MINUTES

Financial Accounting Standards Board

To:	Board Members		
From:	Staniszewski (ext. 445)		
Subject:	Minutes of the July 25, 2007 Board Meeting (Short-Term Convergence, Earnings per Share)	**Date:**	July 25, 2007
cc:	FASB: Golden, Bielstein, MacDonald, Chookaszian, Polley, Lott, Klimek, Project Team, Carnrick, Stevens, Allen, Gabriele, FASB Intranet; IASB: Upton, Stewart		

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: Short-Term Convergence—Earnings per Share

Basis for Discussion: Memorandum dated July 6, 2007

Length of Discussion: 9:35 a.m. to 10:08 a.m.

Attendance:

Board members present: Herz, Batavick, Crooch, Smith, Linsmeier, and Young

Board members absent: Seidman

Staff in charge of topic: J. Sarno

Other staff at Board table: Staniszewski, Bielstein, Cassel, and Wyatt

Outside participants: None

Summary of Decisions Reached:

The Board reached the following decisions in addressing the drafting issues related to the Short-Term Convergence—Earnings per Share project:

1. The Board decided that no changes should be made to FASB Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*, in order to achieve convergence with IAS 33, *Earnings per Share* because the earnings per share guidance in Statement 150 on forward purchase contracts that require gross physical settlement is consistent with the accounting treatment for those instruments.
2. The Board decided that the objective of the convergence project was to arrive at the same denominator in the diluted earnings per share calculation. Therefore, convergence will be achieved when both U.S. GAAP and IFRS result in the same diluted EPS denominator, regardless of any differences that may arise in the numerator (*the control number used in calculating EPS*).
3. The Board decided to expand the "fair value method" proposed at the March 2007 Board meeting to include compound instruments for which the embedded derivative with a share settlement alternative is accounted for separately as a liability and measured at fair value through earnings for the reporting period.
4. The Board decided that actual distributions (as opposed to hypothetical distributions) to outstanding common stock should be used in the computation of diluted EPS under the two-class method. The Board agreed with the staff recommendation to solicit feedback from constituents on this issue in the Notice for Recipients.
5. The Board agreed that the amendments to Statement 128 should be effective for fiscal years beginning after December 15, 2008, and should be applied retrospectively to all prior periods presented. Early adoption will not be permitted.
6. The Board decided that the proposed Statement should be exposed for a 120-day comment period to be consistent with the IASB's comment period.

Objective of Meeting:

The objective of the meeting was for the Board to consider the issues that have arisen in drafting the proposed Statements on the amendments to FASB Statement No. 128, *Earnings per Share*, and IAS 33, *Earnings per Share*. The staff plans to address the following issues: (a) instruments with the same accounting and the same EPS amount, but achieved through different methods of computing EPS, (b) instruments with different underlying accounting and therefore different methods of computing diluted EPS that achieve the same EPS denominator, (c) instruments in which an embedded option is accounted for separately as a liability and measured at fair value through earnings for the reporting period, (d) allocation of dividends in the computation of diluted EPS under the two-class method, (e) effective date, and (f) comment period. The objective of the meeting was met.

Matters Discussed and Decisions Reached:

1. Mr. Sarno began by stating the purpose of this meeting is to discuss the issues that have arisen in drafting the proposed Statements on amendments to both FASB Statement No. 128, *Earnings per Share,* and IAS 33, *Earnings per Share*. Mr. Sarno made a few observations before discussing the drafting issues. He stated that the current earnings per share (EPS) model is a hybrid model. That is, the message employed today to compute earnings per share is different for different types of instruments. While the proposed amendments would incorporate a new means of depicting dilution (*that is, through fair value adjustments rather than through the denominator*), the staff believes the amendments would achieve the stated objectives of the convergence project. Further, the staff believes that the amendments will also improve and simplify the computation of EPS.

2. Mr. Sarno stated that the staff would now like to address some of the issues that has arisen in drafting, which include: (a) instruments with the same accounting and the same EPS amount, but achieved through different methods of computing EPS, (b) instruments with different underlying accounting and therefore different methods of computing diluted EPS that achieve the same EPS denominator, (c) instruments in which an embedded option is accounted for separately as a liability

and measured at fair value through earnings for the reporting period, (d) allocation of dividends in the computation of diluted EPS under the two-class method, (e) effective date, and (f) comment period.

Instruments with the Same Underlying Accounting, Same EPS, but Achieved Through Different Methods of Computing EPS

3. Mr. Sarno stated that forward purchase contracts that require gross physical settlement are accounted for under FASB Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity* and IAS 32, *Financial Instruments: Presentation*, as a liability with an offset to equity at contract inception. However, U.S. GAAP provides specific guidance on the computation of EPS for these instruments whereas, IFRS does not. The staff believes that the accounting and EPS guidance as prescribed in Statement 150 is internally consistent. Mr. Sarno stated that the staff is looking for a reaffirmation from the Board that the guidance prescribed in Statement 150 is internally consistent, and therefore, the staff could present to the IASB a change to their standard (which would align it with the guidance prescribed in Statement 150) to make their guidance more internally consistent. Mr. Sarno asked if the Board believed that no changes should be made to the EPS guidance in Statement 150 in order to achieve convergence. All Board members voted in favor of not making changes to Statement 150.

Instruments with Different Underlying Accounting and Therefore Different Methods of Computing Diluted EPS that Achieve the Same EPS Denominator

4. Mr. Sarno said the second issue to address deals with instruments with different underlying accounting for certain instruments and therefore different methods of computing diluted EPS that achieve the same EPS denominator. These instruments include (a) forward purchase contracts that provide the option of gross physical or net share or net cash settlement, (b) written put options requiring gross physical settlement, and (c) written put options that provide the option of gross physical or net share or net cash settlement that are accounted for under U.S. GAAP as deriviative instruments and measured at fair value with changes

reported in earnings and are accounted for under IFRS as a liability with an offset to equity. Mr. Sarno indicated that as a result of the use of the "fair value method" and the application of the modified reverse treasury stock method, neither method will require these instruments to be included in the computation of diluted EPS. Because of the differences in the underlying accounting for these instruments as well as differences in accounting for other arrangements, the staff believes that convergence will be achieved by arriving at the same denominator, as opposed to achieving the same numerator (net income). All Board members agreed that convergence will be achieved through obtaining the same EPS denominator.

Instruments in Which the Embedded Option is Fair Valued

5. Mr. Sarno stated that the third issue to address is whether instruments that are, in part, measured at fair value should be subject to the fair value method exclusion. The staff had previously limited the fair value method to instruments that are measured at fair value in their entirety for comparability purposes because U.S. GAAP and IFRS have different requirements on whether an embedded derivative should be separately accounted for and measured at fair value. However, the staff acknowledges that there already exists a lack of comparability for instruments that are measured at fair value in their entirety among and between U.S. GAAP and IFRS due to an entity's ability to elect the fair value option on an instrument by instrument basis. Mr. Sarno stated that the staff therefore recommends that the proposed fair value method be expanded to include embedded derivative instruments that contain a share settlement alternative which is separately classified as a liability and measured at fair value through earnings for the reporting period.

6. Mr. Herz clarified that the staff is proposing that to the extent you are required to bifurcate an instrument that includes a share settlement alternative and it would not be reported as equity due to EITF Issue 00-19, *Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock*, then under the fair value method there would only be a numerator impact in

EPS for the bifurcated instrument because the changes in fair value are reported in earnings. No Board members objected to the staff's recommendation to expand the fair value method to these embedded derivative instruments that have been bifurcated and measured at fair value through earnings.

7. Mr. Herz noted that his inclination would be to rely on the Liabilities and Equity project which will provide a narrower view of equity. Based on the Board's preliminary decisions, these instruments would be treated as an indirect interest, but under the current literature, which may result from the problems with Issue 00-19, the guidance is not very transparent. Mr. Sarno explained that the rationale behind the fair value method was to get consistency with the accounting representation on the balance sheet and the computation of EPS. Essentially, if you were going to classify an instrument as a liability on the balance sheet with changes in fair value marked through earnings, there would be no need to put any shares in the denominator. If, however, the instrument is classified as equity, one of the methods currently in Statement 128 (*treasury stock method, if-converted method, etc*) should be applied in computing diluted EPS.

8. Mr. Young stated that he did not like the fair value method. He believes that it is conceptually inconsistent with the objective of diluted EPS, which he believes is a denominator focused objective. He does not believe that the fair value method provides investors with the denominator information that he believes they are looking for. Mr. Young stated that he will dissent over the use of the fair value method in this project. Aside from Mr. Young, no other Board members objected to the staff recommendation.

9. Mr. Linsmeier asked if the staff had any plans to conduct further analysis on the fair value method, or because it's a hybrid set of methods, does the staff think the current proposals are sufficient (*referring to having a hybrid approach to EPS computation*). Mr. Sarno stated that the current EPS model is a hybrid model. He noted that when the Liabilities and Equity project is completed, it may be a good time to do an analysis on whether or not the use of a single method should be revisited. Therefore, Mr. Sarno noted that the staff is not planning to do any

additional analysis. Mr. Herz said that it would be useful to analyze constituents' reactions to the use of the fair value method, which will only affect the numerator and not the denominator. Mr. Cassel replied that the modified treasury stock method will take the liability carrying amount as proceeds, so the fair value method is just applying the proceeds (*modified treasury stock method*) to the extreme. He would be surprised if anyone would be upset with the proposed fair value method (as a result of the decisions with the modified treasury stock method). Mr. Sarno stated that the staff developed the fair value method because when you put the carrying value of a liability in as assumed proceeds under the modified treasury stock method, you will always get an anti-dilutive result. Therefore, the staff attempted to simplify the computation of EPS by not requiring entities to apply the modified treasury stock method for these instruments.

10. Mr. Herz stated that at the education session, some Board members noted that the denominator impact gives users an idea of potential future share issuances. At that meeting, the Board and staff discussed whether Statement No. 129, *Disclosure of Information about Capital Structure,* provided that information and whether another project should address presentation of all potential future share issuances in one place and in a more user friendly format. Mr. Herz noted that he believes the concern expressed by Mr. Young may have to do with taking information away, but he does not believe that the information that may be taken away will have a major impact. Mr. Cassel noted that it would be hard to gauge the takeaway from the staff's proposal. The only differential is for the instruments that are being accounted for as liabilities but were fully expected to be settled in shares. Mr. Herz noted that the takeaway for him is more in the Liabilities and Equity project, where the Board is proposing to account for essentially all equity derivatives as liabilities, even though most will be share settled. He noted that the current EPS project is transferring a subset of instruments to the fair value method, and as a result, it will be changing the EPS treatment from what is currently required under GAAP. Mr. Herz stated that we have the EPS treatment of these instruments consistent with the accounting, but there appears to be a need for information about future potential shares. He stated

that there may be a need in the Liabilities and Equity project to give users information about potential future issuances of shares.

11. Mr. Young noted that under Statement 128, an entity is required to provide a reconciliation between basic and diluted share count. Mr. Young noted that there will be disclosures that fall out with the proposed fair value method. He stated that he does not necessarily disagree with the fair value method, but he disagrees with shifting it into the current accounting for liabilities and equity. He does not believe that this shift can be done without requiring more disclosures. Mr. Herz noted that the requirement to include the carrying value of a liability as assumed proceeds does not apply yet and therefore agreed that there is a potential information loss under the proposed model. Mr. Cassel replied that the only takeaway would be for a subset of instruments that are classified as liabilities but will be share settled because those that will be cash settled would not have an impact on EPS. Mr. Herz noted that it falls back to the problems associated with Issue 00-19. Mr. Sarno stated that the reconciliation does not include antidilutive shares and from a treasury stock perspective it only includes net shares as opposed to gross shares. Mr. Cassel noted that at the end of the day, the resulting diluted EPS will be the same under the staff's proposal, except for those instruments classified as liabilities, but the entity fully intends to share settle. Mr. Linsmeier commented that even if the fair value method were not adopted, the instruments would be considered anti-dilutive. Thus, they would not be included in the reconciliation. Mr. Herz asked if the staff could work with Mr. Young to alleviate his remaining concerns on the use of the fair value method.

Allocation of Actual Dividends in the Computation of Diluted EPS under the Two-Class Method

12. Mr. Sarno stated that the next issue the staff would like to address is the computation of diluted EPS under the two-class method. The illustrations in the proposed amendments on the calculation of diluted EPS under the two-class method have two components: distributed earnings and an allocation of undistributed earnings. The staff has interpreted the words in the current

standards (as well as pre-existing literature, APB 15) to include in distributed earnings only actual dividends distributed (or declared) to outstanding common stockholders. As a result, the staff has drafted the proposed amendments to Statements 128 and IAS 33 requiring that the computation of diluted EPS under the two-class method only reduce income from continuing operations by the actual amount of dividends distributed (or declared). Mr. Sarno stated that a question arose during drafting as to whether an entity should assume distributions to potential shareholders (a hypothetical distribution) in computing diluted EPS. The staff recommends using actual distributions because that appears to be consistent with current guidance as well as pre-existing guidance. The staff would also recommend asking for feedback in the Notice to Recipients on whether distributed earnings should be based on actual or hypothetical distributions.

13. Mr. Cassel noted that theory behind using hypothetical distributions is stronger than the theory behind using actual distributions, however, recommending the use of hypothetical dividends would be an improvement rather than a convergence issue. Mr. Smith commented that to the extent there is a large pool of potential common shares such that using the same dividend rate would increase the total amount distributed, the question was whether, hypothetically, the board of directors would act differently. No Board members objected to the staff's recommendation to use actual distributions declared or paid in computing diluted EPS under the two-class method.

Effective Date

14. Mr. Sarno noted that the next issue deals with the effective date. Given that this is a convergence project, the staff is trying to align its effective date with the IASB. The staff is proposing an effective date for annual periods beginning after December 15, 2008 with an intent on aligning the effective date with the IASB. Mr. Herz noted that the IASB's one year rule may pose a problem that would require the standard to be out by the end of the year. Mr. Sarno noted that there

are some questions about whether the IASB's one year rule will apply. No Board members objected to the staff's recommendation regarding the December 15, 2008 effective date.

15. Mr. Herz asked how early adoption would be handled. Mr. Sarno stated that the staff had originally proposed early adoption because generally, with an EPS change, an entity is required to restate previous EPS amounts. Mr. Herz stated that he would not allow early adoption. Mr. Linsmeier also stated that he would not allow early adoption because of noncomparability across entities. Mr. Batavick asked if Mr. Sarno could clarify the SAB 74 impact on this issue. Mr. Sarno stated that SAB 74 would not necessarily require a proforma type disclosure based on the staff's discussions with the SEC staff. Mr. Batavick stated that he would therefore be against early adoption. Mr. Smith noted that he thought that disclosure or presentation only items would not be required to be disclosed under SAB 74 because that would be tantamount to early adoption. Mr. Herz asked if any Board members wanted to allow early adoption. The Board voted to not allow early adoption.

Comment Period

16. Mr. Sarno noted that the next issue has to deal with the comment period. In an effort to align with the IASB, the staff believes the comment period should be aligned with the 120-day period that was adopted by the IASB. No Board members objected with the 120-day comment period.

<u>Follow-up Items:</u>

17. None

<u>General Announcements:</u>

18. None