MINUTES

To:	Board Members		
From:	Liabilities and Equity—Bellantoni (ext. 445)		
Subject:	Minutes of the November 29, 2005 Board Meeting: Liabilities and Equity—Measurement and Display under the Obligation-First Approach	**Date:**	December 16, 2005
cc:	Leisenring, Bielstein, Smith, Golden, Petrone, Bossio, Sullivan, Mahoney, Beswick, Jacobs, Polley, Financial Instruments Team, Liabilities and Equity Team, Gabriele, Getz, Sutay, Gavin Francis (IASB), Michael Thomas (IASB), FASB Intranet		

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Topic: Liabilities and Equity: Measurement and Display under the Obligation-First Approach

Basis for Discussion: Board Memorandum Nos. 34 and 35

Length of Discussion: 9:00 a.m. to 9:49 a.m.

Attendance:

Board members present: FASB: Herz, Batavick, Crooch, Schipper, Seidman, Trott, and Young
IASB: Leisenring

Board members absent: None

Staff in charge of topic: Carnrick and Richards

Other staff at Board table: Bellantoni, Bergstrom, Carnrick, Lott, Thuener, and Bielstein

Outside participants: None

Summary of Decisions Reached:

The Board continued its discussion of the *ownership-settlement approach* for instruments with characteristics of equity, liabilities, or both. This meeting focused on the measurement of multiple-component instruments that under the separation principles would not be separated or would be separated using the obligation-first approach.

1. The Board agreed on the following measurement requirements for nonseparated instruments:

    a. *Instruments classified as equity* that may ultimately be settled with cash or other assets would be separately displayed in the same section as single-component instruments that have cash or asset settlement requirements (for example, callable stock). Subsequently, those instruments would be remeasured at the amount that results from applying the redemption formula at the reporting date. Changes in amounts would be recorded in equity accounts and not as part of net income or comprehensive income. All other instruments classified in equity would not be remeasured subsequent to initial recognition.

    b. *Instruments classified as either a liability or as an asset* that are comprised of two or more nonequity components would be subsequently measured at fair value with changes reflected in net income if at least one of the nonequity components represents an outcome with a payoff at settlement that would vary based on an underlying.

2. For instruments that are separated, the Board affirmed its previous decisions that:

    a. Equity and nonequity components would be identified by examining the possible payoffs.

    b. The nonequity component would be initially measured at its fair value.

    c. The residual amount of the proceeds (the difference between the transaction price and the nonequity component's fair value) would be allocated to equity.

3. For purposes of determining its initial fair value, the Board decided that a nonequity component would be described by constructing a hypothetical freestanding instrument with terms that would affect the same outcome (as observed by the payoff profile under the nonequity outcome). That description includes consideration of the following:

    a. The amount and timing of the nonequity outcome may be affected by various factors including share prices, put, call, and conversion features.

    b. Under the obligation-first approach, a minimum settlement amount (a floor) results in describing a fixed amount that is 100 percent likely to be paid. For example, the floor in convertible debt or shares puttable at a fixed price would always be paid even if the equity outcome occurs.

c. If the amount or timing of a settlement obligation varies or is uncertain, the fair value of the nonequity component would be described by considering the probability-weighted (expected) settlement date (or dates) and amount (or amounts) due.

d. However, if the nonequity component would be subsequently accreted, the probability-weighted (expected) settlement date is determined first and then used to calculate the amount due at that date and the implicit interest rate for the settlement period.

4. The Board also decided on the following subsequent accounting requirements for separated nonequity components:

   a. Components that would be subsequently measured at fair value (by continuing to apply the descriptions described above in paragraph 3) include derivatives and nonequity components that have varying or uncertain settlement amounts.

   b. Nonequity components that are not subsequently measured at fair value would be accreted to the amount due at the initially determined expected settlement date based on the implicit interest rate.

   c. For those components that are accreted, reallocation of the nonequity and equity components would be required only if (1) the forecasted expected settlement date lapses and the nonequity component remains outstanding or (2) early settlement occurs. That reallocation would be performed by applying the extinguishment accounting procedures previously decided by the Board at its October 5, 2005, meeting.

5. Based on the above decisions, the Board agreed that its following prior decisions would be revised as follows:

   a. The Board's above decision for describing the nonequity component would be applied to all separated nonequity components instruments and not just those with contingent settlement date features.

   b. Under the obligation-first approach, conversion into a fixed number of shares is considered extinguishment of the nonequity component. In that case, conversion occurring earlier than the expected settlement date would result in a gain or loss similar to other early extinguishments.

Finally, nonequity components with uncertain settlement dates would use an expected settlement date method and those with uncertain settlement amounts would be subsequently measured at fair value. As a result, the Board's previous decision to require measurement at the current settlement value (for nonderivatives) would no longer be necessary.

Objective of Meeting:

The meeting's objective was to decide on measurement and display for multiple-component instruments that: (a) would not be separated or (b) would be separated using the obligation-first approach. The objectives of the meeting were met.

Matters Discussed and Decisions Reached:

1. Ms. Carnrick opened the discussion by proposing measurement and display requirements for multiple-component instruments that are not separated under the separation criteria. She divided those instruments into three categories: (a) instruments with two equity components, for example, convertible preferred stock, (b) instruments that have both equity and non-equity components but do not embody an obligation, for example, callable stock, and (c) instruments with two nonequity components, for example, debt convertible into a fixed number of shares or equivalent amount of cash.

2. Ms. Carnrick explained that the objectives in developing measurement and display requirements are (a) to provide information about the magnitude of a reporting entity's possible cash (or asset) outflows and (b) to maintain consistency with the decisions made for single-component instruments. Ms. Carnrick then presented the staff's recommendations for measurement and display of nonseparated instruments as follows:

    a. *Instruments classified as equity* (the first two categories in paragraph 1) that may ultimately be settled with cash or other assets would be separately displayed in the same section as single-component instruments that have cash or asset settlement requirements (for example, callable stock). Subsequently, those instruments would be remeasured at the amount that results from applying the redemption formula at the reporting date. Changes in amounts would be recorded in equity accounts and not as part of net income or comprehensive income. All other instruments classified in equity would not be remeasured subsequent to initial recognition.

    b. *Instruments classified as either a liability or as an asset* (the third category in paragraph 1) that comprise two or more nonequity components would be subsequently measured at fair value with changes reflected in net income if at least one of the nonequity components represents an outcome with a payoff at settlement that would vary based on an underlying

3. Ms. Carnrick stated that the staff considered an alternative for both recommendations, which would require instruments to be analyzed under FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, to determine if they should be separated.

However, the staff rejected the alternative because it is more complex and is not consistent with previous Board decisions. Ms. Carnrick also noted that the staff's recommended measurement requirements would result in an amendment to Statement 133 so that separately displayed equity instruments are not separated.

4. Finally, Ms. Carnrick stated that some complex instruments do not meet the Board's definition of a multiple-component instrument (for example, shares puttable at fair value). In Milestone 1, it was questionable whether such instruments were considered single- or multiple-component. Ms. Carnrick recommended that an instrument not meeting the definition of a multiple-component instrument be classified and measured based on the single-component requirements developed in Milestone 1. Under those requirements, shares puttable at fair value would be classified as equity and separately displayed.

5. The Board unanimously agreed with the measurement and display requirements recommended by the staff including its reasoning, noting that the recommendations are consistent with previous Board decisions. Ms. Seidman and Ms. Schipper asked the staff to continue to analyze the interaction between the decisions made in this project and Statement 133.

6. Mr. Trott noted that using the redemption formula at the reporting date for equity classified instruments may not accurately account for the time value of a delayed redemption. Mr. Trott also asked the staff to provide the Board with examples illustrating how settlement value is calculated.

7. Ms. Richards began the discussion for the next subject by summarizing the Board's previous decisions relating to separation of the nonequity component of a multiple-component instrument. At the October 5, 2005, meeting, the Board decided that equity and nonequity components are identified by examining the possible payoffs at settlement. Additionally, they decided that an instrument with both equity and nonequity components would be separated and that the nonequity component would be initially measured at its fair value with the remainder of the proceeds allocated to equity. However, at that meeting, the Board did

not finalize how to describe the nonequity component for purposes of determining its fair value.

8. To determine its fair value upon separation, Ms. Richards recommended that a nonequity component be described by constructing a hypothetical freestanding instrument with terms that would affect the same outcome (as observed by the payoff profile under the nonequity outcome). That description includes consideration of the following:

   a. The amount and timing of the nonequity outcome may be affected by various factors including share prices, put, call, and conversion features (as in the timing of the floor component of puttable, callable, convertible debt).

   b. Under the obligation-first approach, a minimum settlement amount (a floor) results in describing a fixed amount that is 100 percent likely to be paid. For example, the floor in convertible debt or shares puttable at a fixed price would always be paid even if the equity outcome occurs.

   c. If the amount or timing of a settlement obligation varies or is uncertain (as in a contingent liability), the fair value of the nonequity component would be described by considering the probability-weighted (expected) settlement date (or dates) and amount (or amounts) due.

   d. However, if the nonequity component would be subsequently accreted (for example, the floor component of convertible debt), the probability-weighted (expected) settlement date is determined first and then used to calculate the amount due at that date and the implicit interest rate for the settlement period.

9. Ms. Richards explained that the recommendation is consistent with identifying the payoff under the separation criteria, which includes considering the cause of the payoff. She also noted that the recommendation is universally applicable, compatible with the separation principles, and consistent with the treatment of other instruments with varying settlement amounts.

10. Ms. Richards also presented an alternative method for describing the nonequity component that would exclude the share price affect on the timing or the amount of the nonequity outcome. Under that alternative, the floor component of puttable, callable, convertible debt would be treated as plain vanilla puttable, callable debt that is not affected by share prices. However, she explained that the alternative does not provide a realistic description of the nonequity component and as a result, the initial and subsequent values may not be faithfully

represented. Additionally, the alternative is not consistent with the identification and separation principles for examining the payoff profile. Therefore, Ms. Richards stated, the interaction of the equity component's affect on the nonequity component should not be ignored but should be incorporated into its timing and amount.

11. The Board unanimously agreed with the staff's recommendation and reasoning, noting that it is consistent with previous decisions made in this project. Mr. Young stated that he was concerned with the extinguishment accounting for an instrument that remains outstanding after the expected settlement date. However, he did not object to the staff's recommendation.

12. Mr. Trott agreed that fair value would be the preferred measurement attribute for the non-equity component. However, he was concerned that obtaining a fair value would be difficult for some entities. Mr. Trott suggested that, in the future, the staff may need to explore an alternative to compute the minimum amount required for the nonequity component but did not recommend providing a measurement exception at this stage of the project.

13. Ms. Seidman supported the staff's recommendation, noting that it produces representationally faithful information that reflects the economics of the instruments.

14. Next, Ms. Richards presented the staff's recommendations for subsequent accounting for the nonequity component as follows:

    a. Components that would be subsequently measured at fair value (by continuing to apply the descriptions described above in paragraph 8) include derivatives and nonequity components that have varying or uncertain settlement amounts.

    b. Nonequity components that are not subsequently measured at fair value would be accreted to the amount due at the initially determined expected settlement date based on the implicit interest rate.

    c. For those components that are accreted, reallocation of the nonequity and equity components would be required only if (1) the forecasted expected settlement date lapses and the nonequity component remains outstanding or (2) early settlement (or a modification) occurs. That reallocation would be performed by applying the extinguishment accounting procedures previously decided by the Board at its October 5, 2005, meeting.

15. To achieve consistency between the decisions made at this meeting and previous Board decisions, the staff also recommended the following revisions to previous decisions:

a. The Board's above decision for describing the nonequity component would be applied to all separated nonequity components instruments and not just those with contingent settlement date features.

b. Under the obligation-first approach, conversion into a fixed number of shares is considered extinguishment of the nonequity component. In that case, conversion occurring earlier than the expected settlement date would result in a gain or loss similar to other early extinguishments.

c. Finally, nonequity components with uncertain settlement dates would use an expected settlement date method and those with uncertain settlement amounts would be subsequently measured at fair value. As a result, the Board's previous decision to require measurement at the current settlement value (for nonderivatives) would no longer be necessary.

16. Board members unanimously agreed with the staff's proposed subsequent accounting method and changes to previous decisions. They asked that the staff provide examples of extinguishment accounting under various scenarios.

Follow-up Items:

The staff will provide the Board with examples of applying the above decisions to calculate settlement value and the accounting upon extinguishment under various scenarios.

General Announcements:

None.