

**MINUTES**



**To:** Board Members

**From:** Financial Instruments: Liabilities and Equity Team (Belot, ext. 363)

**Subject:** Minutes of the May 5, 2004 Liabilities and Equity Board Meeting      **Date:** May 14, 2004

**cc:** Leisenring, Bielstein, Smith, Golden, Cassel, Project Team, Mahoney, Swift, Polley, Sutay, Gabriele, Petrone, Thompson, FASB Intranet

Topic: Liabilities and Equity: Reassessed Expected Outcomes Approach Informational Presentation

Basis for Discussion: Memorandum of April 28, 2004

Length of Discussion: 8:30 a.m. to 11:00 a.m.

Attendance:

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

Board members absent: None

Staff in charge of topic: Bullen and Richards

Other staff at Board table: Arbuckle, Belot, Bielstein, and Lott

Outside participants: None

### **Summary of Decisions Reached:**

The Board listened to a staff presentation about a possible alternative method—the Reassessed Expected Outcomes (REO) Approach—for determining classification, unit of account, measurement, and earnings per share (EPS) for all financial instruments involving an issuer’s own shares. The meeting was informational and no decisions were reached

### **Objective of the Meeting:**

The objective of the meeting was to inform the Board about the REO approach. That objective was accomplished.

### **Matters Discussed and Decisions Reached:**

Mr. Bullen and Ms. Richards presented an overview of the REO approach, including examples of its applications to instruments, comparisons between economically similar instruments, a summary of its illustrated advantages, ramifications, and other issues. While the purpose of the Board meeting was informational, Board members gave the staff feedback about perceived issues of pursuing such an approach.

Mr. Trott expressed concern over the definition of an ownership relationship. Specifically, he asked whether it was necessary for the counterparty’s payoff to move 100 percent with the issuer’s stock price, or whether a 70 or 80 percent correlation would suffice. He also expressed concern that the proposed REO model would leave out the notion of a requirement to transfer assets, because the notion of liquidity is a principal concept in the definition of a liability. Two Board members [KAS and EWT] asked the staff to research further whether financial statement users believe information about settlement options of financial instruments and their liquidity implications are useful. Furthermore, if that information is useful, they asked if there is still a way to provide it while using the REO model.

Mr. Herz expressed concern about the appropriateness of substituting the issuer’s straight debt rate for the risk-free rate in adapting the Black-Scholes-Merton formula for the REO model. The staff said that by using the issuer’s straight debt rate, the issuer’s credit risk is factored into the

results. However, the staff will further research whether that is desirable for every financial instrument linked to equity. In addition, Mr. Herz asked what the interest expense under REO represents and whether users of financial statements will understand that.

Ms. Seidman expressed concern about some aspects of the proposed measurement method under the REO model. Specifically, she expressed a preference for all liabilities to be measured consistently—either at fair value, historical cost, or another variation. She also asked the staff to consider the implications for the counterparty. Specifically, Ms. Seidman questioned whether reflecting unissued shares on the issuer’s financial statements as outstanding would affect determining whether an investor had significant influence.

Ms. Schipper noted that the REO method requires preparers to understand how financial instruments can be synthetically linked together to achieve similar results to a single financial instrument. For example, straight debt linked with a written call option acts similar to convertible debt, and both are accounted for similarly under the REO approach. However, Ms. Schipper and Mr. Trott suggested that while issues of whether to link financial instruments for accounting purposes are mitigated under an REO approach, linkage is still an issue in some circumstances. An example is the classification of a written call option as either an asset or contra-liability for the expected inflow of assets. It might be appropriate for a freestanding written call option linked to debt to be classified as contra-liability; however, that treatment is questionable if the written call option is freestanding. Ms. Schipper and Mr. Trott requested that the staff provide further information about the relevance and the extent that linkage remains an issue under an REO approach.

Several Board members commented on the effects of the REO approach on the current definitions of assets, liabilities, and equity in FASB Concepts Statement No. 6, *Elements of Financial Statements*. Mr. Trott commented that the method does not produce results that are consistent with his understanding of equity. Mr. Schieneman expressed interest in using REO for purposes of calculating EPS but said that, for classification purposes, he preferred applying REO with an overriding liquidity test.

**Follow-Up Items:**

None.

**General Announcements:**

None.