



Board Meeting Handout

Short-Term Convergence—Earnings per Share

January 23, 2008

The purpose of this handout is to identify and address the issues that have arisen in drafting the proposed Statement on the amendments to FASB Statement No. 128, *Earnings per Share*. Specifically, the staff intends to discuss:

1. The basis for the Board's decision to exclude from the denominator of diluted earnings-per-share (EPS) instruments that are measured at fair value with changes in fair value recognized in earnings each reporting period
2. The meaning of fair value in the context of financial instruments (or contracts) within the scope of FASB Statement No. 123 (revised 2004), *Share-Based Payment*
3. The Board's request for the staff to consider whether additional disclosures should be made for instruments subject to the *fair value method*.

Instruments That Can Be Settled in Cash or Shares and Are Measured at Fair Value with Changes in Fair Value Recognized in Earnings for the Reporting Period

In drafting the preballot draft, the FASB staff included what it believes is the IASB's and the FASB's rationale for excluding from the denominator of diluted EPS instruments that can be settled in cash or share and are measured at fair value with changes in fair value recognized in earnings for the reporting period. Those reasons include the following:

1. The changes in fair value recognized in earnings reflect the economic effect of these instruments on current shareholders. Excluding these instruments from the computation of EPS also satisfies the Board's objective of simplifying EPS.
2. The inclusion of the carrying value of a liability that is measured at fair value with changes in fair value recognized in earnings in computing incremental shares under the modified treasury stock and reverse treasury stock methods will **always** be antidilutive, therefore why not eliminate these instruments from the computation of EPS?

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The staff determined that the second reason may not always be true under the reverse treasury stock method, specifically when the fair value of the instrument is less than the intrinsic value of the option (or embedded option). Because measuring a liability at fair value, as defined in FASB Statement No. 157, *Fair Value Measurements*, requires consideration of the entity's creditworthiness, it may be possible for the fair value of an instrument to be less than its intrinsic value. The situation in which an instrument may have been dilutive under the treasury stock, reverse treasury stock, or if-converted methods is not limited to written put options. The fair value of an instrument may be subject to a multitude of different variables (for example, interest rates, credit risk, probabilities, and liquidity risk) that may result in the fair value of the instrument being less than its intrinsic value.

The staff believes that the FASB ultimately decided to adopt the fair value method because the changes in the fair value of those instruments reflect the economic effect of those instruments on current shareholders for the reporting period. The Board also reasoned that excluding those instruments from diluted EPS represented a more realistic picture of the effect of those instruments on current shareholders because the fair value method does not assume one or more hypothetical transactions (for example, the treasury stock method assumes the exercise of all in-the-money options and the subsequent repurchase of shares from the proceeds of those exercises) and it would simplify the computation of diluted EPS.

The staff would like to confirm that the FASB's view on the fair value method would not change because the inclusion of the carrying value of a liability (that is marked-to-market each reporting period) as an assumed proceed in the treasury stock and reverse treasury stock methods will not always be antidilutive. If Board members' views change, then the staff believe that the IASB and FASB will need to further discuss modifications and adjustments to the computation of diluted EPS. The staff believes that modification(s) would have the effect of reducing the simplicity that the staff intended through the use of the fair value method.

Question 1—*Does the fact that including the carrying value of a liability (that is marked-to-market each reporting period) as an assumed proceed in the treasury stock and reverse treasury stock methods may not always be antidilutive change your view that an entity should use the fair value method for instruments measured at fair value with changes in fair value recognized in earnings for the reporting period?*

The staff also is proposing to clarify that a financial instrument or contract subject to Statement 123(R) that is recognized (or would be recognized upon satisfaction of a performance or service condition) as a liability and measured under that Statement's fair-value-based measurement approach would be considered to be recognized at fair value for purposes of applying the proposed Statement.

Question 2—*Do you agree with the staff's proposed clarification of fair value for share-based payment awards subject to Statement 123(R)?*

Additional Disclosures for Instruments Subject to the Fair Value Method

Don Young and Stephen Cooper requested that the staff develop a disclosure that would enable a user to compute diluted EPS in accordance with the methods required by IAS 33, *Earnings Per Share*, and Statement 128 for instruments that are not measured at fair value (that is, the treasury stock method, reverse treasury stock method and the if-converted method). Separately, Stephen Cooper requested the staff develop a disclosure that would enable users to compute diluted EPS in a manner different from what is currently required by IAS 33 and Statement 128. Those alternatives are as follows:

Alternative 1: Disclose Information Necessary to Compute Diluted EPS under Previous Methods

Messrs. Young and Cooper believe that the objective of diluted EPS is to enable users to project future share issuances. Because the denominator of the diluted EPS computation would no longer be adjusted for the incremental number of shares issuable upon exercise or conversion of instruments that are measured at fair value through profit or loss, the objective of the disclosure proposed by Messrs. Young and Cooper is to provide enough

information to enable users to compute diluted EPS using the treasury stock, reverse treasury stock, and if-converted methods for these instruments.

Alternative 2: Disclose the Fair Value of All Instruments

Mr. Cooper has suggested that many financial analysts would prefer to compute diluted EPS differently than the method required in IAS 33 and Statement 128; he believes that there is an approach to computing diluted EPS that would be simpler and provide more decision-useful information to users of financial statements. Mr. Cooper acknowledges that a fundamental review of the computation of diluted EPS is beyond the scope of the short-term convergence project. However, he believes that an improved disclosure could assist those users who would prefer to apply this approach. This objective could be satisfied by requiring an entity to disclose the fair value of all options, warrants, and conversion options embedded in convertible instruments.

Staff Recommendation

The staff does not believe that any of the proposed disclosures should be required as part of the Board's short-term convergence project. The Boards have decided that the changes in fair value of those instruments reflect the economic effect of those instruments on current shareholders for the period and, therefore, no further adjustment to the denominator of diluted EPS is necessary.

The staff is also concerned that the proposed disclosures would neutralize the simplification of the calculation of diluted EPS that is intended by the proposed fair value method. The disclosures would require the preparer to perform a calculation of diluted EPS as if the standards had not been simplified. In effect, an entity will be reporting diluted EPS on the face of the financial statements in one manner and reporting it (or information for a user to compute incremental shares) differently in the disclosures. In addition, the disclosures may provide misleading information if incremental shares (or information for a user to compute incremental shares) are disclosed because those shares could have been antidilutive under the previous methods. Additionally, the staff has not

had the opportunity to evaluate the benefits and costs of requiring the disclosure suggested by Mr. Cooper.

The staff recommends asking constituents in the Exposure Draft whether (a) they agree with the basis for conclusions for excluding instruments that are measured at fair value through profit or loss from the denominator of an EPS computation and (b) additional information should be provided in a disclosure for these instruments and why.

Question 3: Does the Board agree with the staff's recommendation regarding disclosures?



Board Meeting Handout

ACCOUNTING FOR TRADING INVENTORY

January 23, 2008

PURPOSE

The purpose of the meeting is for the Board to discuss whether to issue an exposure draft on accounting for trading inventory. The Board will discuss (a) alternatives for determining the scope of a proposed FSP to amend ARB No. 43, *Restatement and Revision of Accounting Research Bulletins*, to require fair value accounting for certain inventory, (b) disclosure requirements related to transferring of inventory from production activities to trading activities and vice versa, and (c) transition.

ALTERNATIVES:

Alternative 1: Trading plus readily determinable fair value.

This alternative amends paragraph 17 of ARB 43 to require mark-to-market accounting if the entity is trading the item **and** the item has a readily determinable fair value.

Alternative 1a: Trading, no readily determinable fair value.

This alternative amends paragraph 17 of ARB 43 to require mark-to-market accounting if the entity is trading the item. There is no requirement for the item to have a readily determinable fair value.

Alternative 2: Trading plus readily determinable fair value. Producers are excluded.

This alternative is similar to Alternative 1 above but excludes producers. That is, if a company has both a trading desk **and** uses the same commodity in its production, wholesale, or retail activities, they are outside the scope of the proposed FSP.

Alternative 3: All commodities are fair value unless used for production.

This premise of this alternative is that all commodities are required to be accounted for at fair value **unless** those items are used in production. This alternative would require definitions of *commodity* and *production*.

DISCLOSURE REQUIREMENTS FOR TRANSFERS

The Board will discuss the following disclosures that would be required for transfers from nontrading (production) to trading:

- a. The carrying value of the inventory (average cost, LIFO, and FIFO amount) and volume of inventory transferred (barrels of oil and bushels of wheat)
- b. The amount of embedded (unrecognized) gain or loss that gets recognized upon transfer of inventory.

The following disclosures would be required for transfers from trading to nontrading (production):

- a. Disclose the fair (market) value of the inventory and volume of inventory transferred (barrels of oil and bushels of wheat)
- b. Disclose the cost basis of the inventory (average cost, LIFO, FIFO)
- c. Disclose the profit margin that would have resulted had the inventory been in production from the beginning.

TRANSITION METHOD

The staff recommends that the proposed FSP be exposed requiring a prospective transition method with a cumulative-effect adjustment to retained earnings.

Comment Period

The staff recommends a 45-day comment period on the proposed FSP to expedite issuance of guidance.



Financial Accounting Standards Board

Board Meeting Handout

Interpretation 48—Delay of Effective Date for Nonpublic Entities Meaning of Adopt and Other Issues

January 23, 2008

PURPOSE

The purpose of this meeting is to discuss the comments letters received on the Proposed FSP FIN 48-b, *Effective Date of FASB Interpretation No. 48 for Nonpublic Enterprises*, and request that the Board clarify issues related to its scope and effective date.

BACKGROUND

The proposed FSP, to defer the effective date of FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes*, was issued in response to a letter from the Private Company Financial Reporting Committee (PCFRC). Their letter recommended a deferral for nonpublic entities because many of them were not aware that they were included within the scope of Interpretation 48 until after it became effective. Many nonpublic enterprises are pass-through entities which have not paid income taxes in the past and they believed that they were not subject to the requirements of the Interpretation. Therefore, they had issued interim financial statements without having applied the provisions of Interpretation 48.

The proposed FSP, as written, would allow nonpublic enterprises to defer the effective date of FASB Interpretation 48 to years beginning after December 15, 2007 if the nonpublic enterprises had not adopted its provisions for financial statements or information issued to third parties prior to the effective date of this FSP.

ISSUES

Among the comments received, several significant issues were raised that the staff believes the Board should consider in redeliberations:

1. What did the Board mean by “adopted the provisions of Interpretation 48 before the issuance of this FSP” in the proposed amendment to paragraph 22 of Interpretation 48?
2. Should the issuance of financial information other than a full set of financial statements prevent a nonpublic enterprise from utilizing the deferral?
3. Should nonpublic enterprises be eligible for the deferral whether or not they adopted Interpretation 48 prior to the issuance of this proposed FSP?
4. Should private subsidiaries of a public company be eligible for the deferral for stand-alone financial statements?
5. Should the Board consider a revision to the effective date of the proposed deferral?
6. Should the Board consider a deferral to the effective date of FSP FAS 13-2, *Accounting for a Change or Projected Change in the Timing of Cash Flows Relating*

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to Income Taxes Generated by a Leveraged Lease Transaction, for nonpublic enterprises?

The first three issues relate to the scope of the proposed FSP, defining which entities are eligible for the deferral and which are not. The last three issues deal with other significant issues raised by respondents.

ISSUES 1 – 3 (Scope)

Because of differing points of view, respondents to the proposed FSP asked the Board to clarify what nonpublic entities fell within the scope of the FSP. The staff believes the first three issues raised by respondents can be resolved by one of the following three alternatives:

- a. Modify the FSP to indicate that all nonpublic enterprises are eligible for the deferral, regardless of whether they previously adopted Interpretation 48.
- b. Clarify that the FSP deferral only applies to a nonpublic enterprise if it did not issue GAAP financial statements or other financial information to third parties prior to the effective date of the FSP.
- c. Modify the FSP to indicate that a nonpublic enterprise would be eligible for the deferral unless they issued a full set of annual financial statements incorporating the recognition, measurement, and disclosure requirements of Interpretation 48.

The staff recommends alternative (c). The staff notes this alternative would allow more entities to fall within the scope of the FSP and would provide the deferral for the entities the PCFRC was trying to help. Alternative (c) would also eliminate the confusion about whether having issued only financial information other than a full set of financial statement disqualifies the nonpublic enterprise from the deferral.

QUESTIONS FOR THE BOARD

Q1: Does the Board want to modify FSP FIN 48-b?

Q2: If yes, does the Board agree with the Staff's recommendation (Alternative C)?

ISSUE 4 (Private Subsidiary of a Public Company)

The staff noted that the definition of a nonpublic entity used in the FSP would permit a subsidiary of a public company to be eligible for the deferral for stand-alone financial statements, assuming the above criteria are met.

QUESTIONS FOR THE BOARD

Q3: Does the Board want to permit a subsidiary of a public company to be eligible for the deferral for its stand-alone financial statements?

Q4: If yes to the previous question, does the Board want a separate effective date for a subsidiary of a public company?

ISSUE 5 (Effective Date)

One respondent suggested changing the deferral period to the *end* of fiscal years beginning after December 15, 2007. This respondent stated that the existing deferral date would require an entity issuing interim financial statements to apply Interpretation 48 for the interim statements issued early in 2008. They do not believe the existing effective date provides the time needed to properly implement Interpretation 48 for those interim statements. They propose changing the effective date to the end of fiscal years beginning after December 15, 2007.

The staff notes that the majority of nonpublic companies only issue year-end statements, so the staff believes the impact will be minimal. However, they recognize that the population of those entities issuing interim financial statements is still a significant number.

QUESTIONS FOR THE BOARD

Q5: Does the Board want to consider a change in the effective date of the deferral period?

ISSUE 6 (Extending the Deferral to Leveraged Lease Transactions)

One respondent asked for a conforming one-year deferral for nonpublic entities in applying FSP FAS 13-2. This respondent noted that without such a deferral, nonpublic entities with leveraged lease transactions would be required to adopt Interpretation 48 while other nonpublic entities would not.

The staff believes only large sophisticated entities will have leveraged lease transactions. As a result, these entities most likely would have been aware of and properly applied Interpretation 48 in interim financial statements. Therefore, they would not be entitled to the deferral. Accordingly, the staff recommends the Board not extend the deferral to leveraged lease transactions.

QUESTION FOR THE BOARD

Q6: Does the Board want to conform the one-year deferral to nonpublic entities applying FSP FAS 13-2?