

MINUTES



To: Board Members
From: Short-Term Convergence—Phase 1
Varian (ext. 353)
Subject: Minutes of the October 6, 2004 Board Meeting **Date:** October 14, 2004
cc: Bielstein, Smith, Leisenring, Swift, Polley, Gabriele, Intranet (email),
Project Team (J. Johnson, McKenna, Varian, Vincent), McGeachin
(IASB via e-mail)

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 EPS 1 dated September 20
Memorandum EPS 3 dated September 22

Length of Discussion: 9:00 a.m. to 9:45 a.m.

Attendance:

Board members present: Herz, Batavick, Crooch, Schieneman,
Schipper, Seidman, and Trott

Board members absent: None

Staff in charge of topic: J. Johnson

Other staff at Board table: Beilstein, Cassel, McKenna, Varian

Outside participants: Leisenring, Bugg by phone (IASB)

Summary of Decisions Reached:

The Board redeliberated two issues related to the December 2003 FASB proposed Statement, *Earnings per Share*:

1. The Board decided to require that mandatorily convertible shares be used in the calculation of basic earnings per share (EPS), whether the effect of including the additional shares is dilutive or antidilutive.
2. The Board decided to require that a contract that may be settled in cash or shares be subject to the guidance in paragraph 29 of FASB Statement No. 128, *Earnings per Share*, even if the contract only requires share settlement under certain circumstances. An otherwise cash-settled instrument that contains a provision that requires or permits share settlement under certain circumstances is not a contingently issuable share agreement; therefore, share settlement must be assumed for purposes of computing diluted EPS. The Board decided to make an exception to this guidance for an instrument that does not permit share settlement under any circumstance other than the bankruptcy of the issuer.

Objective of Meeting:

The objective of the Board meeting was to redeliberate certain remaining issues related to the proposed Statement, *Earnings per Share*.

Matters Discussed and Decisions Reached:

Mr. Johnson began by stating that the first issue to be discussed was whether the Board intended for mandatorily convertible shares to be used in the calculation of basic EPS even if the effect of including the additional shares is antidilutive. The two alternatives are (1) to include the additional shares in the computation of basic EPS regardless of the result or (2) to include the additional shares in the computation of basic EPS only if the result is dilutive. Mr. Johnson stated that the staff originally recommended that these instruments be included in EPS only if the effect is dilutive; however, he stated that he spoke to people at the IASB, to interested parties in industry, and to certain Board members who expressed the view that that these shares should be included in the computation of basic EPS whether the effect is dilutive or antidilutive. The logic behind this

belief is that it is only a matter of time until these instruments are converted into shares; therefore, these instruments are virtually equivalent to shares. He recommended that it be required that mandatorily convertible shares be used in the calculation of basic EPS whether effect of including the additional shares is dilutive or antidilutive. Ms. Seidman stated that given that the Board decided to include mandatorily convertible securities in basic EPS, it is more consistent to include these instruments in basic EPS whether the effect of including the additional shares is dilutive or not. She stated that otherwise, it would appear that the rationale for diluted EPS is being used as the basis for this decision, which relates to basic EPS. All Board members agreed with the staff recommendation.

Mr. Johnson stated that the next issue to be discussed was the question of whether a financial instrument that generally requires cash settlement, but permits or requires share settlement only under certain circumstances, is subject to the guidance in paragraph 29 of FASB Statement No. 128, *Earnings per Share*. Paragraph 29 states, in part:

If an entity issues a contract that may be settled in common stock or in cash at the election of either the entity or the holder, the determination of whether that contract shall be reflected in the computation of diluted EPS shall be made based on the facts available each period. It shall be assumed that the contract will be settled in common stock and the resulting potential common shares included in diluted EPS (in accordance with the relevant provisions of this Statement) if the effect is more dilutive. [Footnote reference deleted.]

Inquirers asked the staff whether the wording of paragraph 29 that states, *at the election of the entity or the holder*, means that circumstances that are outside the election of the entity or the holder, which permit or require share settlement, fall outside the scope of paragraph 29. Four alternatives exist for this question. Alternative 1 requires strict application of paragraph 29 of Statement 128 as amended by the Exposure Draft. This alternative requires that any potential dilution that may result from a contract that could be settled in shares under any

circumstances should be reflected in the computation of diluted EPS. Alternative 2 requires consideration of the probability of share settlement in determining whether an instrument should be included in diluted EPS for cases where the circumstance of share settlement is outside the election of the entity or the holder. Alternative 3 declines clarification of the proposed Statement. Finally, Alternative 4 views these contract provisions as contingencies. This alternative requires consideration of the contingency guidance in paragraphs 30–35 of Statement 128 before looking at paragraph 29, and once the contingency is met, the instrument would be included in diluted EPS. The staff recommended Alternative 3.

Mr. Trott stated that he was attracted to Alternative 1 because he believes the purpose of fully diluted EPS is to show maximum dilution. However, he suggested the possibility of a modified Alternative 1 that requires strict application of paragraph 29 of Statement 128 except in the cases where the contract provisions permit or require share settlement in the event of bankruptcy of the issuer only. Mr. Johnson stated that Mr. Trott's proposal would address some, but not many, of the asserted issues related to circumstances that permit or require share settlement. He stated that many contracts include provisions that permit or require share settlement in the event of default and not bankruptcy. Mr. Trott expressed concern over using default as the trigger for not including these potential shares in diluted EPS. He believes this would allow too many instruments to be excluded from diluted EPS.

Mr. Batavick agreed with Mr. Trott's beliefs about bankruptcy provisions, but he was troubled by other default circumstances. He stated that if all potential shares related to default provisions were included in diluted EPS, he does not believe that EPS would be a very meaningful number.

Ms. Seidman stated that she reads paragraph 29 of Statement 128 to mean that one would need to assess whether either party can elect cash or share settlement in accordance with contractual terms of the arrangement. She believes that a party would not be acting in accordance with the contractual

terms of the arrangement in the event of default or bankruptcy. She views default or bankruptcy as a nonmarket contingency; therefore, one would not include potential shares related to default or bankruptcy until that contingency occurs.

Mr. Crooch stated that he believes that the goal of this guidance was to include all the potential shares in diluted EPS; therefore, he supports Alternative 1 without modification as recommended by the staff. Mr. Schieneman agreed.

Ms. Schipper stated she supports Alternative 1 without modification. She believes that if an exception was given default or bankruptcy provisions, enterprises would have the ability to create contracts that include circumstances that permit or require share settlement in order to circumvent the intent of Statement 128.

Mr. Herz stated that his preference was Alternative 2. He believes that probability of occurrence of share settlement should be considered.

Five Board members did not object to Alternative 1 modified to exclude potential shares related to bankruptcy provisions in the computation of diluted EPS; Mr. Crooch and Ms. Schipper objected.

Mr. Johnson stated that one remaining issue related to EPS is how to apply the treasury stock method to instruments that are classified as liabilities and that can potentially be settled in shares. Mr. Johnson stated that the staff has developed what they believe to be the alternatives on how to apply the treasury stock method to these instruments. He stated that this guidance was not included in the Exposure Draft and that it would need to be exposed. He suggested that this guidance could be issued as an FASB Staff Position, and therefore, issuance of the final Statement on EPS would not be delayed.

Follow-up Items:

None

General Announcements:

None