MINUTES

To: Board Members

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

Subject: Minutes of the March 28, 2007 Board Meeting (Short-Term Convergence**—** Earnings per Share)

Date: April 6, 2007

cc: FASB: Smith, Bielstein, MacDonald, Chookaszian, Polley, Lott, Carney, Golden, Project Team, Carnrick, Sutay, Allen, Gabriele, FASB Intranet; IASB: Upton, Singleton

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: Memorandums No. 10 and No. 11, dated March 8, 2007

Length of Discussion: 9:00 to 9:40 a.m.

Attendance:

Board members present:	Herz, Seidman, Trott, Crooch, and Young
Board members absent:	Batavick and Linsmeier (by phone)
Staff in charge of topic:	J. Sarno
Other staff at Board table:	Staniszewski, Bielstein, Cassel, and Sarno
Outside participants:	IASB staff (by phone)

Summary of Decisions Reached:

The Board discussed the remaining issues that need to be addressed in order to achieve convergence between FASB Statement No. 128, *Earnings per Share,* and IAS 33, *Earnings per Share*. In discussing the remaining issues, the Board decided the following:

1. Instruments that can be settled in cash or shares, are classified as a liability, and are marked-to-market (in their entirety) each reporting period with gains and losses recognized in earnings should no longer be subject to (a) the treasury stock method (including fully and partially vested share-based payment awards), (b) the if-converted method, or (c) the two-class method. That is, the Board decided that the change in fair value recognized in earnings captures the dilutive effect of those instruments, eliminating the need to include such instruments in the determination of diluted earnings per share (EPS).

2. The treasury stock method should be modified for all instruments subject to that method that are not remeasured at fair value each reporting period. The modified treasury stock method would (a) include the end-of-period value of the liability as an assumed proceed (if applicable) and (b) use the end-of-period market price in computing the number of incremental shares to be included in the determination of diluted EPS.

3. As a result of the modifications to the treasury stock method, instruments classified as a liability (but are not remeasured fair value) that will be settled by issuing an equal value of equity instruments for the carrying value of the liability will have no effect on the diluted EPS calculation.

4. Questions in practice regarding the (a) clarification of the definition of participating securities to forward contracts or (b) application of the two-class method to master limited partnerships will not be addressed in the convergence project. The Board will consider the need to provide application guidance at a later date.

5. The guidance in proposed FASB Staff Position (FSP) FAS 128-a, "Computational Guidance for Computing Diluted EPS under the Two-Class Method," will be

codified into Statement 128 through the convergence project rather than being issued in the form of an FSP.

6. Statement 128 will be amended to clarify that convertible participating securities are included in basic EPS using the two-class method—essentially codifying the requirement in Issue 7 of EITF Issue No. 03-6, “Participating Securities and the Two-Class Method under FASB Statement No. 128”.
7. The Board refined its past decision regarding mandatorily convertible instruments that should be included in basic earnings per share using the two-class method. The Board decided that only those instruments that could participate in current period earnings with common shareholders should be reflected in basic EPS using the two-class method. That is, if the mandatorily convertible instrument holders would receive additional consideration (above their otherwise contractual return) solely as a result of distributions made to common shareholders, then and only then would the instrument be considered a participating security and, therefore, included in basic EPS using the two-class method.
8. Options and warrants with nominal exercise prices should be included in the computation of basic EPS if either of the following conditions is met: (a) the instrument is currently exercisable or convertible into common shares for little or no cost to the holder of the instrument, or (b) the instrument can presently participate in earnings with common shareholders. If the latter condition is met the instrument would be included in basic EPS using the two-class method.

Objective of Meeting:

The objective of this meeting was to resolve the remaining issues that need to be addressed in order to achieve convergence between IAS 33 and Statement 128. The objective of the meeting was accomplished. The Board directed the staff to proceed to drafting a third Exposure Draft on amendments to Statement 128 incorporating the tentative decisions reached at this and prior Board meetings.

Matters Discussed and Decisions Reached:

1. Mr. Sarno began the meeting by noting that the purpose was to discuss the remaining issues that need to be addressed in order to achieve convergence between IAS 33 and Statement 128. He also noted that the staff's intent was to present the Board with (a) converged solutions on instruments that can be settled in cash or shares and are classified as liabilities on an entity's balance sheet and (b) its recommendations on other potential issues that might be addressed in the short-term convergence project.

Intruments That Can Be Settled in Cash or Shares

2. Mr. Sarno noted that the first issue relates to instruments that can be settled in cash or shares, are classified as a liability, and are marked-to-market (in their entirety) with gains or losses recognized in earnings for each reporting period. Those instruments should no longer be subject to (a) the treasury stock method (including fully and partially vested share-based payment awards), (b) the if-converted method, or (c) the two-class method in the computation of diluted EPS. Mr. Sarno stated that it was the staff's belief that recognizing the effects in earnings from remeasuring such instruments at fair value is a better reflection of the dilutive effects of potential common shares for instruments that can be settled in cash or shares and are classified as liabilities. Therefore, the staff recommended that the Board amend Statement 128 to exclude from the computation of diluted EPS any instrument that can be settled in cash or shares that is classified as a liability and is marked to fair value each reporting period.

3. Mr. Sarno observed that at the prior week's IASB Board meeting, the IASB Board members agreed with their staff's recommendations to exclude all instruments that can be settled in cash or shares, are classified as a liability, and are marked-to-market (in their entirety) with gains and losses recognized in earnings for each reporting period from the computation of diluted EPS. That includes instruments that are subject to (a) the treasury stock method (including partially and fully vested share-based payment awards), (b) the if-converted method, or (c) the two-class method. Mr. Sarno asked the Board if it agreed with

the staff's recommendation that use of the fair value measurement for all instruments (including share-based payment awards) that can be settled in cash or shares and are classified as a liability on an entity's balance sheet with changes in fair value recognized at each reporting period through the income statement negates the need to include such instruments in determining EPS.

4. Mr. Young noted that he agrees with the staff recommendation on the fair value treatment for most items that are fair-valued through earnings, but he does not agree with using the fair value method for convertible instruments. The fair value adjustments do appear to reflect the current economics for the reporting period, and if stewardship were the staff's objective, the proposed method would achieve that objective. However, Mr. Young stated that his belief of the objective for convertible instruments in diluted EPS should be providing information for projecting future earnings and future cash flows. The if-converted method is superior from an investor's standpoint in achieving that objective. He also noted that he believes there is a simplier way to approach this matter. It appears that what the staff is really proposing is the modified treasury stock method. Mr. Young suggested simplifying the approach by using only the modified treasury stock method. He stated that there is information content for forward earnings forecasting that is provided by adjusting the numerator and denominator. That will be of value to investors. Mr. Young reiterated that he does not disagree that the fair value method captures the economics of the current period, but that he believes that the objective of diluted EPS is to provide for forward looking forecasts.

5. Mr. Sarno replied by stating that the objective for both basic and diluted EPS computations in Statement 128 is to measure the performance of an entity over a reporting period. Forward looking forecasts are not the current stated objective of Statement 128. Disclosures may provide information content to users about what may potentially happen in the future, but this convergence project is focused on the current objective of EPS (that is, measuring the performance of an entity over a period of time.) Mr. Sarno believes the fair value method achieves that objective.

6. Mr. Young stated that he finds the diluted computation in Statement 128 as being a potential share count, which is a future event. Mr. Young does not believe the fair value method takes into account future events, and he believes it would be better to get rid of diluted EPS than to go with the current proposed method (fair value method). Mr. Young reiterated that he believes diluted EPS is forward looking, not just a stewardship approach to what happened in the quarter. Mr. Trott stated that EPS is a metric to measure what has happened in the quarter. Mr. Young replied that he believes diluted EPS is a future concept of potential shares.

7. Ms. Seidman stated that the issue seems to be whether or not diluted EPS for these instruments (convertibles) should be accounted for under the fair value method. She noted that if one is accounting for an adjustment in the numerator, the question would be if one should account for an adjustment in the denominator. Mr. Young noted that he would like to account for convertible instruments by requiring an adjustment to the numerator and the denominator. His argument was in favor of reporting the gross amount of shares that the convertible instrument would have included in the denominator for purposes of future forecasts. He does not believe that a fair value adjustment will help in determining future cash flows. Mr. Trott explained that it might not be possible to determine if the instrument will be settled in equity or cash to require an accurate adjustment to the denominator.

8. Mr. Herz noted that this issue is in line with the same issues the Board dealt with in the liability and equities project. He noted that the determination of whether or not an instrument is equity or liability is a bigger issue outside of the EPS project. It is understandable that an analyst may want to predict the future earnings and cash flows, taking into account the number of shares that are likely going to be there at some point in time in the future. For in-the-money convertibles treated as a liability, the numerator adjustment does not appear to have a lot of substance. If it is pretty certain that a convertible instrument is going to be converted, it should be treated as equity. However, Mr. Herz reiterated that there appears to be a bigger problem with accounting, not something within the scope of this project.

9. Mr. Sarno noted that the issue seems to be whether the disclosure being looked for is gross shares. He stated that gross shares are not being accounted for currently under the treasury stock method with options or warrants. Mr. Herz stated that there would have to be a table that illustrated the total number of potential shares that could be exercised or converted in the future. Mr. Sarno stated that a table would provide the maximum dilution computation, and that *that* was considered in Statement 128 but rejected.

10. Mr. Leisenring stated that Mr. Young's objective seems to be showing the structure of how many shares could be issued using some type of matrix model. He noted that there has never been a fully diluted EPS model under Statement 128. Mr. Trott noted that he would not consider EPS an accounting concept; if anything, it is an analyst concept.

11. The Board voted in favor of the staff's recommendation in a 6 to 1 majority vote. Mr. Young dissented to the use of the fair value method for convertible instruments, but agreed with the staff's recommendation to use the fair value method for instruments subject to the treasury stock method and the two-class method.

12. Mr. Sarno stated that given that the Board agrees with the prior staff recommendation, the staff is planning on drafting the revisions to Statement 128 to exclude these instruments from the scope of Statement 128 with an observation that the instruments would not be dilutive or subject to special provisions of the two-class method. He asked if the Board agreed with the proposed drafting.

13. Ms. Seidman brought up a minor point that the guidance provided in the standard should state that the instruments will have no effect on diluted EPS, rather than excluding the instruments from the scope. She clarified that her comment is more of a drafting preference, and Mr. Sarno agreed with her position. The Board agreed with Ms. Seidman's point and decided to leave the issue up to the staff when it drafts the guidance.

Modified Treasury Stock Method

14. Mr. Sarno noted the next issue the staff would like to discuss is proposed modifications to the treasury stock method. The staff recommended the use of a modified treasury stock method for all instruments that are required to use the treasury stock method and not marked to fair value at each reporting period. The modified treasury stock method would (a) include the end-of-period carrying value of the liability as an assumed proceed (if applicable) and (b) use the end-of-period market price in computing the number of incremental shares to be included in the diluted EPS calculation. Mr. Sarno explained that this method would achieve consistency in the computation of the treasury stock method by assuming that the hypothetical exercise of the award and the hypothetical repurchase of the treasury shares would occur on the last day of the period.

15. Further, Mr. Sarno stated that if the Board agrees with the modifications to the treasury stock method, then the staff proposes excluding from the scope of Statement 128 and the computation of diluted EPS all instruments that are classified as a liability (not marked-to-market) and will be settled by issuing an equal value of shares for the current carrying value of the liability. He noted that these instruments will always result in no dilution under the modified treasury stock method.

16. Mr. Sarno observed that IASB Board members agreed with their staff's recommendations to modify the treasury stock method for all instruments that are required to use the treasury stock method and are not marked to fair value at each reporting period to (a) include the end-of-period carrying value of the liability as an assumed proceed and (b) use the end-of-period market price in computing the number of incremental shares to be included in the diluted EPS calculation. Additionally, the IASB Board members also agreed with their staff's recommendation to exclude from the computation of diluted EPS instruments that otherwise would be subject to the treasury stock method but are classified as a liability (and not marked-to-market) and will be settled by issuing an equal value of shares for the current carrying value of the liability. Mr. Sarno asked if the

Board agreed with the staff's recommendation to modify the treasury stock method for all instruments subject to the treasury stock method that are not marked to fair value at each reporting period.

17. Mr. Young stated that he did not think that the fair value method is needed. Using the modified treasury stock method will give the same answer, and it will simplify the current recommendation of having two methods. Mr. Sarno noted that the staff is not creating a new method. The name "fair value method" is only describing the characteristics of the instruments that will be affected. He noted that it will end up being a drafting issue (in the scope paragraph of Statement 128 or in the exception paragraph that talks about the treasury stock method). Mr. Cassel clarified that the fair value method would apply to instruments subject to the if-converted and the two-class methods, whereas the modified treasury stock method would apply only to instruments subject to the treasury stock method. The end result, however, may be the same.

18. Mr. Trott stated that he agrees with the staff recommendations, but he likes the idea of not scoping out the instruments from Statement 128. He agrees with Ms. Seidman's previous comment in that the paragraphs should be modified to provide guidance on how the diluted computations will be handled. Mr. Trott raised an issue related to the quarterly and year-to-date calculations. He asked if the quarters were going to add up to the year-to-date amounts under the proposed method. Mr. Herz noted that the four quarters will not add up because the computations will be at the end of each period. Mr. Herz noted that he would like to leave the issue of drafting up to the staff. All of the Board members agreed with the staff's recommendation.

19. Mr. Sarno asked if the Board agreed with the staff recommendation to exclude from the scope of Statement 128 and the computation of diluted EPS instruments that otherwise would be subject to the treasury stock method but are classified as a liability (and not marked-to-market) and will be settled by issuing an equal value of shares for the current carrying value of the liability. The Board voted

unanimously in favor of the staff's recommendation and it reiterated to leave the scoping issues to the staff's drafting.

Scoping Issues and Potential Agenda Items

20. Mr. Sarno stated that the next set of issues are related to the computation of EPS. The staff has received several inquiries relating to the application of Statement 128 in certain situations. Mr. Sarno noted that although the questions are valid, the staff concluded that the issues regarding (a) clarification of the definition of participating securities to forward contracts and (b) application of the two-class method to master limited partnerships do not relate to existing differences between IAS 33 and Statement 128. Therefore, the staff proposed that these issues not be addressed as part of the convergence project.

21. Mr. Sarno observed that the IASB Board members agreed with their staff's recommendation not to address these issues in their amendments to IAS 33 as part of the convergence project. Mr. Sarno asked if the Board agreed with the staff recommendation that the convergence project should not address these practice issues. The Board voted unanimously in favor of the staff's recommendation.

22. Mr. Sarno noted that the next set of issues relating to the computation of EPS have been addressed or are in the process of being addressed by the FASB. The guidance (or the potential guidance) on the computation of EPS interprets provisions of Statement 128 that are currently converged with IAS 33, and the staff believes that guidance is an acceptable interpretation of both of those standards. That guidance includes (a) Issue 2 of Issue 03-6 on the definition of a participating security, (b) Issues 3–6 and Issue 8 of Issue 03-6 on the computation of EPS using the two-class method, (c) proposed FSP EITF 03-6-a, "Determining Whether Instruments Granted in Share-Based Payment Transactions Are Participating Securities," on the definition of a participating security to an unvested share-based payment award, (d) EITF Issue No. 04-8, "The Effect of Contingently Convertible Instruments on Diluted Earnings per Share," on contingently convertible instruments, and (e) proposed FSP FAS 128-a on the computation of diluted EPS using the two-class method.

23. Mr. Sarno stated that if the Board agrees with the staff's interpretation that this guidance (or potential guidance) does not create a convergence difference between Statement 128 and IAS 33, then the staff also would recommend codifying the guidance included in proposed FSP FAS 128-a into the convergence project and not issuing the final FSP. He observed that the IASB Board members agreed with their staff's recommendation that the guidance previously mentioned does not create a convergence difference between Statement 128 and IAS 33. The IASB also agreed not to include this guidance in their amendments to IAS 33 as part of the convergence project. They did agree, however, to include in their amendments to IAS 33 the guidance in proposed FSP FAS 128-a.

24. Mr. Sarno asked the Board if it agreed with the staff recommendation that the above guidance (or potential guidance) does not create a convergence difference between Statement 128 and IAS 33? The Board voted unanimously in favor of the staff's recommendation. The Board also voted unanimously in favor of the staff's recommendation not to finalize the guidance in proposed FSP FAS 128-a and to codify that guidance into the convergence project.

25. Mr. Sarno stated that the next issue the staff would like to discuss relates to Issue 7 of Issue 03-6. The staff recommended amending Statement 128 to clarify that convertible participating securities are included in basic EPS using the two-class method. This recommendation would essentially codify the requirement in Issue 7 of Issue 03-6 regarding the applicability of the two-class method to a convertible participating security. He observed that the IASB Board members agreed to amend IAS 33 to clarify that convertible participating securities are included in basic EPS using the two-class method. The Board voted unanimously in favor of the staff's recommendation.

Mandatorily Convertible Instruments

26. Mr. Sarno stated that the final topic deals with mandatorily convertible instruments. He noted that the FASB Exposure Draft, *Earnings per Share,* required that these instruments be included in basic EPS on the date the conversion becomes mandatory using the if-converted method. As part of the comment letter analysis and redeliberations of this project, the staff recommended using the two-class method rather than the if-converted method. Further, he noted that the staff wanted to clarify its intent when recommending the use of the two-class method for mandatorily convertible instruments. The staff recommended that the Board require the use of the two-class method for mandatorily convertible instruments that could participate in current period earnings with common shareholders. For those mandatorily convertible instruments that do not participate in current period earnings with common shareholders, the staff recommended not including those instruments in the computation of basic EPS. Said differently, if the mandatorily convertible instrument holders would receive additional consideration (above their otherwise contractual return) solely as a result of distributions made to common shareholders, then, and only then, would the instrument be considered a participating security and included in basic EPS using the two-class method. If the mandatorily convertible instrument would not receive additional consideration as a result of distributions made to common shareholders, then the mandatorily convertible instruments would not be considered a participating security and would not be included in basic EPS using the two-class method.

27. Mr. Sarno observed that the IASB Board members agreed with their staff's recommendation to amend IAS 33 to require the two-class method for computing basic EPS for mandatorily convertible instruments with a stated participation right. Mandatorily convertible instruments without a stated participation right should be excluded from the calculation of basis EPS.

28. Mr. Sarno asked if the Board agreed with the staff's recommendation to provide guidance on the method to be used to include mandatorily convertible instruments

in basic EPS. The Board voted unanimously in favor of the staff's recommendation.

29. Mr. Sarno noted that given that the Board agreed with the staff's prior recommendation on mandatroily convertible instruments, he stated that the staff is also recommending to include options or warrants with nominal exercise prices in the computation of basic EPS if either of the following conditions are met: (a) the instruments are currently exercisable into common shares for little or no cost to the holder of the instrument or (b) the instruments can presently participate in earnings with common shareholders (the latter would be included in basic EPS using the two-class method).

30. Mr. Sarno observed that the IASB Board members agreed with their staff's recommendation to amend IAS 33 to include options and warrants with a nominal exercise price in the computation of basic EPS if (a) the instruments are currently exercisable into ordinary shares for little or no cost to the holder or (b) the option or warrant currently participates in earnings with ordinary shareholders. The latter is included in basic EPS using the two-class method. None of the Board members objected to the staff's recommendation.

Issuing Another Exposure Draft

31. Mr. Sarno noted that, based on the conclusions reached at the meeting, the staff is recommending issuing another Exposure Draft. The Board agreed to have the staff to start drafting another Exposure Draft, which would be an amendment to Statement 128.

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

32. The Board directed the staff to proceed drafting another Exposure Draft.

General Announcements:

33. Mr. Herz commented that Mr. Young's statements brought up an issue that may apply to the financial statement presentation project. He recommended that the staff research how information about shares will be presented in the financial statement presentation project. The objective will be to determine if share information will be transparent for users to make informed decisions. Ms. Seidman noted that it may be a good starting point to analyze the disclosure requirements in Statement 128 and FASB Statement No. 129, *Disclosure of Information about Capital Structure*. Mr. Herz agreed with Ms. Seidman and noted that the current requirements are not transparent. Ms. Bielstein stated that the staff will begin to research the disclosure requirements under Statements 128 and 129.