MEMORANDUM

To: Board Members

From: Liabilities and Equity Team

Subject: Minutes of January 22, 2003 Board Meeting **Date:** January 29, 2003

cc: Bielstein, Leisenring, Smith, Petrone, Swift, Polley, Project Team, Thompson, FASB Intranet (e-mail), Sutay, Gabriele

Topics: Matters that Arose from Board Members and Others on a Draft of the Proposed Statement

Basis for Discussion: Staff memoranda dated January 13, 2003 and January 16, 2003

Length of Discussion: Starting Time: 10:00 a.m. Concluding Time: 12:00 p.m.

Attendance:

Board members present:	Herz, Crooch, Foster, Schieneman, Schipper, Trott, and Wulff
Board members absent:	None
Staff in charge of topic:	Bullen, Martin, and B. Richards
Other staff at Board table:	Bielstein, Nesta, and R. Richards
Outside participants:	None

Summary for ACTION ALERT:

The Board discussed matters that arose from comments by Board members and others on a draft of the forthcoming final Statement, *Accounting for Certain Financial Instruments with Characteristics of Liabilities and Equity*.

The Board decided:

- To affirm its previous decision that separate freestanding financial instruments should not be combined in applying the provisions of this Statement if any of the instruments is a liability. The Board also decided to clarify that the classification requirements in the Statement should be applied to each embedded derivative embodying an obligation to determine whether bifurcation is required. (That is, in analyzing multiple embedded derivatives in a host contract for possible separation under the requirements of paragraph 12 of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, each embedded derivative should be analyzed separately. However, all derivatives bifurcated from one host contract would then be bundled together for purposes of accounting and reporting.) [All Board members agreed]
- To affirm its previous decision that for forward contracts to purchase an entity's equity shares that require physical settlement in exchange for cash (physically settled forward purchase contracts), the liability should initially be measured by the issuer of the shares at the present value of the amount to be paid at settlement. [4 Board members agreed: GMC, RHH, GSS, EWT; 3 disagreed: KAS, JMF, JKW]
- That for mandatorily redeemable instruments and physically settled forward contracts, the shares to be redeemed or repurchased should not be considered outstanding shares for purposes of basic and diluted earnings per share (EPS) calculations. The Board clarified that the dividends or other amounts attributable to those shares that are to be redeemed or repurchased are interest costs that should be reflected in the earnings available to common stockholders (the numerator of EPS calculations). [All Board members agreed]
- For obligations to repurchase an entity's own equity shares that require a transfer of assets and for certain share-settled obligations, the liability should be subsequently measured at fair value unless another measurement attribute is specified by either this Statement or other accounting guidance. The Board also decided that mandatorily redeemable instruments should be subsequently measured by accreting the carrying amount to the redemption amount, using the interest method at the rate implicit at initial measurement if the redemption amount and date are fixed or determinable. If the redemption amount or date is variable, a mandatorily redeemable instrument should be subsequently measured at the redemption amount. Those methods also should be applied to a physically settled forward purchase contract. [All Board members agreed]
- When a contingently redeemable instrument becomes mandatorily redeemable, upon reclassification the issuer should initially measure that liability at fair value and reduce equity by the amount of that initial measure, recognizing no gain or loss. [All Board members agreed]
- To remove from the scope of this Statement all obligations for stock compensation arrangements addressed in APB Opinion No. 25, *Accounting for Stock Issued to Employees*, FASB Statement No. 123,

Accounting for Stock-Based Compensation, and other related guidance. [All Board members agreed]

- That for mandatorily redeemable instruments and physically settled forward purchase contracts, accumulated prior accretion would not be recognized upon transition. Embedded derivatives that are now subject to bifurcation should follow the guidance in paragraph 51 of Statement 133 using the effective date in the proposed Statement. The Board also decided that this Statement will not require recognition at transition of liabilities for existing minority interests that are mandatorily redeemable to result in changes in amounts previously recognized in business combinations under the purchase method. The Board directed the staff to include examples of cumulative-effect entries in the Statement for various classes of instruments. [All Board members agreed]
- To clarify its previous decision that entities having equity instruments, all of which are mandatorily redeemable, should describe those instruments as shares subject to mandatory redemption in statements of financial position to distinguish those instruments from other liabilities. The Board noted that the presentation requirements would be the same for entities with more than one class of mandatorily redeemable instruments if all classes are mandatorily redeemable. [All Board members agreed]
- To change the effective date of the final Statement for contracts entered into before the issuance date to the first interim period beginning after June 15, 2003. [All Board members agreed]
- To affirm its previous decision requiring cumulative-effect transition, rather than permitting restatement. [4 Board members agreed: RHH, KAS, JMF, EWT; 3 disagreed: GMC, JKW, GSS]

<u>Matters Discussed and Decisions Reached</u>:

The Board discussed the following matters that arose from comments by Board members and others on a draft of the proposed Statement:

1. Preclusion of Combining Freestanding Financial Instruments Within the Scope of the Proposed Statement and Identifying Multiple Embedded Derivatives

The Board decided to affirm its previous decision that separate freestanding financial instruments should not be combined in applying the provisions of this Statement if any of the instruments is a liability. The Board reasoned that (1) a liability under the proposed Statement should be reported as such (2) allowing the liability to be combined with another contract could cause a liability not to be reported or change the liability's measurement from fair value to present value, (3) although precluding combining might allow structuring opportunities, allowing combining would allow even more egregious structuring opportunities, and (4) the guidance is straightforward.

The Board also decided to clarify that the classification requirements in the Statement should be applied to each embedded derivative embodying an obligation to determine whether bifurcation is required. (That is, in analyzing multiple embedded derivatives in a host contract for possible separation under the requirements of paragraph 12 of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, each embedded derivative should be analyzed separately. However, all derivatives bifurcated from one host contract would then be bundled together for purposes of accounting and reporting.) The Board reasoned that the preclusion of combining freestanding instruments that are in the scope of the proposed Statement should be applied consistently when analyzing multiple embedded derivatives in a host contract for possible separation under the requirements of paragraph 12 of Statement 133.

The Board also noted that the guidance is consistent with Statement 133 implementation guidance to analyze each embedded derivative as freestanding in identifying embedded features for possible separation. The Board clarified that if more than one embedded feature is separated, then those derivatives would be bundled and reported as a single compound derivative consistent with Statement 133.

One Board member asked that the proposed Statement state explicitly that the Statement does not change the process for bifurcation. Another Board member asked the staff to better articulate the differences between freestanding, compound, and embedded instruments and suggested that the staff add a comprehensive example illustrating the application of the proposed Statement for each of those instruments. The Board also requested that a flowchart illustrating how the Statement along with Statement 133 is applied to derivatives be provided in the Statement's implementation guidance.

2. Recognition and Measurement of Physically Settled Forward Purchase Contracts

The Board decided to affirm its previous decision that for forward contracts to purchase an entity's equity shares that require physical settlement in exchange for cash (physically settled forward purchase contracts), the liability should initially be measured by the issuer of the shares at the present value of the amount to be paid at settlement. The Board reasoned that physically settled forward purchase contracts are akin to a financing of a stock purchase or a treasury stock transaction and, therefore, should be initially measured at present value. The Board clarified that the special measurement provisions are only applicable when cash would be exchanged for the shares. If the issuer is to exchange a foreign currency, the transaction would be remeausured under FASB Statement No. 52, *Foreign Currency Translation*. If the exchange is to be a barter (for example, gold for shares), the forward purchase contract would be accounted for as a derivative, subsequently measured at fair value.

3. Earnings Per Share

The Board decided that for mandatorily redeemable instruments and physically settled forward contracts, the shares to be redeemed or repurchased should not be considered outstanding shares for purposes of basic and diluted earnings per share (EPS) calculations. The Board reasoned that the EPS calculations should be consistent with its decision to treat the physically settled forward purchase contracts and mandatorily redeemable shares as liabilities rather than equity. Thus, since no equity is recorded for those instruments, no shares should be considered outstanding for purposes of EPS calculations.

The Board clarified that the dividends or other amounts attributable to those shares that are to be redeemed or repurchased are interest costs that should be reflected in the earnings available to common stockholders (the numerator of EPS calculations).

4. Subsequent Measurement of Certain Instruments Within the Scope

The Board decided that for obligations to repurchase an entity's own equity shares that require a transfer of assets and for certain share-settled obligations, the liability should be subsequently measured at fair value unless another measurement attribute is specified by either this Statement or other accounting guidance. Generally, that measurement applies to financial instruments that are not deemed to be derivatives for purposes of Statement 133 and that are not mandatorily redeemable. The Board reasoned that fair value information is available for those instruments, and subsequent measurement at fair value would provide more relevant information than historical cost. The Board also decided that mandatorily redeemable instruments should be subsequently measured by accreting the carrying amount to the redemption amount, using the interest method at the rate implicit at initial measurement if the redemption amount and date are fixed or determinable. If the redemption amount or date is variable, a mandatorily redeemable instrument should be subsequently measured at the redemption amount. Those methods also should be applied to a physically settled forward purchase contract. The Board noted that the required method is consistent with guidance currently required by SEC and EITF literature for mandatorily redeemable instruments.

5. Reclassification of Contingently Redeemable to Mandatorily Redeemable

The Board decided that when a contingently redeemable instrument becomes mandatorily redeemable, upon reclassification the issuer should initially measure that liability at fair value and reduce equity by the amount of that initial measure, recognizing no gain or loss. The Board noted that its decision was consistent with its other initial measurement decisions and that the adjustment of the carrying amount should not be reflected in earnings.

6. Scope Exception for Stock Compensation Arrangements

The Board decided to remove from the scope of this Statement all obligations for stock compensation arrangements addressed in APB Opinion No. 25, *Accounting for Stock Issued to Employees*, FASB Statement No. 123, *Accounting for Stock-Based Compensation*, and other related guidance. The Board noted that it will likely revisit stock compensation arrangements in the near future and that it did not want to provide guidance that could potentially conflict with future decisions.

7. Cumulative Effect Entries upon Transition

The Board decided that for mandatorily redeemable instruments and physically settled forward purchase contracts, accumulated prior accretion would not be recognized upon transition. Embedded derivatives that are now subject to bifurcation should follow the guidance in paragraph 51 of Statement 133 using the effective date in the proposed Statement. The Board also decided that this Statement will not require recognition at transition of liabilities for existing minority interests that are mandatorily redeemable to result in changes in amounts previously recognized in business combinations under the purchase method. The Board directed the staff to include examples of cumulative-effect entries in the Statement for various classes of instruments. The Board noted that the business combination project should address those grandfathered minority interests in that project's transition guidance.

8. Entities with Multiple Classes of Mandatorily Redeemable Instruments

The Board decided to clarify its previous decision that entities having equity instruments, all of which are mandatorily redeemable, should describe those instruments as shares subject to mandatory redemption in statements of financial position to distinguish those instruments from other liabilities. The Board noted that the presentation requirements would be the same for entities with more than one class of mandatorily redeemable instruments if all classes are mandatorily redeemable. The Board's intent was to provide special presentation for entities having no equity reported. Additionally, the Board noted that those entities should disclose other comprehensive income adjustments along with other information that is provided in the required footnote disclosure.

9. Transition and Effective Date

The Board decided to change the effective date of the final Statement for contracts entered into before the issuance date to the first interim period beginning after June 15, 2003. The Board reasoned that its constituents needed more time to prepare for the requirements of the proposed Statement since the original issuance date has been delayed. The Board also decided to affirm its previous decision requiring cumulative-effect transition, rather than permitting restatement.

Follow-up Items:
None

General Announcements:
None