIMATES EFFECTED BY A CHANGE IN ACCOUNTING PRINCIPLE?****Alternatives**

1. Changes in the method of amortization and depletion should be treated as changes in accounting estimate effected by a change in accounting principle, as would be required by the Exposure Draft.
2. The requirement should be limited to changes in the method of depreciation method.

***Staff Recommendation***

The staff recommends that the staff draft be modified to clarify that the reference to depreciation, amortization, and depletion refers only to methods of allocating costs of long-lived assets and not to other uses of those terms in GAAP.

**QUESTION 4: SHOULD THE FINAL STATEMENT INCLUDE AN IMPRACTICABILITY EXCEPTION TO THE RETROSPECTIVE RESTATEMENT REQUIREMENT FOR CORRECTION OF AN ERROR IN PRIOR PERIOD FINANCIAL STATEMENTS?**

**Alternatives**

1. Modify the final Statement to permit correction of an error via cumulative-effect adjustment when retrospective restatement is impracticable, consistent with IAS 8.
2. Retain the Opinion 20 requirement of retrospective restatement for error corrections.

***Staff Recommendation***

The staff recommends that the proposed Statement be finalized as currently drafted, without an impracticability exception for error corrections.



**Board Meeting Handout  
FAIR VALUE MEASUREMENT PROJECT  
March 2, 2005 Board Meeting**

At the March 2, 2005 Board meeting, the Board will continue redeliberations of the proposed FASB Statement, *Fair Value Measurements* (FVM), focusing on the definition of fair value and its application to liabilities and related issues.

**1. Fair Value Measurements and Liabilities**

**Does the Board support its earlier tentative decision in the FVM project that for a liability, fair value should reflect the amount that would be paid by the reporting entity (obligor) to transfer the liability to a willing third party of comparable credit standing (layoff amount)?**

The Board will consider whether to affirm its earlier decision clarifying the fair value measurement objective for a liability. That decision is consistent with the view that because a liability is a present obligation to others that can only be settled (and, thus, leaves an entity little or no discretion to avoid the future sacrifice of assets), the fair value of a liability should reflect its settlement (layoff amount) considered from the perspective of a marketplace participant—that is, *the market's estimate of future net cash outflows assuming rational economic behavior.*

**2. Transaction Prices and Initial (Day 1) Fair Value Measurements**

**Should the FVM Statement incorporate the general presumption within GAAP that at initial recognition, the price in an actual transaction for the asset or liability being measured provides evidence of the fair value of that asset or liability? If so, should the FVM Statement clarify that at initial recognition where there is an actual transaction for the asset or liability being measured, the fair value hierarchy applies only if the transaction price presumption is rebutted and provide examples of situations in which the presumption would be rebutted?**

The FVM ED incorporates the transaction price presumption but implicitly, not explicitly. The Board will consider whether the FVM Statement should incorporate the transaction price presumption explicitly, clarifying that at initial recognition where there is an actual transaction for the asset or liability being measured, the fair value hierarchy applies only if the presumption is rebutted. The Board also will consider situations in which the transaction price presumption would be rebutted, including the following:

- a. The price is negotiated in a transaction that is not encompassed within the definition of fair value. For example, the transaction (1) is not arm's-length, (2) occurs under duress, or (3) is between marketplace participants that are not equally knowledgeable.
- b. The transaction is a contractual revenue arrangement that gives rise to a liability (if the contract is prepaid) or a contract asset (if the contract is not prepaid). The contract price provides presumptive evidence of the fair value of the arrangement in the aggregate but not the stand-alone liability or contract asset. Absent evidence to the contrary, the contract price and the fair value of the liability (layoff amount) or asset are different.

### **3. Day 1 Recognition Guidance**

**Should the FVM Statement or other pronouncements provide guidance for recognition of a difference that results in situations in which the transaction price presumption is rebutted (Day 1 difference)?**

Day 1 recognition approaches include the following:

- a. Include the Day 1 difference in the measurement of the related asset or liability.
- b. Recognize the Day 1 difference in earnings.
- c. Establish a Day 1 (market-based) reliability threshold for revenue recognition within the fair value hierarchy (for example, within Level 3) and recognize the Day 1 difference in earnings if the threshold is met. Otherwise, defer the Day 1 difference.

Absent Day 1 recognition guidance in the FVM Statement, the Board will consider the need to separately provide related guidance under existing pronouncements. In particular, the Board will focus on those pronouncements in which revenue transactions give rise to liabilities that are measured at "fair value" using a transaction price (an incurred amount) that might not represent a layoff (settlement) amount (EITF Issue 02-3, FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, and FASB Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others*).

#### 4. Day 2 Recognition Guidance

**If applicable, should the FVM Statement or other pronouncements provide guidance for recognition on Day 2 of a Day 1 difference that is deferred under item c (above)?**

Day 2 recognition approaches include the following:

- a. Recognize the Day 1 difference in earnings when the specified Day 1 reliability threshold is met, in effect, establishing a single standard of reliability that would apply in all periods.
- b. Amortize the Day 1 difference in earnings.
- c. Defer the Day 1 difference.

Absent Day 1 recognition guidance in the FVM Statement, the Board will consider the need to separately provide related guidance under existing pronouncements where a Day 1 difference is recognized as under item c (above), in particular, EITF Issue 02-3.

#### 5. Credit Standing and Liability Remeasurements

**Does the Board support its earlier decision to include the credit standing concept within the FVM Statement, thereby elevating that concept to Level A GAAP? If so, should the FVM Statement or other pronouncements specify limitations on the application of that concept for liability remeasurements at fair value in certain specified circumstances?**

Footnote 4 to paragraph 5 of the FVM ED states, “For a liability, the estimate of fair value should consider the effect of the entity’s credit standing so that the estimate reflects the amount that would be observed in an exchange between willing parties of the same credit quality.”

In its previous discussions, the Board affirmed that for a liability, a measurement that excludes credit standing is not a “fair value” measurement. However, many respondents expressed concerns about the application of that credit standing concept within Level A GAAP for liability remeasurements at fair value (which would require entities to report “losses” for credit upgrades and “gains” for credit downgrades). In response, the Board will consider whether to affirm its decision to include the credit standing concept within the FVM Statement, thereby elevating that concept to Level A GAAP and, if so, whether the FVM Statement and/or other pronouncements should:

- a. Clarify that the effect of a change in the credit standing of the entity should be included in those remeasurements when the effect of the change is contemplated in the marketplace (where the effect is identifiable, measurable, and significant)

- b. Limit the application of the credit standing concept, as clarified, to situations in which the effect of the change is realizable, considering possible realizability indicators. Absent limitations on the application of the credit standing concept in the FVM Statement, the Board will consider the need to separately provide related guidance under existing pronouncements that require liability remeasurements at fair value (in particular, FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments*, Statement 133, and FASB Statements No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, and No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*). If applicable, the Board will consider possible default measurement attributes when credit is no longer included in a fair value measurement.

## **6. Level 4 Estimates**

**Does the Board support its earlier decision to include Level 4 within the fair value hierarchy? If so, how should the resulting estimates be communicated (disclosed)?**

In its previous discussions, the Board affirmed its decision in the FVM ED to specify that in the absence of observable markets and/or observable market inputs, “hypothetical” market prices should be replicated using entity inputs as a practical expedient, subject to the requirements of other existing pronouncements. The Board decided to separately refer to those entity inputs within Level 4 of the fair value hierarchy, as revised. In response to concerns about the hypothetical construct within Level 4, the Board will consider whether to affirm its earlier decision to include Level 4 within the fair value hierarchy and, if so, whether Level 4 estimates should be communicated (disclosed) as fair value estimates or, alternatively, as fair value based estimates.



## Board Meeting Handout

### Liabilities and Equity

March 2, 2005

The Board will discuss Memorandum No. 18, which summarizes resource group and FASB staff comments on the FASB milestone draft, *Proposed Classification for Single Component Instruments with Characteristics of Equity*. In addition to other various clarifying changes, the staff is recommending the following significant clarifications be made to the draft:

- a. Add to the summary a list of topics that will be addressed in the next milestone as well as some related literature that may be affected.
- b. Clarify the definition and application of the term *counterparty payoff*.
- c. Clarify the definition and application of the term *contingent settlement provision*.
- d. In Appendix A, further explain why a written call option would not be a direct ownership instrument.
- e. Clarify the scope of the document.

**Question 1:** After reviewing the summary of comments, do Board members agree with the staff's recommended clarifications and changes (or no changes) to be made to the draft?

The staff recommends that the Board consider five additional issues before proceeding toward the next milestone (staff members have mixed views about whether Issue 5 should be addressed in this or the next milestone). The staff is not requesting that the Board deliberate these issues at this meeting but, at this time, would welcome any input or discussion related to the proposed issues (the staff will address each issue individually with the Board).

**Issue 1:** Should perpetual instruments be subject to direct ownership requirements?

**Issue 2:** Should characteristics of a subsidiary's instrument carry over to the consolidated entity (for example, should a perpetual instrument of a subsidiary be considered a perpetual instrument of the consolidated entity)?

**Issue 3:** How should instruments settled with the consolidated entity's shares be classified by the subsidiary?

**Issue 4:** Definition of direct ownership instruments—Can a holder's claim be limited prior to liquidation (for example, would a share that is redeemable at

book value represent a limited claim even if there is a provision to participate in the net assets in liquidation)?

**Issue 5:** What are the indicators in distinguishing substantive from nonsubstantive or remote settlement requirements? For example:

- a. Does a non-recourse note receivable exchanged for shares have two substantive settlement possibilities—either a fixed amount of cash or a fixed number of shares?
- b. Should criteria similar to paragraphs 12–32 of EITF Issue No. 00-19, “Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company’s Own Stock,” be considered?
- c. Should the timing of the redemption matter?
- d. How should one determine whether an entity’s discretion over redemption is nonsubstantive or remote?

**Question 2:** For each of these five potential issues, do Board members agree that the issues should be deliberated by the Board? Should the issues be addressed as part of this milestone or in the next milestone? Do Board members have any input on the issues or possible resolutions of them?

**Question 3:** Do Board members believe that there are other issues that should be deliberated (either as part of this milestone or the next one)?

The staff’s proposed next steps are as follows:

- a. Address issues of this milestone identified by the Board.
- b. Staff attends March IASB meeting to discuss milestone draft.
- c. Revise the milestone draft and basis based on the Board’s deliberations and the staff’s proposed changes to the draft.
- d. Board reviews the revised draft.
- e. Post draft to website (including basis?).
- f. Start deliberating issues included in the next milestone beginning with measurement and display of single component instruments and then addressing the definition of multiple component instruments.

**Question 4:** Do Board members agree with or have any input on the staff’s proposed next steps (details about the next steps will follow at the next tech plan meeting)?



**Board Meeting Handout**  
**Leveraged Lease Accounting**  
**March 2, 2005**

At the November 10, 2004 Board meeting, the Board decided that a change in the timing alone of tax benefits expected to be realized from a leveraged lease should result in a recalculation of the leveraged lease as described in paragraph 46 of FASB Statement No. 13, *Accounting for Leases*.

The staff will present the following questions to the Board at this meeting:

*Issue 1:* What threshold or scope limitation, if any, should be incorporated into the guidance for determining whether a recalculation should be performed for a change in the timing of the realization of tax benefits? Should the guidance be limited to LILO and SILO transactions? Should the types of changes in the timing of the realization of tax benefits exclude those relating to AMT and NOL carryforwards?

*Issue 2:* If the Board decided that a threshold should be incorporated into the guidance, should the guidance for determining whether a recalculation should be performed for a change in amount of estimated net income be consistent?

*Issue 3:* Does the Board affirm its previous decision that a change in the timing of the realization of tax benefits from a leveraged lease should require a recalculation of the leveraged lease?

*Issue 4:* Does the Board affirm its previous decision that a change in the realization of tax benefits from a leveraged lease should require a reevaluation of the classification of the leveraged lease?

*Issue 5:* In what form should this guidance be issued?

*Issue 6:* What should be the appropriate transition method for this guidance?

*Issue 7:* What should be the appropriate effective date for this guidance?

## **ISSUES**

**Issue 1: What threshold or scope limitation, if any, should be incorporated into the guidance for determining whether a recalculation should be performed for a change in the timing of the realization of tax benefits? Should the guidance be limited to LILO and SILO**

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The staff prepares Board meeting handouts to facilitate the audience's understanding of the issues to be addressed at the Board meeting. This material is presented for discussion purposes only; it is not intended to reflect the views of the FASB or its staff. Official positions of the FASB are determined only after extensive due process and deliberations.

**transactions? Should the types of changes in the timing of the realization of tax benefits exclude those relating to AMT and NOL carryforwards?**

***Scope Limitation***

**LILO/SILO**

At the November 10, 2004 Board meeting, Board members discussed whether to limit the scope of this project to “LILO” (lease-in/lease-out) transactions and “SILO” (sale-in/lease-out) transactions. The FASB staff does not believe such a scope limitation should be incorporated into the guidance. Although the most significant impact currently will likely stem from “LILO” and “SILO” transactions, there may be other types of leveraged lease transactions in the future where a change in timing of the tax benefits will occur. Limiting the scope to these types of transactions would effectively “scope out” other types of leveraged lease transactions. In order to alleviate any concerns regarding potential future transactions, the staff believes the scope of this project should include all transactions that are classified as leveraged leases under the provisions of Statement 13.

**AMT/NOL**

The FASB staff believes only changes in important assumptions that are directly related to the leveraged lease and change the timing of the tax benefits expected to be realized should require a recalculation and these important assumptions should not include timing as a result of AMT and NOL carryforwards.

***Threshold Issue***

The FASB staff is presenting three views regarding a possible threshold. The term *any important assumption* as used in each of the views presented below may exclude AMT and NOL carryforwards depending on the Board decision on Issue 1. The views for the Board to consider are as follows:

- *View A:* Any important assumptions affecting the timing of the realization of tax benefits from the lease shall be reviewed at least annually. If during the lease term, the revision of an important assumption changes the timing of the realization of tax benefits from the lease, the rate of return and the allocation of income to positive investment years shall be recalculated from the inception of the lease following the method described in paragraph 44 of Statement 13. The accounts constituting the net investment balance shall be

adjusted to conform to the recalculated balances, and the change in the net investment shall be recognized as a gain or loss in the year in which the assumption is changed.

- *View B:* Any important assumptions affecting the timing of the realization of tax benefits from the lease shall be reviewed at least annually. If during the lease term, the revision of an important assumption that affects the timing of the realization of tax benefits results in a more than minor change in the timing of estimated total net income from the lease, the rate of return and the allocation of income to positive investment years shall be recalculated from the inception of the lease following the method described in paragraph 44 of Statement 13. A “more than minor change” is based on whether the gain or loss in the year the assumption is changed is equal to or greater than 10% of the net income recognized to date from the leveraged lease transaction. The accounts constituting the net investment balance shall be adjusted to conform to the recalculated balances, and the change in the net investment shall be recognized as a gain or loss in the year in which the assumption is changed.
- *View C:* Any important assumptions affecting the timing of the realization of tax benefits from the lease shall be reviewed at least annually. If during the lease term, the revision of an important assumption that affects the timing of the realization of tax benefits results in a more than minor change in the timing of the estimated total net income from the lease, the rate of return and the allocation of income to positive investment years shall be recalculated from the inception of the lease following the method described in paragraph 44 of Statement 13. A “more than minor change” is based on whether the gain or loss in the year the assumption is changed is equal to or greater than 10% of the total net income expected to be recognized from the leveraged lease transaction. The accounts constituting the net investment balance shall be adjusted to conform to the recalculated balances, and the change in the net investment shall be recognized as a gain or loss in the year in which the assumption is changed.

The FASB staff recommends View A.

**Issue 2: If the Board decided that a threshold should be incorporated into the guidance, should the guidance for determining whether a recalculation should be performed for a change in amount of estimated net income be consistent?**

**Issue 3: Does the Board affirm its previous decision that a change in the timing of the realization of tax benefits from a leveraged lease should require a recalculation of the leveraged lease?**

**Issue 4: Does the Board affirm its previous decision that a change in the realization of tax benefits from a leveraged lease should require a reevaluation of the classification of the leveraged lease?**

**Issue 5: In what form should this guidance be issued?**

The FASB staff believes there are two possible forms that the guidance for this project may be issued: (a) as an amendment to Statement 13 or (b) as a Board-directed FSP. The FASB staff recommends this guidance be issued in the form of an FSP because of the need for narrow and limited revisions to Statement 13 (specifically paragraph 46) and the fact that there is precedence for issuing FSPs to amend existing standards.

**Issue 6: What should be the appropriate transition method for this guidance?**

The staff believes that there are three transition methods for the Board to consider:

- *View A:* This guidance shall be applied prospectively to revisions in important assumptions that result in changes in timing of the realization of tax benefits from leveraged lease transactions. Earlier application of this guidance, including retroactive application to all leveraged leases regardless of when the revision in the important assumption occurred, is encouraged but not required.
- *View B:* Accounting changes adopted to conform to the provisions of this guidance shall be applied retroactively.
- *View C:* An entity shall recognize the cumulative effect of initially applying this guidance as a change in accounting principle as described in paragraph 20 of APB Opinion No. 20, *Accounting Changes*. The amount to be reported as a cumulative-effect adjustment in the statement of operations is the difference between the amount of net income from leveraged leases recognized in the statement of financial position since lease inception prior to the application of this guidance (under the provisions of Statement 13) and the net income from leveraged leases that would have been recognized in the statement of

financial position since lease inception pursuant to this guidance. Leveraged leases shall be reclassified pursuant to this guidance as of the effective date of this guidance. Earlier application of this guidance is encouraged but not required.

The FASB staff recommends View C.

**Issue 7: What should be the appropriate effective date for this guidance?**

The staff is presenting three effective dates for the Board's consideration:

- *View A:* This guidance shall be effective for the first reporting period beginning after the date the guidance is finalized.
- *View B:* This guidance shall be effective for fiscal years beginning after December 15, 2005 (January 1, 2006, for calendar-year end enterprises).
- *View C:* This guidance shall be effective for fiscal years ending after December 15, 2005 (December 31, 2005, for calendar-year end enterprises).

If the Board decides that View A is the appropriate transition method (that is, prospective treatment), the FASB staff believes the effective date should be based on View A since no additional time would be needed to recalculate leveraged leases for past changes in the timing of tax benefits. If the Board decides that either View B or View C is the appropriate transition method, the FASB staff believes the effective date should be based on View C since this provides adequate time to perform the necessary recalculations.



**Board Meeting Handout**  
**Proposed Statement 133 Implementation Issue B38**  
**March 2, 2005**

At the March 2, 2005 Board meeting, the Board will discuss alternatives presented by the staff to address a concern among certain Board members regarding the applicability of the clearly and closely related tests in paragraph 13(b) of Statement 133 to certain prepayment options in commercial loans.

**Background**

At the February 2, 2005 meeting, there was a concern among certain Board members that the issuance of Statement 133 Implementation Issue No. B38, "Evaluation of Net Settlement with Respect to Embedded Prepayment Options in Certain Debt Instruments," as drafted, would require certain prepayment options in commercial loans that contain penalties (specifically those that are not considered clearly and closely related to the debt host under paragraph 13(b) of Statement 133) to be bifurcated and accounted for separately as derivatives. Some Board members believed that common prepayment options in commercial loans should always be considered clearly and closely related to the debt host, which, in certain circumstances, may be contrary to the current guidance in paragraph 13(b).

**Issue**

As a result, the staff was asked to further research how Statement 133 could be amended or interpreted such that certain common prepayment options in commercial loans *would be* considered clearly and closely related under paragraph 13(b) and, therefore, would not be affected by the guidance in Implementation Issue B38, as drafted.

## **Alternatives**

The staff has outlined three alternatives to address the concern that common prepayable commercial loans may contain embedded derivatives.

Alternative 1—*Provide an explicit scope exception from the requirements of paragraph 13(b) for hybrid instruments that have certain characteristics of common prepayable commercial loans*

Alternative 1 requires defining a set of objectively observable characteristics to narrowly describe a typical prepayable commercial loan arrangement, whereby, if all of the characteristics are present, the prepayment option would be presumed to be clearly and closely related, negating the need to further analyze the contract under the provisions of paragraph 13(b). The staff has presented the Board with a preliminary list of such characteristics for their consideration.

Alternative 2—*Provide an explicit scope exception from the requirements in paragraph 13(b) to an embedded call option in a debt instrument if the right to accelerate the settlement of the debt instrument can only be exercised by the borrower (issuer)*

Alternative 2 modifies the applicability of paragraph 13(b) to make that paragraph's application consistent with the rationale underlying the guidance in Statement 133 Implementation Issue No. B5, "Investor Permitted, but Not Forced, to Settle without Recovering Substantially All of the Initial Net Investment," which addresses only the application of paragraph 13(a). Alternative 2 broadens the applicability of Alternative 1 by effectively providing *all* call options embedded in debt instruments (including all prepayment options) with an exception from the requirements of paragraph 13(b).

Alternative 3—*No changes to paragraph 13(b)*

Alternative 3 is considered a workable solution if the Board concludes that the guidance in Implementation Issue B38, as drafted, is applicable only prospectively to new transactions, with the expectation that new debt or loan

agreements entered into may have to contain prepayment or call “lockout” periods in order to “fail” the paragraph 13(b) clearly and closely related test.

**Staff Recommendation**

The staff recommends Alternative 2.