



**Liabilities and Equity**  
**Board Meeting Handout**  
**August 16, 2006**

**BACKGROUND**

1. At the June 2006 education sessions, the Board discussed two alternatives for describing the narrower view of equity approach. The first alternative distinguishes assets and liabilities from equity based on present rights and obligations embodied in the financial instruments rather than on the expected probable outcomes (similar to a fundamental components approach). The second alternative modifies the ownership-settlement approach by classifying all indirect ownership instruments as liabilities or assets.
2. An example that illustrates the difference between the two approaches is stock puttable at a fixed price. Under the first alternative, that puttable stock is bifurcated into an equity share and a derivative liability (put option). Under the second alternative, that puttable stock is a liability in its entirety measured at fair value.
3. At the education session, the Board directed the staff to further develop the second alternative for future comparison to the ownership-settlement approach and the reassessed expected outcomes approach. This approach will be referred to as the ownership approach. Today's discussion focuses on issues that arise under the ownership approach.

**OBJECTIVE**

4. The Board will discuss memorandum number 47, which addresses the following:
  - a. The financial statement location for recognizing equity derivative instrument gains and losses occurring under a narrow view of equity (the ownership approach).
  - b. The financial statement display for those gains and losses.
5. For purposes of this handout and meeting, equity derivative instruments are liability and asset instruments that have counterparty payoffs at settlement that vary with the issuer's equity instruments (thus, they are measured at fair value under the ownership approach). Equity derivative instruments include both freestanding and embedded equity derivatives (for example, the description includes both a written option to issue shares and a convertible debt instrument).

## **PART I: RECOGNITION**

6. The staff has identified four possible methods for recognizing fair value gains and losses arising from remeasuring equity derivative instruments at fair value. Those four methods are explained below.

### **Net Income Method**

7. Under the net income method, all fair value changes in equity derivative instruments are recognized through net income. This method is recommended by the staff.

### **OCI Method**

8. Under the other comprehensive income (OCI) method, the changes in fair value of equity derivative instruments are initially recognized in OCI as they occur. Subsequently, the accumulated balance related to the equity derivative instrument is reclassified out of OCI into net income at the settlement or derecognition date.

### **OCI-Interest Method**

9. The OCI-interest method was recommended by a constituent group. It separates recognition of income into two components: a financing component (either a cost of borrowing or income from lending) and an unpredictable cost or income component (based on underlying variables). The following is a brief explanation of the accounting for the two components:
  - a. The fair value of the instrument at the reporting date is determined (which may include factors other than share price changes).
  - b. Interest expense (or income) is recognized based on the instrument's fair value at the beginning of the reporting period times the straight debt rate (normal borrowing or lending rate) at the beginning of the reporting period. Interest is recorded through net income.
  - c. The remaining fair value change on the instrument plus or minus any cash payments or receipts is recorded through OCI and cumulatively recognized through net income (trued up) at the settlement or derecognition date (as discussed in the OCI method). This results in partial recognition through net income over the term of the instrument and a remaining "true up" recognition through net income at the settlement or derecognition date.

### **Equity Account Method**

10. Under the equity account method, fair value changes in equity derivative instruments are permanently recognized through an equity account. The staff notes that this method is more consistent with a broad view of equity in which equity derivative instruments are classified as equity.

## Staff Recommendation and Reasoning

11. The staff recommends the net income method for the following reasons:

- a. **Consistency with the ownership theory**—The ownership approach is based on a theory that focuses on how the existing shareholders' net worth may or will be affected by other claimants. It follows then that the net income method would be the appropriate way to account for fair value changes in equity derivative instruments classified as assets or liabilities because income available to shareholders and earnings per share (EPS) would reflect those changes. As a result, the changes in value are more prominently displayed than if they were recognized in OCI.
- b. **Consistency with current GAAP**—In addition to the net income method being consistent with the ownership theory, the staff believes that the net income method is consistent with current GAAP theory for recognizing changes in liabilities and assets through comprehensive income. Certain equity derivative instruments are currently classified as liabilities and assets with changes in fair value recognized in net income. The net income method is consistent with that current accounting and does not change the accounting for those instruments.
- c. **Simplicity**—Finally, the staff believes that the net income method is less arbitragable and significantly simpler to apply and explain than both of the OCI methods. For example, under the OCI methods, the Board would have to describe the class of instruments that would be eligible for OCI recognition. In contrast, no such distinctions are necessary under the net income method. Simplicity also is achieved in the EPS calculation as shareholder dilution is reflected in EPS without having to perform a diluted EPS calculation. Another noteworthy advantage is that bifurcation of embedded equity derivatives would not be required as the entire instrument would be accounted for at fair value with changes reflected in net income.

## Question for the Board

12. Do Board members agree that changes in fair value for equity derivatives should be recorded through net income and, if so, why? If Board members do not agree with the staff recommendation, please state your preferred method and the reasoning for that method.

## PART II: DISPLAY

13. If the Board chooses the net income method recommended by the staff, the following four alternatives for financial statement display have been identified:

- a. Gains and losses for *all* instruments classified as liabilities or assets and measured at fair value should be reported on a separate line item on the income statement, and the instruments should be separately displayed on the balance sheet.
- b. Gains and losses for *all equity derivative instruments* classified as liabilities or assets should be reported on a separate line item on the income statement, and the instruments should be separately displayed on the balance sheet.

- c. Gains and losses for *certain equity derivative instruments* classified as liabilities or assets should be reported on a separate line item on the income statement (for example, separately present changes from instruments that are positively correlated with the entity's share price). Those instruments also should be separately displayed on the balance sheet.
- d. **Staff Recommendation:** At this stage of the project, do not address separate display issues for gains and losses arising from changes in fair value. Other projects are already addressing these issues, and special display of fair value changes may more appropriately be addressed in the Exposure Draft process.

### **Question for the Board**

- 14. Do Board members agree that display issues should not be addressed at this time and, if so, why? If Board members believe that display issues should be addressed now, please state your preference and objective of that display.



**Board Meeting Handout**  
**Fair Value Option Phase 1**  
**August 16, 2006**

**Objective of the Meeting**

At today's meeting, the Board will redeliberate certain issues regarding the scope of Phase 1 of the Fair Value Option (FVO) project. Items are grouped based on how the Board considered them in its initial deliberations of the scope of the FVO Exposure Draft. The staff's recommendations for each item and related questions to the Board are also included.

**Items Excluded from Statement 107 and Included in the Scope of the Proposed FVO Statement**

1. The scope of the proposed Statement includes the following financial assets and financial liabilities that were excluded from the scope of FASB Statement 107, *Disclosures About Fair Value of Financial Instruments*:

- a. An investment being accounted for under the equity method

The staff recommends that (1) equity method investments remain in the scope of Phase 1 of the FVO project, (2) no eligibility criteria be imposed, (3) an entity be required to apply the FVO, if elected, to all of its financial investments (equity and debt) in an investee, rather than on a contract-by-contract basis, and (4) an entity may irrevocably elect the FVO upon obtaining significant influence. Does the Board agree with the staff's recommendations?

- b. Investments in equity securities that do not have readily determinable fair values, as described in paragraph 3 of FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*

The staff recommends that (1) investments in equity securities that do not have a readily determinable fair value remain in the scope of Phase 1 of the FVO project, and (2) no eligibility criteria be imposed. Does the Board agree with the staff's recommendations?

- c. Insurance and reinsurance contracts that are financial instruments, as discussed in FASB Statements No. 60, *Accounting and Reporting by Insurance Enterprises*, No. 97, *Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments*, and No. 113, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts*

The staff recommends that (1) insurance and reinsurance contracts that meet the definition of a financial instrument should remain in the scope of Phase 1 of the FVO project and (2) the scope of Phase 1 of the FVO project be expanded beyond insurance and reinsurance contracts that are financial instruments to also include insurance contracts that do not prohibit settlement of the insurer's obligation by payment to a third party provider of goods or services rather than by payment to the insured or other claimant. Does the Board agree with the staff's recommendations?

- d. Warranty obligations that are financial liabilities and warranty rights that are financial assets

The staff recommends that (1) warranty rights and obligations that meet the definition of a financial instrument should remain in the scope of Phase 1 of the FVO project and (2) the scope of Phase 1 of the FVO project be expanded beyond warranty rights and obligations that are financial instruments to also include warranty rights and obligations that do not prohibit settlement of the warranty obligation by payment to a third party provider of goods or services rather than by payment to the claimant. Does the Board agree with the staff's recommendations?

- e. Unconditional purchase obligations that are recorded as financial liabilities on the purchaser's statement of financial position as discussed in paragraph 10 of FASB Statement No. 47, *Disclosure of Long-Term Obligations*.

The staff recommends that unconditional purchase obligations, as described above, remain in the scope of Phase 1 of the FVO project. Does the Board agree with the staff's recommendation?

### **Otherwise Unrecognized Firm Commitments Involving Only Financial Instruments**

2. The proposed Statement permits an entity to elect the FVO at inception for a firm commitment, as defined in Statement 133, that would otherwise not be recognized at inception under existing GAAP. The staff recommends that otherwise unrecognized firm commitments that satisfy Statement 133's definition of a firm commitment and involve only financial instruments remain in the scope of Phase 1 of the FVO project. The staff does not recommend expanding the scope of Phase 1 of the FVO project to nonfinancial items. Does the Board agree with the staff's recommendations?

### **Written Loan Commitments**

3. Written loan commitments were originally excluded from the scope of Phase 1 of the FVO project since the determination of their fair value involves consideration of nonfinancial components. Based on responses to the Exposure Draft, the staff recommends that written loan commitments not accounted for under Statement 133 should be included in the scope of Phase 1 of the FVO project. Does the Board agree with the staff's recommendation?

### **Financial Liabilities for Demand Deposit Accounts**

4. Financial liabilities for DDAs were originally excluded from the scope of Phase 1 of the FVO project since the determination of their fair value involves consideration of nonfinancial components. The staff still recommends that the Board consider DDAs

in Phase 2 of the FVO project. The staff also recommends that the Board define DDAs as financial liabilities of financial institutions with demand features in a manner consistent with the IASB. Does the Board agree with the staff's recommendations?

### **Items Excluded from Statement 107 and the Proposed FVO Statement**

5. The scope of the proposed Statement excludes the following financial assets and financial liabilities that were also excluded from the scope of Statement 107:

- a. An investment that would otherwise be consolidated

The staff recommends that the scope exception be changed to reflect the Board's intention that all interests (whether investments or other interests) that would otherwise be consolidated shall be excluded from the scope of the proposed Statement. Does the Board agree with the staff's recommendation?

- b. Employers' and plans' financial obligations for pension benefits, other postretirement benefits (including health care and life insurance benefits), postemployment benefits, employee stock option and stock purchase plans, and other forms of deferred compensation arrangements as defined in FASB Statements No. 35, *Accounting and Reporting by Defined Benefit Pension Plans*, No. 87, *Employers' Accounting for Pensions*, No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions*, No. 112, *Employers' Accounting for Postemployment Benefits*, No. 123 (revised December 2004), *Share-Based Payment*, No. 43, *Accounting for Compensated Absences*, and No. 146, *Accounting for Costs Associated with Exit or Disposal Activities*, and APB Opinion No. 12, *Omnibus Opinion—1967*

The staff recommends that the Board keep the scope exception for pension and other postretirement benefits and certain compensation arrangements without modification. Does the Board agree with the staff's recommendation?

- c. Financial liabilities recognized under lease contracts as defined in FASB Statement No. 13, *Accounting for Leases*. (This exclusion does not include a contingent obligation arising out of a cancelled lease or a guarantee of a third-party lease obligation.)

The staff recommends that the scope exception be revised to exclude both financial assets and financial liabilities recognized under lease contracts as defined in Statement 13 from the scope of the proposed Statement. Does the Board agree with the staff's recommendation?

**Other —Current and Deferred Income Tax Assets and Liabilities**

6. The basis for conclusions of the proposed Statement explicitly states that the FVO is not permitted for income tax assets and liabilities since they do not satisfy the definition of financial assets or financial liabilities. The staff recommends that no additional reference to the exclusion of such assets and liabilities be made in the scope section of the standards section of the final Statement. Does the Board agree with the staff's recommendation?



## Board Meeting Handout

### Statement 133 Implementation Issue—Hedging Proceeds to be Received from a Forecasted Foreign Currency Denominated Debt Issuance

August 16, 2006

#### PURPOSE

At the August 16, 2006 Board meeting, the Board will discuss the issuance of an exposure draft of the proposed Statement 133 Implementation Issue No. H17: “Hedging Functional Currency Equivalent Proceeds to Be Received from a Forecasted Foreign Currency Denominated Debt Issuance.”

#### BACKGROUND

This issue was added to the Board’s agenda at the February 15, 2006 Board meeting. The agenda memo prepared by the staff in February 2006 included the following reasons for the Board to address this issue:

1. Some believe that hedge accounting should be allowed in these circumstances because there is true economic risk involved that is easily identifiable and measurable.
2. There is diversity in practice.
3. An external accounting practice guide included an example of how a company could enter in to a qualifying cash flow hedge. However, this guidance did not address the specific question in this issue related to paragraph 29(c) of Statement 133.

The issue in question centers on whether a forecasted issuance of a fixed amount of foreign currency denominated debt is eligible for designation as a hedged transaction in a cash flow hedge of the functional currency equivalent variability of the proceeds received. A forecasted transaction is eligible for designation as a hedged transaction in a cash flow hedge if the transaction meets the requirements in paragraphs 28 and 29 of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*. In addition, an entity must meet the criteria prescribed in paragraph 40 of Statement 133 in order to apply cash flow hedge accounting for foreign currency risk.

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Paragraph 29(c) requires that the forecasted transaction must be a transaction with a party external to the reporting entity and must present an exposure to variations in cash flows for the hedged risk that could affect reported earnings. The specific concern is with the phrase in paragraph 29(c), which requires that "the forecasted transaction...presents an exposure to variations in cash flows for the hedged risk **that could affect reported earnings**" (emphasis added).

#### **QUESTION FOR THE BOARD**

Does the Board approve the issuance of an exposure draft of the proposed Statement 133 Implementation Issue No. H17: "Hedging Functional Currency Equivalent Proceeds to be Received from a Forecasted Foreign Currency Denominated Debt Issuance"?

, and No. 146, *Accounting for Costs Associated with Exit or Disposal Activities*. The staff plans to discuss those practice issues with the Board at its meeting on August 30, 2006.

If the Board decides to defer issuance of the FVM Statement, related issues are whether to (1) reconsider the scope of the FVM Statement, (2) reconsider the practicability exceptions in the FVM Statement (for risk adjustments), and (3) revise aspects of the guidance in the FVM Statement for fair value measurements using significant unobservable inputs within Level 3 of the fair value hierarchy.

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