

MINUTES



Financial Accounting
Standards Board

To: FASB Board Members

From: Financial Instruments with Characteristics of Equity
(Clark, x443 and Prince, x229)

Subject: Minutes of the September 8, 2008,
Roundtable: Financial Instruments with
Characteristics of Equity

Date: October 1, 2008

cc: Leisenring, Bielstein, Golden, Bossio, Lott, Allen, Klimek, Chookaszian,
Posta, Malcolm, Mills, Glotzer, C. Smith, Stoklosa, Proestakes, Sutay,
Mechanick, Bhave, Petrone, Prince, Clark, Gabriele, Finden (GASB), Liz
Figgie (IASB), Gavin Francis (IASB), LiLi Lian (IASB), Rebecca Villmann
(IASB), Ian Hague (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, Interpretation, or FASB Staff Position.

Topic: Financial Instruments with Characteristics of
Equity

Basis for Discussion: Financial Instruments with Characteristics of
Equity Roundtable Discussion Questions
(Attachment A)

Length of Discussion: Session 1: 9:30 a.m.–12:00 p.m.
Session 2: 1:00 p.m.–3:30 p.m.

Attendance:

Board members present: FASB: Herz, Batavick, Linsmeier,
Seidman, and L. Smith

IASB: Leisenring

Board members participating by phone: None

Board members absent: None

Staff in charge of topic:	Switter
Other staff at Board table:	FASB: Golden, C. Smith IASB: Figgie
Constituent Participants:	See Participant Listing (Attachment B)

Objective of the Meeting:

The objective of the roundtable was to obtain information to assist the Board in future deliberations in this project. The objective was met.

SESSION 1

Matters Discussed:

Introduction

1. Mr. Linsmeier began the roundtable by discussing the objective of the meeting. He stated that the purpose of the meeting was to obtain information to assist the FASB in developing a converged standard. He acknowledged that the Board has not discussed how the requirements in the FASB Preliminary Views, *Financial Instruments with Characteristics of Equity*, will interact with the Board’s joint conceptual framework and financial statement presentation projects.

Underlying Principles for Identifying Equity Instruments and Measurement

2. Mr. Linsmeier asked the participants to each describe their underlying principle for distinguishing between equity and non-equity instruments. Ms. Smith stated that for the Chartered Financial Analyst Institute and the Investors Technical Advisory Committee (ITAC), the underlying principle is that equity is the most residual claimant. Any other claim should be classified as a liability (or an asset) because it dilutes (or enhances) the residual claimant.

3. Mr. Bielstein suggested two underlying principles: (a) if an obligation is settled in cash or other assets, then it is a liability and (b) if an obligation is settled in cash, other assets, or shares of the entity, then it is a liability. Ms. Seidman commented that the first principle is similar to an approach the Board considered but rejected. She explained that some Board members objected to instruments with identical economic profiles (payoffs) having different classifications based solely on the form of settlement (cash versus shares). Ms. Seidman further

noted that Mr. Bielstein's first principle also would require separation, for example, if a settlement obligation is embedded in a share, which adds complexity to the approach. She stated that the Board is trying to reduce complexity and structuring.

4. Ms. Smith stated that she talked to several users (representatives from equity firms and rating agencies) who noted that the complexity of the instruments and the structuring opportunities under current accounting requirements make it difficult to perform their analysis. They believe the Board's basic ownership approach would provide them with the most decision-useful information.

5. Ms. Maher noted that her company will continue to analyze financial statements based on the approach explained in her comment letter regardless of what approach the Board decides to pursue in this project. Ms. Maher further noted that analyzing financial statements prepared under the basic ownership approach would be easier than analyzing those prepared under the ownership-settlement approach.

6. Mr. Uhl suggested an instrument should be classified as equity if it (a) represents a direct claim to the net assets of the issuer, (b) shares substantially in the risk and rewards of ownership of the issuer's net assets, (c) does not contain a requirement for the issuer to transfer economic resources to the holder, except for or other than the sharing in the performance of net assets, and (d) remains after all requirements to transfer value have been satisfied. Mr. Herz asked whether a perpetual instrument with a fixed dividend would be a liability under Mr. Uhl's proposed approach. Mr. Uhl stated that the fixed dividend would be separated from the share and classified as a liability and the share itself, if it participated in earnings, would be classified as equity.

7. Ms. Smith stated that some users who she spoke to noted that the basic ownership approach reduces complexity and improves comparability and transparency. Other users believe that the basic ownership approach oversimplifies classification. Those users believe that classification should be dependent on the terms of each instrument. Additionally, she stated, some users believe classifying preferred shares as equity would be a better reflection of the economics of instruments. Some users also noted that traditional return analyses (for example, return on equity and return on capital) would become more difficult if more liabilities are measured at fair value.

8. Mr. Linsmeier asked the participants if their concerns with the basic ownership approach were related to the balance sheet presentation or the effects the balance sheet presentation could have on the income statement. Mr. Tovey stated that he is concerned with recognizing a change in market capitalization through profit and loss statement. Mr. Leung noted that he is concerned that users will not understand the effects on net income that are related to the change in an instrument's fair value. He stated that disclosures may be necessary to explain those changes.

9. Mr. Linsmeier asked participants if separate display requirements that differentiate within the liability section of the balance sheet liabilities to be settled with assets vs. those to be settled with shares vs. those not to be settled would resolve any concerns with the basic ownership approach. Mr. Karr stated that such a presentation would help but that there are several other problems with the basic ownership approach. He stated that he is concerned with the income statement impact. He is also concerned that the average user may not take the time or know how to perform the necessary calculations to remove the effects of the fair value fluctuations from the results of an entity's operations. Ms. Smith noted that ITAC believes reporting liabilities that are required to be settled with shares separately from those required to be settled in cash would provide decision-useful information.

10. Mr. Linsmeier asked if participants thought it would be difficult to identify the most residual claimant. Mr. Karr and Mr. Bielstein stated that they thought it would be hard to identify the most residual claimant in partnerships and cooperative-type arrangements. Mr. Tovey added that identifying the most residual claimant could be difficult in legal jurisdictions outside of the United States.

11. Ms. Seidman asked why some participants think measuring more instruments at fair value would increase complexity. Ms. Seidman noted that she would like to understand whether it is the frequency with which items are measured or the fact that the approach may need additional disclosures. Mr. Bielstein stated that he cannot assess the overall complexity of the basic ownership approach without the Board addressing the measurement and presentation issues. Mr. Liesenring noted additional presentation requirements for income statement and balance sheet would add complexity.

12. Mr. Linsmeier asked if there was a conceptual basis for classifying equity instruments as redeemable (either mandatorily or puttable) at fair value. Mr. Tovey stated that he believes a

puttable instrument should be classified as a liability because it can require an entity to distribute assets. Mr. Uhl stated that the form of settlement or potential settlement should not determine classification.

13. Mr. Linsmeier noted that many respondents objected to not classifying perpetual preferred shares as equity. Ms. Cole stated that many people believe lack of a settlement is a characteristic of equity. Other participants (Mr. Karr and Mr. Bielstein) agreed. Ms. Maher stated that in addition to a lack-of-settlement requirement, an equity instrument also must absorb losses.

14. Mr. Linsmeier stated that the staff is developing a new underlying classification principle that would require an instrument to be classified as equity if it (a) lacks a settlement requirement and (b) entitles the holder to a share of the entity's net assets in liquidation. Mr. Uhl noted that all perpetual instruments are the not same. He added that some perpetual instruments are akin to perpetual debt or financing and, therefore, the issue of economic compulsion must be addressed.

15. Mr. Linsmeier asked the participants if they support separating financial instruments. Ms. Maher stated that Fitch supported the basic ownership approach because it minimizes separation. Ms. Smith added that the users she spoke with agreed. Mr. Tovey and Mr. Leung stated that their firms support separation based on whether or not the instrument contains an obligation to transfer cash or other assets.

Income Statement Presentation

16. Mr. Linsmeier asked participants if the change in an instrument's fair value should be disaggregated in the income statement. Mr. Bielstein stated that Board should consider disaggregating the amount. He noted that an obligation to pay interest expense would be viewed differently from the change in fair value on a preferred stock share. Mr. Linsmeier stated that users are suggesting that disclosure of credit risk is important.

17. Mr. Herz stated that there is a difference between changes in value that occur from external market interest rates and changes in value that are related to that an entity's stock. He suggested that the changes should be presented in separate categories. Mr. Tovey added that it would be daunting to articulate the reasons for the significant fair value changes.

18. Ms. Smith stated that ITAC and other analysts stressed the importance of disaggregating stock option marks, especially those related to the grant-date mark versus those related to market changes subsequent to the grant date. She stressed that analysts need the ability to preserve the trend analysis of gross margin and operating margin. She added that interest expense and financing charges should be disaggregated and presented separately. Ms. Seidman stated that she is concerned about adding complexity to an approach through disclosure requirements.

Earnings per Share

19. Mr. Linsmeier began the discussion stating the Board issued an Exposure Draft, *Earnings per Share*, which proposes to amend FASB Statement No. 128, *Earnings per Share*. The Exposure Draft describes a new method for calculating diluted earnings per share for freestanding instruments that are measured at fair value with changes reported in income. Specifically, the method requires the change in an instrument's fair value to be reflected in the numerator of the earnings per share calculation instead of increasing the denominator for the number of additional shares that would arise from the exercise or conversion of an instrument.

20. Ms. Smith stated that users are concerned that when combined with the basic ownership approach, the proposed earnings per share amendments would not provide information about the number of shares that an entity could potentially issue. Mr. Karr noted that earnings per share may not be simplified if preparers are required to supply additional information so that users can perform their own EPS calculations.

SESSION 2

Matters Discussed:

Introduction

21. Mr. Linsmeier began the roundtable by discussing the objective of the meeting, which was the same as the first session.

Underlying Principles for Identifying Equity Instruments and Measurement

22. Mr. Linsmeier noted that a vast majority of respondents to the Preliminary Views desired equity classification for more than just basic ownership instruments. Mr. Linsmeier asked the participants to each describe their underlying principle for distinguishing between equity and

non-equity instruments. Mr. Taylor responded that he believes equity holders (a) bear the risks and rewards of ownership and (b) hold an unsecured claim in the entity. Mr. Taylor explained that a cooperative entity has a different business model than a corporation. Owners of a cooperative entity do not have a share in the cooperative's net assets proportional to their ownership interest like a shareholder in a corporation does. Mr. Taylor further noted that, ideally, an equity instrument would not have a settlement requirement.

23. Mr. Linsmeier noted that equity classification cannot be based on risk of loss because all claims to the assets of a company have a risk of loss, including debt holders. On the other hand, basing classification on either the perpetual nature of an instrument or the residual nature of an instrument are two distinct ways of looking at equity instruments. Mr. Taylor commented that an approach that classifies instruments that lack a settlement requirement as equity may work for cooperative entities.

24. Mr. Linsmeier noted that addressing the concerns of the cooperatives could lead the Board down two different paths, either to (a) provide an exception for cooperatives to an overall concept of equity or (b) attempt to establish an overall concept that would apply to cooperatives as well.

25. Mr. Althoff noted that for PricewaterhouseCoopers, an equity instrument gives the holder the right to participate in the results of the operations of an entity, that is, the ability to participate in the gains and losses of the entity. He commented that the basic ownership approach may not classify instruments that participate in the results of the operations of an entity as equity. For example, he would not preclude participating perpetual instruments from being classified as equity. Mr. Althoff pointed out that participation refers to a direct participation right, that is, a contractual right to participate in the results of the operations of the entity. In other words, instruments whose returns are directly affected by the operating results of the entity would be classified as equity.

26. Mr. Linsmeier noted that if the Board were to define earnings as earnings before any distributions to general financing, then debt holders would be participating in the earnings of an entity through the entity's contractual obligation to pay interest to the debt holders. Mr. Golden commented that perhaps direct participation means that the reward is dependent upon the earnings, that is, the greater the earnings from operations, the greater the reward to the claimant.

In contrast, debt holders' claims are affected when the entity performs poorly, but not when the entity performs well. Mr. Althoff agreed.

27. Ms. Seidman noted that she understands Mr. Althoff's explanation of participation in an entity to mean (a) a return that depends on how well the entity performs and (b) a claim to the net assets of the entity.

28. Mr. Leisenring asked the roundtable participants whether they view the rebate (patronage dividend) that cooperative members receive as a type of earnings participation. Mr. Taylor responded that he does view the rebate as equity. He explained that the amount of the rebate is a function of the current year's earnings and the member's patronage with the cooperative. Mr. Leisenring noted that the rebate could be viewed as a determinant of net income, rather than as a distribution from net income. Mr. Linsmeier noted that the rebates could be viewed as comparable to a price discount.

29. Mr. Leisenring stated that he doubts a workable model can be developed if patronage dividends are viewed as being distributions of earnings rather than distributions to arrive at earnings. Ms. Seidman noted she did not have a problem with the patronage dividends being directly correlated with ownership in a cooperative because the dividends are not available unless one is an owner of the cooperative.

30. Ms. Griffin commented that cooperative members traditionally define equity as their ownership interest in the entity. She observed that the ownership interest is represented by how the member participates in the cooperative, which includes the patronage dividend, the initial membership share, and perhaps more. She also noted that the ownership interest would typically be the most subordinated interest in the cooperative. Furthermore, Ms. Griffin noted that although preferred shares may not be the most subordinated interest, members of cooperatives view these types of instruments as an ownership interest in the cooperative.

31. Ms. Griffin asked Mr. Leisenring whether he would view only the initial membership share in a cooperative as equity. Mr. Leisenring responded that there might be other things that could be considered equity.

32. Mr. Taylor shifted the focus of the conversation to the question of who holds the right to the net assets of a cooperative organization. Mr. Taylor noted that those who use (transact with)

the cooperative have the right to the net assets. In liquidation, after all higher claims have been satisfied, any excess equity goes to members (including former members) that have been patrons of the cooperative throughout its life (He qualified his response by noting that his answers are most prevalent in United States agricultural cooperatives and are not necessarily true for other forms of cooperatives.)

33. Mr. Linsmeier noted that participants have raised three concepts of what could be considered equity: (a) the most residual interest, (b) an interest that participates in earnings, and (c) a perpetual interest. He further noted that all three concepts conflict with at least a part of what cooperatives consider equity.

34. Ms. Griffin noted that the structure of cooperatives differs throughout the world. She further noted that the unallocated capital (which is similar to retained earnings) in a cooperative is distributed to its members as a most subordinated pool of net assets.

35. Mr. Heegemann noted that in Europe, members of a cooperative do not participate in the upside. The retained earnings of a cooperative are not distributed to the members; rather, the members determine who will receive the retained earnings. He noted, however, that members of cooperatives fully participate in the losses of the cooperative. Ms. Griffin noted that most cooperatives agree that the Board should eliminate the requirement that a basic ownership instrument's share to the net assets of an entity cannot have an upper limit.

36. Mr. Linsmeier asked Mr. Heegemann to describe his underlying principle for equity. Mr. Heegemann identified both participation and lack of settlement requirements as two underlying principles of equity instruments. With respect to participation, he commented that the notion of full upside participation may not provide the correct results for cooperatives. He observed that the focus for participation should be on whether the members are the ones who take the greatest advantage of the cooperative. With respect to the perpetual concept, he noted that perpetual instruments provide capital that is available to absorb losses. He commented that he thinks the notion of "permanence of capital" is valuable and that this notion should be maintained.

37. Mr. Leisenring noted that his concern with considering cooperative patronage dividends as equity is that, in the context of regular corporations, the fact that a customer owns shares in a corporation does not mean that transactions with that customer would necessarily be viewed as dividends (in other words, as transactions with an owner as an owner). Ms. Griffin noted,

however, that in contrast to the context of corporations, the interests of owners in, and customers of, a cooperative are aligned.

38. Mr. Heegemann observed that in Europe, patronage dividends play a different role than they do in the United States. He noted that there are differences between countries, mainly due to tax legislation. He further noted that most members of the European Association of Cooperative Banks do not pay patronage dividends.

39. Mr. Counce observed that the Federal Home Loan Bank would define as equity those instruments that participate in (a) the risks and rewards of an entity (for example, dividends) and (b) the net assets of an entity. Mr. Leisenring asked if the equity instruments of Federal Home Loan Bank are puttable and Mr. Counce responded that they were. Mr. Leisenring asked how a holder of the organization's equity instruments would participate in the risks and rewards of the entity if the instruments are not puttable at fair value. Mr. Counce responded by stating that the instrument holders would be participating through dividends. Mr. Counce further stated that he does not think his organization's ownership instruments would meet the definition of equity as presented in the Preliminary Views because the instruments' redemption formula is not based on fair value. Ms. Figgie asked Mr. Counce whether a member who requests redemption of their ownership instrument would have preference (a higher claim) in liquidation if the entity were to liquidate prior to redeeming the member's instrument. Mr. Counce stated that, although he was not certain, he thinks the member would not have preference in liquidation.

40. Mr. Herz noted that developing a single model for equity classification is difficult because there are so many types of business models.

41. Mr. Linsmeier noted that if the Board were to modify the requirements of the Preliminary Views so that redeemable instruments did not have to be redeemed at fair value, then most of the ownership interests that cooperatives consider equity would be included in the definition of equity. Mr. Linsmeier observed that the comment letters he read would like the Board to be more generous on the types of redemption formulas (other than redeemable at fair value, or a less rigorous definition of fair value) that would qualify for equity classification.

42. Ms. O'Dell noted that a lot of the concerns for private entities arise because of the lack of liquidity for their ownership instruments. She noted that the ownership instruments of private entities are generally designed to provide a vehicle for owners to sell their ownership interests.

She further noted that the requirement in paragraph 20(b) of the Preliminary Views could be problematic because most private company buy/sell or shareholder agreements do not contain terms that prohibit redemption if the redemption would impair the claims of instruments with higher priority. She recommended deleting that provision. Ms. O'Dell also noted that the Board needs to consider employee stock ownership plans in its deliberations.

43. Mr. Linsmeier asked Ms. O'Dell to describe her underlying principle of equity. She said that she would agree with considering the lowest residual claim on the net assets of an entity as equity, as long as the prevalent concerns of private entities get resolved. Ms. O'Dell commented that venture capital firms generally invest in preferred stock. She continued by stating that venture capital firms are concerned that the requirements contained in the Preliminary Views would result in their preferred stock being classified as a liability on the investee's balance sheet. Ms. O'Dell commented that another area that has not yet been addressed is limited partnership interests.

44. Mr. Linsmeier asked roundtable participants why they would be troubled if they had to report less equity. Ms. O'Dell noted that reporting less equity would make bank financing an issue; bankers and lenders would have to be educated as to why there is less equity. Ms. Griffin noted that in certain states if the reported equity of a cooperative drops below a certain threshold, then the cooperative is required to issue a guarantee, which would raise costs for the cooperative.

45. Mr. Leisenring observed that all entities are not guaranteed to have equity. There could be cases where entities do not have any equity. Mr. Herz noted that the real question is whether the resulting classification model would produce better information.

46. Mr. Counce observed that another issue would be significant differences between generally accepted accounting principles and regulatory accounting practices, which would lead his organization to have to keep two sets of accounting records.

47. Mr. Heegemann commented that obtaining bank financing may be more difficult because cooperatives will be reporting more liabilities on their balance sheet and, therefore, will be perceived as less stable.

48. Mr. Scoles commented that if entities report less equity, it may lead users of financial statements to perform more analysis on the financial statements, which is likely to be a positive

result. Ms. Griffin questioned whether requiring certain users (for example, vendors) to have to perform more analysis would necessarily be a positive result. Mr. Counce noted that the FASB Preliminary Views could result in his organization reporting no equity, which would require him to explain the lack of equity to users.

49. Mr. Althoff noted that, with respect to presentation issues, people may have concerns with the effects on the balance sheet. However, he observed that the effects on the income statement are probably of equal or greater concern. He noted that the Boards' proposal in the Preliminary Views suffers from the fact that the its joint project on financial statement presentation is not further along in its development. He further observed that the concerns may be assuaged by the Board's proposed presentation model in that project.

50. Mr. Lesienring observed that he does not think many instruments would be considered equity under the loss absorption approach. Furthermore, he does not understand why the cooperatives support an approach that he does not think will address their issues. Mr. Heegemann noted that the loss absorption approach would solve the cooperatives' issues in that it would classify the cooperatives' shares as equity. He further commented that he thinks the loss absorption approach is developed enough.

51. Mr. Heegemann noted that the loss absorption approach emphasizes the exposure to the downside (losses) of an entity whereas the basic ownership approach places equal weight on both upside and downside risks. He noted that he is not convinced that full exposure to upside risk is as relevant as full exposure to downside risk. Mr. Linsmeier noted that he is uncertain how the loss absorption approach distinguishes between equity and liabilities because if a company does not succeed, then all claims of a company become loss absorbing, including accounts payable. Mr. Althoff commented that, as he understands the loss absorption approach, an instrument that is legal-form equity would be a loss absorber whereas an instrument that is not legal-form equity would not be a loss absorber.

52. Mr. Linsmeier commented that two models the Board could consider are (a) one in which equity is defined conceptually as any instrument in which there is not an obligation to pay in cash or in the shares of the entity and (b) one in which an entity always will have equity; if none of the entity's instruments meet the basic principle of equity, then the most residual class is

considered equity. He observed that the comments of the cooperatives and private companies seem to express a preference for the second model.

53. Ms. Griffin asked whether an instrument would be considered not to have an obligation to settle if an entity was allowed to refuse redemption of the instrument. Mr. Linsmeier commented that that question would need to be discussed. Ms. Seidman observed that Ms. Griffin's question raises the issue of substantive terms and whether past practice matters. Mr. Linsmeier also noted that the Boards have not yet considered the issues surrounding retained earnings.

54. Mr. Scoles noted that the principles underlying the basic ownership approach make sense and reduces structuring opportunities. As one begins to look past the most residual claimant, problems arise as to which instruments should be classified as equity. Mr. Scoles further noted that most concerns could be addressed through presentation in the income statement and the balance sheet. Ms. Griffin commented that she likes the simplicity of the "most residual" notion; however, she has a problem with the implications of that notion on preferred instruments and the requirement that a basic ownership instrument has no upper limit.

**FINANCIAL INSTRUMENTS WITH CHARACTERISTICS OF EQUITY
ROUNDTABLE DISCUSSION QUESTIONS
Norwalk, CT—September 8, 2008**

In the course of its project on financial instruments with characteristics of equity, the FASB has considered many approaches for distinguishing between equity and liabilities or assets. Three of those approaches (basic ownership, ownership-settlement, and reassessed expected outcomes [REO]) are described in the Preliminary Views, *Financial Instruments with Characteristics of Equity*. The FASB has reached a preliminary view that the basic ownership approach provides more decision-useful information to investors while significantly simplifying accounting requirements for issuers and their auditors.

The roundtable discussion will focus on the basic ownership approach. The following questions will be used as a guideline for the discussion. Depending on how the meeting develops, some questions may not be discussed or questions that are not included in this document may be raised. If time permits, participants will be able to raise additional issues at the end of the session.

ISSUE 1—WHAT IS EQUITY?

The basic ownership approach uses the concept of a basic ownership instrument, which is the class (or classes) of claims to assets of an entity that are the most subordinated in the event of bankruptcy or liquidation, to identify financial instruments with characteristics of equity. The concept of a basic ownership instrument is consistent with (a subset of) the current definition of equity in paragraph 49 of Concepts Statement 6:

Equity or net assets is the residual interest in the assets of an entity that remains after deducting its liabilities.

The basic ownership approach retains the idea that equity is a residual interest in an entity. A residual interest is one entitled to what is left over, that is, to the residual from the entity's activities. The basic ownership approach defines the residual interest as the most subordinated claim that entitles the holder to a share of the entity's net assets after all higher priority claims have been satisfied. This view is different from how equity has historically been described.

Most respondents agreed that basic ownership instruments are ownership interests in the entity and conceptually are equity. Holders of basic ownership instruments bear the ultimate risks and are entitled to the ultimate rewards inherent in an entity and its activities. However, many respondents did not agree with the Board's narrow view of equity. Those respondents argued that there are different levels of residual interests in an entity. If all claims to an entity's assets were listed in order of seniority, a line could be drawn below any item in that list, and all claims below it would be residual because they are entitled to a share of anything left over after all senior claims are satisfied. For example, one respondent suggested that the residual interest in an entity is a claim to an entity's net assets that lacks a settlement requirement.

Question 1(a): Users, preparers, and auditors seem to have differing views on the characteristics an equity instrument. How would you describe your underlying principle for distinguishing between equity and non-equity instruments?

Underlying Principle of the Basic Ownership Approach

The underlying classification principle for the basic ownership approach is that only the most subordinated claim is classified as equity. All other instruments, for example, all forward contracts, options, and convertible debt, would be classified as liabilities or assets. In other words, claims against the entity's assets are liabilities (or assets) if they reduce (or enhance) the net assets available to the owners of the entity.

Question 1(b): Do you believe the basic ownership approach reduces complexity and provides users with more decision-useful information? How would the proposed changes affect comparability and transparency?

Question 1(c): Does the principle appropriately reflect the economics of equity and non-equity instruments? If not, why not?

Definition of a Basic Ownership Instrument

A basic ownership instrument has both of the following characteristics:

- a. The holder has a claim to a share of the assets of the entity that would have no priority¹ over any other claims if the issuer were to liquidate on the date the classification decision is being made; and
- b. The holder is entitled to a percentage of the assets of the entity that remain after all higher priority claims have been satisfied. The holder's share depends on its share of the total claims with the lowest priority and has no upper or lower limit except for the amount of assets available.

Question 1(d): Do you have any concerns about the operationality or understandability of the definition of a basic ownership instrument? If so, what specifically are those concerns and what modifications would you make?

Instruments Redeemable at Fair Value

An instrument that is redeemable (mandatorily or at the option of the holder)² is deemed to meet the definition of a basic ownership instrument if both of the following criteria are met:

- a. The redemption amount is the same as the share of the issuer's net assets to which the holder would be entitled if it were to liquidate on the classification date; and

¹ Priority refers to subordination, which must be legally determined.

² An instrument that is redeemable at the option of the holder is usually referred to as puttable.

- b. The terms of the instrument prohibit redemption if redemption would impair the claims of any instruments with higher priority than other basic ownership instruments.

Instruments with provisions requiring redemption at fair value (or a book-value based approximation of fair value) do not literally have the first characteristic of a basic ownership instrument because the instrument's fair value might not be the same as the portion of net assets the holder would receive if the entity liquidated. The fair value of an instrument is the best available surrogate for the holder's percentage of the entity's assets.

If both of the following conditions exist, a redemption amount based on book value may be used as a surrogate for the holder's percentage of the entity's assets (instead of using fair value):

- a. The redemption formula is designed to approximate fair value of the instrument or the share of assets to which the holder would be entitled; and
- b. There is no active market for the instrument or the instrument can be exchanged only with the reporting entity.

Question 1(e): Do you believe there is a conceptual basis for classifying these instruments as equity? Does equity classification reflect the economics of the instruments?

Question 1(f): Are the requirements clear and operational? What, if any, potential issues do you foresee?

Perpetual Instruments

Perpetual instruments other than basic ownership instruments are classified as liabilities under the basic ownership approach. That means shares with a preference in liquidation would be liabilities whether they are perpetual, callable, puttable, or mandatorily redeemable. The basis for conclusions explains that those instruments are classified as liabilities because they reduce the assets available for distribution to holders of the basic ownership instruments. Many respondents disagreed with the FASB's decision. Most respondents relied on the current definition of a liability to support their opposing view, noting that preferred shares do not impose an obligation to deliver cash or other assets.

Question 1(g): What, if any, potential issues do you foresee if perpetual instruments that do not meet the definition of basic ownership instruments are classified as liabilities?

One constituent suggested an alternative approach based solely on lack of a settlement requirement (referred to as the perpetual approach). In other words, all perpetual instruments and only perpetual instruments would be classified as equity.

Question 1(h): What problems raised by the basic ownership approach would be avoided by using the perpetual approach? What new problems would arise?

Classifying certain types of perpetual instruments as equity raises issues of economic compulsion. For example, some entities have issued perpetual preferred stock with a dividend requirement that increases over time and is cumulative (must be paid before common dividends can be paid). The dividend rate may eventually become so high that the entity's only economically rational decision seems to be to repurchase the instrument. Even though the terms of the instrument do not create a legal obligation to redeem it, the entity will more than likely repurchase the shares.

Question 1(i): Is this issue significant and prevalent enough that the Board should avoid the perpetual approach or include special provisions to deal with it? If so, how would you suggest the Board resolve this issue?

Classification of Basic Ownership Instruments Issued by Subsidiaries and Variable Interest Entities

Under the basic ownership approach, basic ownership instruments of a subsidiary or consolidated variable interest would be classified as equity in the consolidated financial statements unless their characteristics change upon consolidation. Many respondents asserted that that decision is inconsistent with the underlying principle of the basic ownership approach. For example, noncontrolling interests in a subsidiary would be considered equity of the consolidated entity even though they represent interests that are limited to a share of the net assets of a subsidiary, not the consolidated entity itself.

Question 1(j): What issues would arise if the Board required a consolidated entity to classify a subsidiary's basic ownership instruments as liabilities?

ISSUE 2—MEASUREMENT

Distinguishing between liability instruments and equity instruments is critical for determining an entity's net income. Changes in assets and liabilities affect net income, while changes in equity instruments do not.

Under the basic ownership approach, instruments that have varying or uncertain settlement amounts, for example, hybrid instruments (for example, convertible debt) and derivatives on the issuer's basic ownership instruments, would be measured at fair value unless another standard permits or requires a different measurement attribute. Changes in fair value would be reported in income. Instruments with fixed maturity dates and settlement amounts that are fixed are accreted or amortized. The measurement requirements are generally consistent with the measurement requirements that apply to other similar instruments not within the scope of this project.

Question 2: Are there other alternative measurement requirements that would result in recognizing a gain or loss related to hybrid instruments?

ISSUE 3—INCOME STATEMENT PRESENTATION

The Board has not yet reached tentative conclusions about how to display the effects on net income that are related to the change in the instrument's fair value. Some respondents suggested that interest expense should be displayed separately from the unrealized gains and losses.

Question 3: Should the change in an instrument's fair value be disaggregated? If so, how should that amount be disaggregated and displayed? Does disaggregation introduce complexity that the basic ownership approach seeks to avoid?

ISSUE 4—EARNINGS PER SHARE

The Board has not discussed the implications of the basic ownership approach for the EPS calculation in detail; however, it acknowledges that the approach will have a significant effect on the computation.

In August 2008, the FASB issued a revised Exposure Draft (ED) of a proposed Statement of Financial Accounting Standards, *Earnings per Share*—an amendment of FASB Statement No. 128. Paragraph 7 of that ED states:

“If a freestanding instrument is measured at fair value each period with changes in fair value recognized in earnings, the effect of that instrument on common shareholders during the period is reflected in the numerator of diluted EPS through the fair value changes recognized in earnings. Because the effect of that instrument on common shareholders during the period has been reflected in the numerator, an entity shall not increase the denominator for the number of additional common shares that would arise from the exercise or conversion of that instrument.”

Question 4: Many hybrid instruments and derivatives on an issuer's basic ownership instruments are recorded at fair value under the basic ownership and would be subject to the requirements described above. Does this result provide users with decision-useful information?

ATTACHMENT B

**FINANCIAL INSTRUMENTS WITH CHARACTERISTICS OF EQUITY
ROUNDTABLE MEETING
Norwalk, CT
September 8, 2008
9:30 a.m. – 12:00 p.m.**

Participant List

Participants

Comment Letter No.

	Users:	
Dina M. Maher	Fitch Ratings	#4
	Preparers:	
Norman Leung	Credit Suisse	#58
Paul Karr	Nortel Networks	#32
Mike Tovey	UBS	#26
	Auditors:	
Mark Bielstein	KPMG	#33
Robert Uhl	Deloitte	#46
David Holman	Ernst & Young	#56
	Regulators:	
Cathy Cole	Securities and Exchange Commission	N/A
Adam Brown	Securities and Exchange Commission	N/A

FASB

Bob Herz	Board Chairman
Leslie Seidman	Board Member
Larry Smith	Board Member
George Batavick	Board Member
Tom Linsmeier	Board Member
Russ Golden	Technical Director
Jill Switter	Project Manager
Chandy Smith	Senior Technical Advisor

IASB

Jim Leisenring	Board Member
Liz Figgie	Senior Project Manager

**FINANCIAL INSTRUMENTS WITH CHARACTERISTICS OF EQUITY
ROUNDTABLE MEETING
Norwalk, CT
September 8, 2008
1:00 p.m. – 3:30 p.m.**

Participant List

<u>Participants</u>		<u>Comment Letter No.</u>
	Preparers:	
Daniel Counce	Federal Home Loan Bank	#34
Volker Heegemann	European Association of Cooperative Banks	#24
Mary Griffin	National Cooperative Business Association	#31
Gregory Taylor	National Society of Accountants for Cooperatives	#38
	Auditors:	
John Althoff	PricewaterhouseCoopers	# 44
Mark Scoles	Grant Thornton	# 47
	Other:	
Judith H O'Dell	Private Company Financial Reporting Committee	#8
 FASB		
Bob Herz	Board Chairman	
Leslie Seidman	Board Member	
Larry Smith	Board Member	
George Batavick	Board Member	
Tom Linsmeier	Board Member	
Russ Golden	Technical Director	
Jill Switter	Project Manager	
 IASB		
Jim Leisenring	Board Member	
Liz Figgie	Senior Project Manager	