At today’s meeting, the Board will discuss how the proposed Statement’s amendment to FASB Statement No. 95, *Statement of Cash Flows*, will account for the income tax effects of EBC transactions under FASB Statement No. 123’s, *Accounting for Stock-Based Compensation*, original income tax guidance, which the Board tentatively reinstated. The Board will discuss deferred income tax issues arising from capitalized compensation costs. This Board also will discuss whether a deferred tax asset should be written off if the probability of exercise is remote.

**Issue 1: Accounting for Excess Tax Benefits and Tax Benefit Deficiencies in the Statement of Cash Flows**

At the August 25, 2004 meeting, the Board tentatively reaffirmed its support for amending Statement 95. The Board also directed the staff to consider the impact of its tentative decision to reinstate Statement 123’s method of accounting for income tax effects on the amendment of Statement 95.

Alternative 1 considers the unit of account to be a group (or portfolio) of awards, and Alternative 2 considers the unit of account to be an instrument. Alternative 1 is theoretically consistent with Statement 123’s method, and Alternative 2 is theoretically consistent with the ED’s method. Those alternatives result in very different outcomes in the statement of cash flows. Alternative 1 results in financing cash outflows and operating cash inflows when tax benefit deficiencies are absorbed in equity. The rationale is that excess tax benefits (which are accounted for as financing cash inflows and operating cash outflows) are reduced by tax benefit deficiencies, causing a reduction in the financing cash inflows. Alternative 1’s result is nothing more than a logical extension based on its unit of account.

Alternative 2, on the other hand, only results in excess tax benefits being recognized as financing cash inflows. That is, its unit of account does not permit tax benefit deficiencies to reduce financing cash inflows from excess tax benefits. To contrast that notion with Alternative 1, Alternative 1 is based on a “net” excess tax benefit, being the result of all excess tax benefits from individual instruments and all tax benefit deficiencies from individual instruments. While Alternative 2 is theoretically inconsistent with Statement 123’s method, it has the virtue of recognizing “gross” excess tax benefits.

Because Statement 123’s method establishes that excess tax benefits and tax benefit deficiencies absorbed in equity are equity transactions, the staff notes that Alternative 1 is consistent with that notion and, therefore, recommends that alternative. If the Board prefers Alternative 1, excess tax benefits and tax benefit deficiencies absorbed in equity
can be presented in the statement of cash flows on either a net basis or a gross basis. The staff believes that enterprises should be permitted to make that decision; however, if enterprises choose to present those transactions net, then the staff recommends that such transactions be presented gross in the footnotes to the financial statements.

**Discussion Question No. 1(a):** Does the Board prefer Alternative 1 or Alternative 2?

**Discussion Question No. 1(b):** If the Board prefers Alternative 1, does the Board support the staff’s disclosure recommendation?

**Issue 2: Capitalized Compensation Costs and the Amendment of Statement 95**

As a consequence of the proposed Statement, many companies may begin to capitalize compensation cost from EBC awards as part of inventory or other assets. Statement 123 does not explicitly address that situation.

**Issue 2(a): Tax Basis of Capitalized Compensation Costs**

This issue arises in the context of the Board’s decision to reinstate Statement 123’s original guidance on accounting for income taxes. Under that decision, compensation cost related to the grant of a nonqualified at-the-money stock option will be deemed to give rise to a deductible temporary difference. Consider the following example:

Company X grants one at-the-money stock option with a one-year cliff-vesting service condition to an employee. The employee works 100 percent of the time during the requisite service period on constructing a building for Company X. The grant-date fair value of the stock option is $20. Other costs of constructing the asset total $980, and the total book basis of the asset is $1,000 ($20 + $980). The other construction costs do not create book-tax basis differences.

What is the tax basis of the building at the end of the year? The staff understands that the answer to that question is a matter of tax law and would be $980. Nevertheless, the logical extension of Statement 123’s income tax method is that the grant-date fair value of the instrument ($20) establishes a deemed tax basis for income tax accounting purposes. That is, under that method, the grant-date fair value measurement serves as an estimate of the deduction that an enterprise will receive upon the option’s exercise. Therefore, in the case of capitalized compensation cost, extending that logic means that the grant-date fair value measurement is an estimate of the tax basis that will apply to the asset upon the option’s exercise (and thus, forms a part of the asset’s deemed tax basis for income tax accounting purposes). The staff believes that this conclusion is consistent with the Board’s tentative position.

If the grant-date fair value estimate of compensation cost is not deemed to form a part of the asset’s tax basis, then the staff believes that the book-tax-basis difference would give rise to a temporary difference under FASB Statement No. 109, *Accounting for Income Taxes*, and EITF Issue No. 98-11, “Accounting for Acquired Temporary Differences in Certain Purchase Transactions That Are Not Accounted for as Business Combinations.” The staff believes this position is more consistent with the method in IFRS 2, *Share-based


*Payment*, which recognizes a tax basis for an award granted at-the-money only to the extent that it is in-the-money.

**Discussion Question 2(a):** Does the Board support the notion, based on Statement 123’s method, that capitalized compensation cost for a nonqualified stock option or share of restricted stock should have a deemed tax basis for income tax accounting purposes based on its grant-date fair value?

**Issue 2(b): Frequency of Measurement for Deferred Income Tax Effects of Capitalized Compensation Costs**

Assuming the same facts in the example provided for Issue 2(a) of this memo, the staff is going to provide two scenarios below: in Scenario 1 the stock option expires out-of-the-money and in Scenario 2 the stock option is exercised. The statutory tax rate is assumed to be 40 percent, and the option has a 2-year contractual term. The exercise price of the option is $100.

In Scenario 1, the stock price declines to $80 at the end of year 1 and subsequently rises to $90 by the end of year 2. Thus, the option expires out-of-the-money. At that point, Company X knows that the final tax basis of the asset is $980.

In Scenario 2, the stock price increases to $110 at the end of year 1 and subsequently rises to $130 by the end of year 2. Thus, the option is exercised resulting in a gain to the employee of $30. At that point, Company X knows that the tax basis of the asset is $1,010.

This issue addresses what, if any, deferred tax accounting should take place prior to the exercise or settlement of the stock option (or vesting date for a share of restricted stock). Given that Statement 123’s method of accounting requires no adjustment of deferred tax balances during the interim period (i.e., between the grant date and settlement date) for changes in stock price, the staff believes that the logical extension of that guidance to capitalized compensation costs would mean that any deferred tax balances would be adjusted only upon expiration or settlement.

Consistent with the view that Statement 109 specifies that temporary differences are measured at the date of the financial statements, the staff believes that the measurement frequency most consistent with Statement 109 would be at each balance sheet date.

**Discussion Question No. 2(b):** Does the Board prefer to remeasure the deferred tax effects of capitalized compensation cost at each balance sheet date during the interim periods prior to settlement or only once at settlement (or vesting for restricted stock)?

**Issue 2(c): An Example of Accounting for Capitalized Compensation Costs**

The staff provided the Board with an example of accounting for capitalized compensation costs and their deferred income tax effects under Scenarios 1 and 2 in Appendix B of this handout.
Discussion Question No. 2(c): Does the Board agree with the accounting in the examples in Appendix B for its preferred method?

Issue 2(d): Application of the Statement 95 Amendment to Capitalized Compensation Costs

The staff prepared an example in Appendix B to illustrate the application of Statement 123’s method and the accounting in the statement of cash flows when compensation costs from EBC awards are capitalized as part of a building that is then depreciated over five years. The staff prepared the example to ensure that the Board is comfortable with the application illustrated.

Discussion Question 2(d)(1): Does the Board agree with the application of Statement 123’s method and the amendment of Statement 95 as illustrated in the staff’s example in Appendix B?

Discussion Question 2(d)(2): Does the Board believe that an illustration like the one mentioned above should be included in the implementation guidance?

ISSUE 3: Deferred Tax Asset Write-Offs Under Certain Circumstances

The staff has identified the following alternatives:

a. Retain the Statement 123 method. Statement 123 requires that the deferred tax asset generated from recognized compensation cost not be assessed for recoverability based on subsequent changes in the stock price from the grant date.

b. Establish a bright-line test. The Board might establish a bright line, for example, when the market price of the stock is some percentage of the exercise price (perhaps, 3 percent). The staff does not recommend this approach for the typical reasons bright lines are not recommended (mainly because they are arbitrary with no empirical support and require more rules to implement).

c. Establish a probability test. The Board might establish a probability test, for example, when the probability of exercise is deemed remote or trivial.

d. Retain the Statement 123 method, but require an annual disclosure of the excess tax benefits and tax benefit deficiencies that would have been recognized at the balance sheet date assuming all outstanding awards had been exercised or otherwise settled at that date based on the then-current stock price.

One of the reasons why the IASB did not support the method of accounting in Statement 123 and the ED was that the deferred tax asset was not subject to any test of recoverability until the settlement date. All assets are subject to some type of impairment test. The staff believes that Alternative (c) is theoretically superior to Alternative (a). Nevertheless, the staff believes that Alternative (c) may have some additional consequences. Paragraph 43 of Statement 123 (and the proposed Statement) states the following:
Statement 109 requires a deferred tax asset to be evaluated for future realization and to be reduced by a valuation allowance if, based on the weight of the available evidence, it is more likely than not that some portion or all of the deferred tax asset will not be realized. Differences between (a) the deductible temporary difference computed pursuant to paragraph 42 and (b) the tax deduction inherent in the current fair value of the entity’s stock shall not be considered in measuring either the gross deferred tax asset or the need for a valuation allowance for a deferred tax asset recognized under this Statement.

The additional consequences relate to the initial measurement of the gross deferred tax asset. In other words, if an enterprise writes off a deferred tax asset to equity (assuming there are sufficient excess tax benefits from prior awards to absorb it) during the pre-vesting period because the probability of exercise is remote based on subsequent changes in stock price from the grant date, the question is whether that enterprise should recognize a deferred tax asset as unrecognized compensation cost that is recognized over the remaining vesting period. If the answer is yes, then an enterprise will have immediate write-offs to equity upon initial recognition. If the answer is no, then an enterprise loses its ability to recognize a tax benefit, resulting in higher after-tax compensation cost in the income statement. Given that a write-off of the deferred tax asset occurs because no future tax consequence is expected, the staff believes the theoretically supportable answer to that question is no. The staff believes that if the Board addresses this issue, the Board also must address how to account for initial measurement of the deferred tax asset related to unrecognized compensation cost that is recognized subsequent to the write-off. The staff believes that the Board also would have to provide some guidance for situations in which the probability of exercise ceases to be remote.

Given the above, the staff believes that the Board might consider the following wording for paragraph 43:

Statement 109 requires a deferred tax asset to be evaluated for future realization and to be reduced by a valuation allowance if, based on the weight of the available evidence, it is more likely than not that some portion or all of the deferred tax asset will not be realized. Differences between (a) the deductible temporary difference computed pursuant to paragraph 42 and (b) the tax deduction inherent in the current fair value of the entity’s stock shall not be considered in measuring either the gross deferred tax asset or the need for a valuation allowance for a deferred tax asset recognized under this Statement except in the following circumstance. If the current fair value of the entity’s stock has deteriorated substantially from the grant date and the probability of its subsequent recovery prior to the equity instrument’s contractual expiration is remote, then any deferred tax asset recognized pursuant to paragraph 42 shall be reduced by a valuation allowance with its offset being recognized according to paragraph 44. If that circumstance arises prior to the completion of the requisite service period, then an enterprise shall not recognize a deferred tax asset and tax benefit for the remaining compensation cost to be recognized. This assessment may be performed only once for each award; that is, if an enterprise subsequently concludes that it is
probable the fair value of the stock will recover prior to the equity instrument’s contractual expiration, it shall not recognize any additional income tax effects until the date of exercise or other settlement pursuant to paragraph 44.

The Board also might consider multiple assessments during the requisite service period and a one-time assessment in the post-requisite service period (or multiple assessments during the post-requisite service period). Thus, if an enterprise concludes that its stock price is probable of recovery prior to the contractual expiration of the equity instrument, it may continue to recognize additional deferred tax benefits during the remainder of the requisite service period. Given that the Board has decided tentatively not to have any interim (i.e., between grant date and exercise date) accounting, the staff believes that fewer assessments are more consistent with that decision.

The staff understands that such guidance, which is intended to apply to a limited number of transactions, may be too broad. The additional proposed guidance has been presented for Board members to consider the following discussion questions.

Discussion Question 3(a): Which alternative does the Board prefer?

Discussion Question 3(b): If the Board prefers alternative (c), does the Board support language presented in the first sentence of the proposed additional guidance in paragraph 43 above or does the Board prefer some other type of probability test?

Discussion Question 3(c): If the Board prefers alternative (c), does the Board agree with the staff that such guidance would affect initial measurement of deferred tax assets related to unrecognized compensation cost? And, if so, does the Board support the language in the second sentence of the additional proposed guidance?

Discussion Question 3(d): If the Board prefers alternative (c), does the Board support a one-time assessment or multiple assessments during the requisite service period?

Discussion Question 3(e): If the Board prefers alternative (c), does the Board support a one-time assessment or multiple assessments during the post-requisite service period?
## Appendix A of Memo No. 85

### Issue 1: Amendment of Stmt 95 & 123 Method

<table>
<thead>
<tr>
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<th>Scenario 1</th>
<th>Scenario 2</th>
<th>Scenario 3</th>
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<tr>
<td>GD FV of Restricted Stock</td>
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<tr>
<td>GD FV of Stock Option</td>
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<tr>
<td>Exercise Price of Stock Option</td>
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<td>$100</td>
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<td>Contractual Life of Stk Option</td>
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<tr>
<td>Vesting</td>
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<td>Excess Tax Benefits from Prior Awards: beg of year 1</td>
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<td>Excess Tax Benefits from Prior Awards: end of year 2</td>
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<tr>
<td>Stock Price at End of Year 2</td>
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<td>$90</td>
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</table>

All journal entries are performed at year-end.

### End of Year 1

**JE #1**

- Compensation Cost - Stock: $100 $100 $100
- Compensation Cost - Stock Option: $20 $20 $20
- APIC: $(120) $(120) $(120)

(To recognize compensation cost)

**JE #2**

- Deferred Tax Asset - Stock: $40 $40 $40
- Deferred Tax Asset - Stock Option: $8 $8 $8
- Deferred Tax Benefit (P&L acct): $(48) $(48) $(48)

(To recognize income tax effects)

**JE #3**

- Deferred Tax Expense - Stock: $40 $40 $40
- Current Tax Payable: $32 $32 $32
- APIC: $8 $8 -
- Deferred Tax Asset - Stock: $(40) $(40) $(40)
- Deferred Tax Expense - Stock: $(40) $(40) $(32)

(To recognize income tax effect of vesting in restricted stock)

### Statement of Cash Flows

**Alternative 1 (UnitOA=Portfolio)**

Cash inflow from operating activities:
- Tax Benefit Deficiency from EBC Arrangement: $8 $8 $ -

Cash outflow from financing activities:
- Tax Benefit Deficiency from EBC Arrangement: $(8) $(8) $ -

**Alternative 2 (UnitOA=EBC Instrument)**

Cash inflow from operating activities:
- Tax Benefit Deficiency from EBC Arrangement: $- $- $ -

Cash outflow from financing activities:
- Tax Benefit Deficiency from EBC Arrangement: $- $- $ -
End of Year 2

**JE #4**

Deferred Tax Expense - Stock Option $8 $8 $8  
Current Tax Payable $- $- $- $-  
APIC $8 $2 $- $-  
  Deferred Tax Asset - Stock Option $-(8) $(8) $(8) $(8)  
  Deferred Tax Expense - Stock Option $-(8) $(2) $- $-  
(To recognize income tax effect of stock option lapse)

**Statement of Cash Flows**

**Alternative 1 (UnitOA=Portfolio)**

Cash inflow from operating activities:  
  Tax Benefit Deficiency from EBC Arrangement $8 $2 $- $-  
Cash outflow from financing activities:  
  Tax Benefit Deficiency from EBC Arrangement $-(8) $(2) $- $-  

**Alternative 2 (UnitOA=EBC Instrument)**

Cash inflow from operating activities:  
  Tax Benefit Deficiency from EBC Arrangement $- $- $- $-  
Cash outflow from financing activities:  
  Tax Benefit Deficiency from EBC Arrangement $- $- $- $-  

Appendix B of Memo No. 85

<table>
<thead>
<tr>
<th>Issue 2: Amendment of Stmt 95 and Cap Comp Cost</th>
<th>Scenario 1</th>
<th>Scenario 1</th>
<th>Scenario 2</th>
<th>Scenario 2</th>
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<tr>
<td>GD FV of Stock Option</td>
<td>$20</td>
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<td>$20</td>
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</tr>
<tr>
<td>Exercise Price of Stock Option</td>
<td>$100</td>
<td>$100</td>
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</tr>
<tr>
<td>Contractual Life of Stock Option</td>
<td>2 years</td>
<td>2 years</td>
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<td>2 years</td>
</tr>
<tr>
<td>Vesting</td>
<td>1 year</td>
<td>1 year</td>
<td>1 year</td>
<td>1 year</td>
</tr>
<tr>
<td>Excess Tax Benefits from Prior Awards: beg of year 1</td>
<td>$100</td>
<td>$100</td>
<td>$100</td>
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</tr>
<tr>
<td>Statutory Tax Rate</td>
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</tr>
<tr>
<td>Stock Price at End of Year 1</td>
<td>$80</td>
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<td>$110</td>
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<tr>
<td>Stock Price at End of Year 2</td>
<td>$90</td>
<td>$90</td>
<td>$130</td>
<td>$130</td>
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</table>

All journal entries are performed at year-end.

Simultaneous Equations Calculation:
- FBB = Final Book Basis
- CPP = Purchase Price $20 (Grant Date Fair Value of Stock Option)
- TB = Tax Basis - $ (Under Issue 98-11 Approach)
- TR = Tax Rate 40%

Beg of Year 1 - Scenario 1 & 2
- FBB - (TR * (FBB - TB)) = CPP
- FBB - (.4 * (FBB - $0)) = $20
- FBB - .4FBB = $20
- .6FBB = $20
- FBB = $33

End of Year 1

**JE #1**
- Compensation Cost (Construction in Process - Asset) $20 $20 $20 $20
- Compensation Cost - 98-11 Gross Up (CIP - Asst) $13 $ - $13 $ -
- Deferred Tax Liability $ (13) $ - $ (13) $ -
- APIC $ (20) $ (20) $ (20) $ (20)

(TO recognize compensation cost and deferred tax effects based on GD FV and simultaneous equations)

(S1 and S2: DTL for Opt ($33-$20))

**JE #2**
- Deferred Tax Liability (($1,013-$990)*.4)=$9.2-$13=$3.8) - $3.8 $ -
- APIC $ - $ - $ (3.8) $ -

(TO adjust DT balances for year end stock change. N/A for S1.)

**JE #3**
- Building (to have SL depr. over 5 years for book and tax ) $1,013.0 $1,000.0 $1,013.0 $1,000.0
- Construction in Process $ (1,013.0) $ (1,000.0) $ (1,013.0) $ (1,000.0)

(TO recognize completed building on 12/31)

**Statement of Cash Flows**

Alternative 1 (UnitOA=Portfolio)
- Cash inflow from operating activities:
  - Tax Benefit Deficiency from EBC Arrangement $ - $ - $ - $ -
- Cash outflow from financing activities:
  - Tax Benefit Deficiency from EBC Arrangement $ - $ - $ - $ -

Alternative 2 (UnitOA=EBC Instrument)
- Cash inflow from operating activities:
  - Tax Benefit Deficiency from EBC Arrangement $ - $ - $ - $ -
- Cash outflow from financing activities:
  - Tax Benefit Deficiency from EBC Arrangement $ - $ - $ - $ -
End of Year 2

JE #4
Deferred Tax Liability (($1,013-$1,010)*.4)=$1.2-$9.2=8) $ - $ - $ 8 $ -
Deferred Tax Asset $ - $ - $ - $ 4
APIC $ - $ - $ 8 $ - $ -
APIC $ - $ - $ - $ (8) $ (4)
Deferred Tax Liability $ - $ - $ (8) $ - $ -
(To recognize income tax effect of stock option lapse (S1) or exercise (S4))
(Note/If Company X did not have prior excess tax benefits, the debit of $8 would go to the income statement)

JE #5
Depreciation Expense - Building $ 202.6 $ 200.0 $ 202.6 $ 200.0
Accumulated Depreciation - Building $ (202.6) $ (200.0) $ (202.6) $ (200.0)
(To recognize annual depreciation expense for building)

JE #6
Deferred Tax Liability ($13,8,1.2/5=$2.6,1.6,.2) $ 2.6 $ 1.6 $ 0.2 $ -
Deferred Tax Expense $ - $ - $ - $ 0.8
Deferred Tax Asset ($4/5=$.8) $ - $ - $ - $ (0.8)
Current Tax Expense $ (2.6) $ (1.6) $ 0.2 $ -
(To recognize annual tax effect from capitalized stock compensation in depreciation)

Statement of Cash Flows
Alternative 1 (UnitOA=Portfolio)
Cash (out)inflow from operating activities:
ETB or TBDA from EBC Arrangement $ - $ 1.6 $ (1.4) $ (0.8)
Cash (out)inflow from financing activities:
ETB or TBDA from EBC Arrangement $ - $ (1.6) $ 1.4 $ 0.8
Alternative 2 (UnitOA=EBC Instrument)
Cash outflow from operating activities:
Excess Tax Benefit from EBC Arrangement $ - $ - $ (1.4) $ (0.8)
Cash inflow from financing activities:
Excess Tax Benefit from EBC Arrangement $ - $ - $ 1.4 $ 0.8

End of Year 3

JE #7
Depreciation Expense - Building $ 202.6 $ 200.0 $ 202.6 $ 200.0
Accumulated Depreciation - Building $ (202.6) $ (200.0) $ (202.6) $ (200.0)
(To recognize annual depreciation expense for building)

JE #8
Deferred Tax Liability ($13,8,1.2/5=$2.6,1.6,.2) $ 2.6 $ 1.6 $ 0.2 $ -
Deferred Tax Expense $ - $ - $ - $ 0.8
Deferred Tax Asset ($4/5=$.8) $ - $ - $ - $ (0.8)
Current Tax Expense $ (2.6) $ (1.6) $ 0.2 $ -
(To recognize annual tax effect from capitalized stock compensation in depreciation)

Statement of Cash Flows
Alternative 1 (UnitOA=Portfolio)
Cash (out)inflow from operating activities:
ETB or TBDA from EBC Arrangement $ - $ 1.6 $ (1.4) $ (0.8)
Cash (out)inflow from financing activities:
ETB or TBDA from EBC Arrangement $ - $ (1.6) $ 1.4 $ 0.8
Alternative 2 (UnitOA=EBC Instrument)
Cash outflow from operating activities:
Excess Tax Benefit from EBC Arrangement $ - $ - $ (1.4) $ (0.8)
Cash inflow from financing activities:
Excess Tax Benefit from EBC Arrangement $ - $ - $ 1.4 $ 0.8
End of Year 4

JE #9
Depreciation Expense - Building $ 202.6 $ 200.0 $ 202.6 $ 200.0
Accumulated Depreciation - Building $ (202.6) $ (200.0) $ (202.6) $ (200.0)
(To recognize annual depreciation expense for building)

JE #10
Deferred Tax Liability ($13,8,1.2/5=2.6,1.6,.2) $ 2.6 $ 1.6 $ 0.2 $ -
Deferred Tax Expense $ - $ - $ - $ - $ 0.8
Deferred Tax Asset ($4/5=0.8) $ - $ - $ - $ - $ (0.8)
Current Tax Expense $ (2.6) $ (1.6) $ 0.2 $ -
(To recognize annual tax effect from capitalized stock compensation in depreciation)

Statement of Cash Flows
Alternative 1 (UnitOA=Portfolio)
Cash (out)inflow from operating activities:
ETB or TBDA from EBC Arrangement $ - $ - $ 1.6 $ (1.4) $ (0.8)
Cash (out)inflow from financing activities:
ETB or TBDA from EBC Arrangement $ - $ - $ (1.6) $ 1.4 $ 0.8

Alternative 2 (UnitOA=EBC Instrument)
Cash outflow from operating activities:
Excess Tax Benefit from EBC Arrangement $ - $ - $ - $ (1.4) $ (0.8)
Cash inflow from financing activities:
Excess Tax Benefit from EBC Arrangement $ - $ - $ - $ 1.4 $ 0.8

End of Year 5

JE #11
Depreciation Expense - Building $ 202.6 $ 200.0 $ 202.6 $ 200.0
Accumulated Depreciation - Building $ (202.6) $ (200.0) $ (202.6) $ (200.0)
(To recognize annual depreciation expense for building)

JE #12
Deferred Tax Liability ($13,8,1.2/5=2.6,1.6,.2) $ 2.6 $ 1.6 $ 0.2 $ -
Deferred Tax Expense $ - $ - $ - $ - $ 0.8
Deferred Tax Asset ($4/5=0.8) $ - $ - $ - $ - $ (0.8)
Current Tax Expense $ (2.6) $ (1.6) $ 0.2 $ -
(To recognize annual tax effect from capitalized stock compensation in depreciation)

Statement of Cash Flows
Alternative 1 (UnitOA=Portfolio)
Cash (out)inflow from operating activities:
ETB or TBDA from EBC Arrangement $ - $ - $ 1.6 $ (1.4) $ (0.8)
Cash (out)inflow from financing activities:
ETB or TBDA from EBC Arrangement $ - $ - $ (1.6) $ 1.4 $ 0.8

Alternative 2 (UnitOA=EBC Instrument)
Cash outflow from operating activities:
Excess Tax Benefit from EBC Arrangement $ - $ - $ - $ (1.4) $ (0.8)
Cash inflow from financing activities:
Excess Tax Benefit from EBC Arrangement $ - $ - $ - $ 1.4 $ 0.8

End of Year 6

JE #13
Depreciation Expense - Building $ 202.6 $ 200.0 $ 202.6 $ 200.0
Accumulated Depreciation - Building $ (202.6) $ (200.0) $ (202.6) $ (200.0)
(To recognize annual depreciation expense for building)

JE #14
Deferred Tax Liability ($13,8,1.2/5=2.6,1.6,.2) $ 2.6 $ 1.6 $ 0.2 $ -
Deferred Tax Expense $ - $ - $ - $ - $ 0.8
Deferred Tax Asset ($4/5=0.8) $ - $ - $ - $ - $ (0.8)
Current Tax Expense $ (2.6) $ (1.6) $ 0.2 $ -
(To recognize annual tax effect from capitalized stock compensation in depreciation)
### Statement of Cash Flows

**Alternative 1 (UnitOA=Portfolio)**

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<thead>
<tr>
<th>Cash (out)inflow from operating activities:</th>
<th></th>
<th></th>
<th>1.6</th>
<th>(1.4)</th>
<th>(0.8)</th>
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<tr>
<td>ETB or TBDA from EBC Arrangement</td>
<td>$</td>
<td>-</td>
<td>$</td>
<td></td>
<td></td>
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<tr>
<td>Cash (out)inflow from financing activities:</td>
<td></td>
<td></td>
<td>(1.6)</td>
<td>1.4</td>
<td>0.8</td>
</tr>
<tr>
<td>ETB or TBDA from EBC Arrangement</td>
<td>$</td>
<td>-</td>
<td>$</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Alternative 2 (UnitOA=EBC Instrument)**

<table>
<thead>
<tr>
<th>Cash outflow from operating activities:</th>
<th></th>
<th></th>
<th>(1.4)</th>
<th>(0.8)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Excess Tax Benefit from EBC Arrangement</td>
<td>$</td>
<td>-</td>
<td>$</td>
<td></td>
</tr>
<tr>
<td>Cash inflow from financing activities:</td>
<td></td>
<td></td>
<td></td>
<td>1.4</td>
</tr>
<tr>
<td>Excess Tax Benefit from EBC Arrangement</td>
<td>$</td>
<td>-</td>
<td>$</td>
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</table>
At today’s meeting, the Board will discuss whether to accept a staff recommendation for amending the requirement in paragraph 27 of FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, for isolation of transferred financial assets.

**Background**

At the August 11, 2004 meeting, the Board considered a recommendation that it adopt an approach that would deem that a financial asset has been isolated from a transferor if a transaction meets the criteria for a true sale at law and the entity to which the assets were transferred would not be substantively consolidated with the transferor by a receiver or bankruptcy court (a nonconsolidation opinion). The Board did not make any decisions on that issue until it could further consider a proposal that would define the isolation requirement in paragraphs 9(a) and 27 in a manner consistent with a legal true sale and nonconsolidation opinion and provide implementation guidance that would describe the characteristics of a true sale for portions of financial assets.

The Board directed the staff to provide further analysis of the proposed implementation guidance using the characteristics identified at the roundtables held in May and June for a true participation and an additional requirement that transfer agreements state that the benefits from a transferor setoff must be passed through to the transferee on a pro rata basis. Lastly, the Board directed the staff to explore whether the guidance should be provided as an example or should be articulated as a requirement that could be applied to all transactions.

The criteria that attorneys would be expected to require in a one-step transfer to render a legal opinion that a transfer is a true sale and that the transferred financial assets would not be deemed under applicable laws in the U.S. to be part of the estate of the transferor or its consolidated affiliates in bankruptcy or receivership have been identified as follows:

1. The transferor has not provided a guarantee of repayment or other form of recourse that would be inconsistent with a true sale at law.
2. The transfer purports to be a sale of a property interest in the underlying financial assets.

3. The interest holder’s interest in the financial assets has the same remaining duration as the underlying financial assets.

4. If the transferor continues to act as a servicer of the financial assets or if the interest holder does not obtain the right to directly enforce the underlying financial contracts, the transferor agrees to:
   a. Act in a custodial capacity (on behalf of or in trust for the participant) with respect to its holding of any underlying instrument or collateral and in holding any proceeds received for the underlying financial assets
   b. Not commingle for any significant period of time proceeds received on the underlying financial assets
   c. Directly pass through any proceeds received from the financial asset to the interest holder, less any proceeds that represent servicing or other compensation to the transferor or an interest in the financial assets retained by the transferor
   d. Administer the financial assets under a standard that does not give it unfettered discretion as to all matters.

Questions for the Board

Isolation

1. Should the implementation guidance relating to isolation be amended to better define isolation in a manner that is consistent with a true sale at law and nonconsolidation opinion?

2. Should language that describes the conditions the Board would expect attorneys to require before issuing the necessary opinions be included in Statement 140? Should those conditions be required to meet the isolation requirement even if an attorney would issue the appropriate opinions without them?

3. Should recourse to the transferor be left to an attorney’s professional judgment based on the facts and circumstances of the transaction or should it be prohibited in all circumstances?

Setoff

4. Should a requirement that a transferor must pass through any benefits it receives by exercising setoff on transferred assets to other parties holding interests in the set off assets be adopted in order for the transaction to be accounted for as a sale?
The Board will be asked to: 1) clarify its decision at the August 4, 2004 Board meeting regarding the election to subsequently measure servicing rights at fair value on a class-by-class basis and 2) decide on disclosure requirements related to separately recognized servicing rights.

**CLARIFICATION OF THE DECISION MADE AT THE AUGUST 4, 2004 BOARD MEETING**

The staff would like to confirm the Board’s decision that the election to use fair value is irrevocable, and it would like to obtain clarification about whether the election should be made once upon adoption of this guidance or once at any point in time on or after adoption.

The staff recommends that the election be made once at any point in time on or after the adoption of this guidance.

**RECOMMENDED DISCLOSURES**

The following represent the proposed disclosure requirements that reflect the recommendations made by the staff. The staff suggests that these disclosures take the place of paragraph 17(e) of Statement 140.

**Servicing Rights Subsequently Measured at Fair Value**

1. The classes of servicing assets and servicing liabilities subsequently measured at fair value and management’s rationale for its decision to subsequently measure these classes of servicing assets and servicing liabilities at fair value

2. The activity in the balance of each class of servicing assets and servicing liabilities—including the beginning and ending balances, additions (through...
purchase or asset transfer at their initial fair value), disposals, and change in fair value during the period from a) disposition at fair value, b) payment on the underlying assets, and c) change in the valuation inputs—for each period for which results of operations are presented.

3. The unrealized gain or loss on the servicing assets and servicing liabilities at the beginning and end of the period.

4. The fair value of the instruments used to manage the risks inherent in servicing rights (offset the impact on operations of a change in fair value of the servicing rights), including a description of the risks being managed, at the beginning and end of the period.

5. A description of the valuation techniques used to estimate fair value of the servicing rights and instruments used to manage the risks inherent in servicing rights (including the methodology and model validation techniques) as well as quantitative and qualitative information about the inputs used in the model (discount rates, prepayments).

6. A sensitivity analysis or stress test showing the hypothetical effect on the fair value of each class of the servicing rights, as well as the instruments used to manage the risks inherent in these assets and liabilities, of two or more unfavorable variations from the expected levels for each key assumption that is reported under (5) above independently from any change in another key assumption, and a description of the objectives, methodology, and limitations of the sensitivity analysis or stress test.

7. The composition of the servicing income (expense)—including servicing fees, changes in fair value of servicing rights, and the instruments used to hedge the servicing assets and liabilities—reported in operations during the period and a description of where these amounts are reported in the statement of income.

Servicing Rights Subsequently Measured at LOCOM

1. The classes of servicing assets and servicing liabilities not subsequently measured at fair value and management’s rationale for its decision not to
subsequently measure these classes of servicing assets and servicing liabilities at fair value

2. The activity in the balance of each class of servicing assets and servicing liabilities—including the beginning and ending balances, additions (through purchase or asset transfer at their initial fair value), amortization, disposals, and impairment (recoveries)—for each period for which results of operations are presented

3. The fair value of recognized servicing assets and servicing liabilities at the beginning and end of the period for which it is practicable to estimate that value and the unrealized gain or loss on the servicing assets and servicing liabilities at the beginning and end of the period

4. The fair value of the instruments used to manage the risks inherent in the servicing rights (offset the impact on operations of a change in fair value of the servicing rights), including a description of the risks being managed, at the beginning and end of the period

5. A description of the valuation techniques used to estimate fair value of the servicing assets and servicing liabilities and the instruments used to manage the risks inherent in servicing rights (including the methodology and model validation techniques) as well as quantitative and qualitative information about the inputs used in the model (discount rates, prepayments)

6. The risk characteristics of the underlying financial assets used to stratify recognized servicing assets for purposes of measuring impairment in accordance with paragraph 63

7. The activity in any valuation allowance for impairment of recognized servicing assets—including beginning and ending balances, aggregate additions charged and recoveries credited to operations, and aggregate direct write-downs charged against the allowances—for each period for which results of operations are presented

8. A sensitivity analysis or stress test showing the hypothetical effect on the fair value of each class of the servicing rights, as well as the instruments used to manage the risks inherent in these assets and liabilities, of two or more
unfavorable variations from the expected levels for each key assumption that is reported under (5) above independently from any change in another key assumption, and a description of the objectives, methodology, and limitations of the sensitivity analysis or stress test.

9. The composition of the servicing income (expense)—including servicing fees, amortization and impairment of servicing rights, and change in fair value of the instruments used to hedge the servicing assets and servicing liabilities—reported in operations during the period and a description of where these amounts are reported in the statement of income.