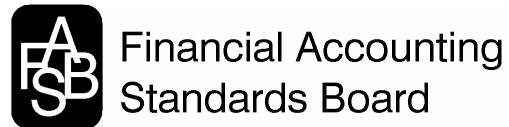


MINUTES



To: Board Members

From: Arbuckle (ext. 275) and Hansen (ext. 298)

Subject: Liabilities and Equity: Minutes of the November 3, 2004 Board Meeting **Date:** November 18, 2004

cc: Leisenring, Bielstein, Smith, Golden, Petrone, Bossio, Figgie, Sullivan, Laurenzano, Mahoney, Swift, Polley, Financial Instruments Team, Liabilities and Equity Team, Gabriele, Sutay, Thompson, Getz, Sandra Thompson (IASB), FASB Intranet

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: Liabilities and Equity: Prior Decisions, Distinguishing Assets from Equity, and Settlement Alternatives

Basis for Discussion: Board memorandums dated October 19, 2004 (No. 14), October 21, 2004 (No. 15), and November 2, 2004 (Follow-up to No. 15)

Length of Discussion: 9:00 a.m. to 10:15 a.m.

Attendance:

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

Board members absent: None

Staff in charge of topic: Richards and Thuener

Other staff at Board table: Lott, Carnrick, Arbuckle, and Hansen

Outside participants: None

Summary of Decisions Reached:

The Board continued its discussion of the proposed Ownership/Settlement Approach for distinguishing liabilities and assets from equity for single component instruments.

The Board discussed a staff-prepared analysis of the status and continuing relevance of past Board decisions under the proposed Ownership/Settlement Approach. (The staff analysis is contained in the Board meeting handout.) The Board agreed with the staff analysis including the list of issues that will require deliberation at a future Board meeting.

The Board discussed the application of the approach in distinguishing assets from equity. The Board decided that the Ownership/Settlement Approach should be consistently applied to single component instruments embodying rights and to those embodying obligations. That is, instruments embodying rights to receive assets, services, shares, or other instruments would be classified as an asset or as equity depending on whether the instrument establishes an ownership relationship and, if the ownership relationship is indirect, the form of settlement. Similar to the application for obligations, an instrument embodying a right, for example, a purchased option, would establish an indirect ownership relationship if the counterparty's payoff at settlement would be based on and would move in the same direction as the fair value of the reference instrument.

The integrated Ownership/Settlement Approach in distinguishing liabilities and assets from equity would be as follows:

1. An instrument that does not embody a settlement obligation or right is equity. An example is a share (common or preferred) that is not subject to redemption requirements or rights.
2. An instrument that establishes a direct ownership relationship between the issuer and the counterparty is equity, even if it embodies a settlement obligation (or possibly, a right). An example is a common share that is mandatorily redeemable at its proportionate share of the fair value of the entity.

3. An instrument that embodies a settlement obligation or right and does not establish either a direct or indirect ownership relationship is a liability or an asset. Examples are a written put option (liability) and a purchased call option (asset).
4. An instrument that establishes an indirect ownership relationship that would be settled or ultimately settled by issuing or receiving an instrument that establishes a direct ownership relationship is equity (such as a physically settled written call or purchased put option). Otherwise, the instrument is a liability or an asset (such as a net cash-settled written call or purchased put option).

Finally, the Board discussed single component instruments that establish an indirect ownership relationship and can be settled by delivering assets, services, *or* shares (that is, instruments containing settlement alternatives). The Board decided that if the choice of settlement is outside the control of the issuer (that is, if the choice is decided or controlled by the counterparty or is determined by factors or other conditions not controlled by the issuer), the issuer should assume delivery of assets or services and classify an instrument embodying an obligation as a liability. The Board decided that if the issuer controls the choice of settlement, the issuer can assume share settlement (and classify the instrument as equity), if that settlement choice is substantive. The Board directed the staff to further analyze the issue of substantive versus nonsubstantive features as it relates to settlement alternatives and other features of instruments. Instruments embodying rights that can be settled by the issuer's receipt of assets or shares will be included in that analysis.

Objective of Meeting:

The objective of the Board meeting was to further refine the Ownership/Settlement Approach by determining which, if any, of the Board's prior decisions relating to classification of single component instruments should be included in the Ownership/Settlement Approach, how the approach should be applied to distinguish assets from equity, and what form of settlement should be assumed if there are multiple settlement alternatives. The objective of the meeting was accomplished.

Matters Discussed and Decisions Reached:

1. Ms. Richards opened the meeting by referring to a staff-prepared list of prior Board decisions and asked the Board if they agreed with the staff's characterization of whether those decisions would be included in the Ownership/Settlement Approach or no longer be relevant. (The list of prior decisions is available in the Board meeting handout.)
2. All Board members agreed with the status and continuing relevance of the prior decisions including the list of issues that will be redeliberated at future meetings. Board members noted that the staff should keep the list updated and delete issues as they are resolved.
3. Ms. Richards introduced the second issue—distinguishing assets from equity. She stated that, in addition to an obligation, a settlement criterion includes a right to receive assets, services, shares,¹ or other instruments. Ms. Richards stated that the Ownership/Settlement Approach can be applied to instruments with asset characteristics in a way similar to that of instruments with liability characteristics. That approach would result in consistent classification for economically similar instruments. She discussed an alternative approach—the Ownership/Settlement II Approach, which would analyze instruments with asset characteristics differently than instruments with liability characteristics. The two approaches would result in opposite classification for instruments with asset characteristics. Ms. Richards said that both approaches would be the same for instruments that establish a direct ownership relationship or no ownership relationship. She stated that the focus will be on how those approaches work for indirect ownership relationships.
4. Ms. Richards stated that, under the Ownership/Settlement Approach, an indirect ownership relationship is established based on the counterparty's payoff and whether the counterparty benefits from increases or suffers from decreases in the issuer's share price. The existence of an indirect ownership relationship is not sufficient in itself for classification. Settlement² or ultimate settlement of an instrument establishing an indirect

¹ The term *shares* refers to instruments that establish a direct ownership relationship.

² For purposes of this project, settlement involves the delivery of consideration and does not include

ownership relationship must result in the issuance or receipt of shares for the instrument to be classified as equity. Under this approach, a physically or net share-settled purchased put option would be classified as equity and, if net cash-settled, would be classified as an asset. A purchased call option would not establish an indirect ownership relationship and, therefore, would be classified as an asset regardless of the form of settlement.

5. Ms. Richards stated that, under the Ownership/Settlement II Approach, the definition of indirect ownership relationship is changed in a way that considers the form of settlement and, if one party receives shares, that party's payoff. For an indirect ownership relationship to be established under that approach, one party must receive shares upon settlement or ultimate settlement, and that party must participate favorably in increases in the issuer's share price. As a result, a physically or net share-settled purchased call option would be classified as equity and, if net cash-settled, would be classified as an asset. A purchased put option would not establish an indirect ownership relationship regardless of the form of settlement and, therefore, would be classified as an asset.

6. The staff recommended the Ownership/Settlement Approach for various reasons. First, the staff believes that for an ownership relationship to be established there must be two parties; therefore, the relationship between the issuer and the counterparty should be analyzed. The staff does not believe that an entity should be considered the owner of its own shares as is implied under the Ownership/Settlement II Approach. Additionally, the staff believes the Ownership/Settlement Approach is a consistent way to classify instruments.

7. Ms. Thuener further explained the staff's portrayal of consistent results under the Ownership/Settlement Approach by referring to a graph. That graph illustrated that a physically settled purchased put and a written call option, which are the building blocks of a forward sales contract, are classified as equity the same as in a forward sales contract. She explained that, under the Ownership/Settlement II Approach, the physically

expiration of an instrument, for example, expiration of an option.

settled purchased put option would be classified as an asset and the written call option would be classified as equity. That classification inconsistency would allow opportunities for accounting arbitrage.

8. Mr. Trott supported the Ownership/Settlement Approach for consistent classification results. He stated that the first approach had a more consistent view of ownership relationship and would reduce the arbitrage capabilities compared to the approach. He questioned whether the Board was complicating the separation of liabilities from equity and assets from equity. He considered the debit side to be more of a display issue than a conceptual issue. He suggested that it was not necessary or appropriate for this project to make a distinction between assets and contra-equity in the conceptual definitions.

9. Ms. Seidman stated that the Board should address whether these debits should be classified as assets or contra-equity. She added that the Board needs to consider the issue of a consistent classification scheme for options that could be put together to imitate a forward contract. She said that without addressing the classification of the debit, the Board would be overlooking structuring opportunities. She stated her preference for the Ownership/Settlement Approach because of the consistent classification scheme.

10. Ms. Schipper expressed her continued support for the Ownership/Settlement Approach. She stated that the alternative approach (Ownership/Settlement II Approach) for distinguishing assets from equity is not internally consistent, while the first approach is closer to having internal consistency.

11. Mr. Crooch stated his concerns about an approach in which increases in an entity's stock price results in recognition of gains in the income statement because an instrument, for example, a purchased call option, is classified as an asset. He agreed that the project should focus on distinguishing between liabilities and equity and reconsider the display in those instances of an instrument's classification as an asset. However, he expressed his support for the Ownership/Settlement Approach because of its consistency.

12. Mr. Trott noted that the Ownership/Settlement Approach is an appropriate approach for determining classification between an asset and contra-equity, but does not see this project as trying to redefine assets at a conceptual level.

13. Mr. Herz acknowledged that the alternative approach (Ownership/Settlement II Approach) has some issues of inconsistency. However, he supported that approach because he believes that if an entity purchases an instrument creating a long position on its own shares, that instrument should be contra-equity. He stated that the classification should be focused on the party that receives the shares and their participation in stock price increases.

14. Ms. Schipper explained that under the Ownership/Settlement II Approach the focus shifts from counterparty's payoff to the issuer's payoff in some instances. She noted that the Board has already concluded that classification should be based on the counterparty's payoff.

15. Mr. Batavick expressed his support for the Ownership/Settlement Approach. He was uncomfortable with certain instrument classifications but believed that the decisions made by the Board were evolving. He hesitated to make any exceptions to the classification before discussing compound instruments.

16. All Board members agreed to proceed with the Ownership/Settlement Approach for distinguishing liabilities and assets from equity, except for Mr. Herz.

17. Ms. Richards introduced the third issue of what form of settlement should be assumed if the instrument can be settled in either shares or assets. Four possible methods were presented by the staff as follows:

- a. Method 1 considers who has discretion or lack of discretion over a transfer of assets, which is similar to current GAAP.
- b. Method 2 considers discretion over a transfer of assets unless there is past practice or another indicator of settling with assets.
- c. Method 3 always assumes settlement with assets.

d. Method 4 uses expectations of settlement based on the facts and circumstances.

18. The staff recommended Method 3 to overcome nonsubstantive or remote settlement methods; however, the staff would not recommend amending FASB Concepts Statement No. 6, *Elements of Financial Statements*, for that method. The staff believes that Method 2, 3 or 4 would be better than Method 1. However, some of the staff is concerned that Method 2 would not always be reliable and would be complex in subsequent reassessment. Other staff members are concerned that, under Method 3, a liability or asset classification could be accomplished even if the issuer intends to settle in shares.

19. Mr. Trott agreed with the staff's recommendation of Method 3 for purposes of classification. He stated that earnings per share (EPS) is a separate issue. He also stated that the conceptual definitions are not a concern for Method 3 because this project exists to determine what changes should be made to the definitions. Additionally, the Board has already decided to change the definitions to include the assessment of ownership relationship in determining classification as a liability. Therefore, Mr. Trott said that it is inappropriate to conclude that the concepts should not be changed for Method 3 until the Board decides how the definitions will be changed.

20. Ms. Seidman stated that Method 1 is grounded in the current conceptual definition of a liability, meaning that the issuer has the contractual ability to avoid the sacrifice of assets. She stated said that this is a critical decision in identifying the characteristics of a liability versus those of an equity. She stated her preference for Method 1 or Method 2. Ms. Seidman believes those methods are more consistent with the current definition of a liability and is concerned about the negative consequences to the definition of a liability arising from disregarding the issuer's discretion over a transfer of assets (Method 3 or 4). Although she would support Method 2, she believes that the issue of nonsubstantive terms is a broader issue than settlement alternatives and should be addressed separately. She did not want to conclude on nonsubstantive features at this time. She later stated that

her decision for Method 1 or 2 was not affected by EPS considerations because EPS is a separate issue.

21. Ms. Schipper supported Method 3. She stated that she places primacy on solvency, which is accomplished with Method 3. She expressed concern over relying too much on the analysis of contract details to make the determination on solvency. She noted that Method 3 was clean and clear in that regard. She recognized that there is a potential conflict with the denominator in diluted EPS calculations. She noted that the denominator in diluted EPS is not accounting, it is a performance metric. She surmised that the Board should not be making definition decisions based on concerns over a performance metric. Ms. Schipper agreed with Mr. Trott about the implications of Method 3 on the conceptual definitions and believes that the inclusion of ownership relationship considerations in the definitions can accommodate Method 3.

22. Mr. Batavick stated that in considering the four methods, Method 4 appeared to have operational problems and Method 3 was a change from the current definition of a liability. He stated his preference for Method 2 because it has a fundamental framework, but also provides flexibility with the facts and circumstances. However, he agreed with Ms. Seidman that the issues of past practice and determining nonsubstantive features should be addressed broadly.

23. Mr. Schieneman favored Method 2. He believes that Method 2 best reflects the settlement outcome. He stated that he is concerned with the effect on EPS calculations, especially for Method 3. He believes Method 3 is too rigid and Method 4 is similar to the reassessed expected outcomes approach (REO), which has already been rejected.

24. Mr. Herz stated his objection to Method 3. He was concerned with assuming asset settlement for classification and share settlement for EPS, which has been tentatively decided for EPS in the short-term convergence project. Mr. Herz supported Method 2.

25. Mr. Leisenring pointed out that the IASB has already considered a model similar to Method 2 and concluded that it was unworkable. Ms. Richards noted that, in addition to her concurrence with Mr. Leisenring as to the workability of Method 2 in certain

circumstances, for example, with new instrument issuances, Method 2 is complex in its application. She noted that, under Method 2, the Board would have to consider issues of subsequent reassessment and how the method would apply for instruments embodying rights and for those embodying both rights and obligations.

26. Because there was not a majority support for a single method, Mr. Herz asked who would object to Method 3. Four Board members objected (RHH, GJB, LFS, and GSS). Mr. Herz then asked who would object to Method 2 with the consideration of past practice and nonsubstantive settlement features in a broad context at a future meeting. Three Board members objected (KAS, EWT, and GMC).

Follow-Up Items

The staff will consider the issues of determining substantive versus nonsubstantive features, in addition to those with a remote likelihood of occurrence, at a future meeting. At that time, the staff also will consider issues of subsequent reassessment and how the settlement method would apply to instruments embodying rights, in addition to those embodying both rights and obligations.

General Announcements:

None.