

## MINUTES



**To:** Board Members

**From:** Arbuckle (ext. 275)

**Subject:** Liabilities and Equity: Minutes of the October 6, 2004 Board Meeting

**Date:** October 20, 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

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Topic: Liabilities and Equity: Approaches for Distinguishing Liabilities from Equity for Single Component Instruments.

Basis for Discussion: Board memorandums dated August 24, 2004 (No. 12) and September 17, 2004 (No. 13)

Length of Discussion: 11:00 a.m. to 11:45 a.m.

Attendance:

Board members present:	Herz, Batavick, Crooch, Schieneman, Schipper, Seidman, and Trott
Board members absent:	None
Staff in charge of topic:	Richards
Other staff at Board table:	Lott, Carnrick, Arbuckle, and Hansen
Outside participants:	None

### Summary of Decisions Reached:

The Board discussed and agreed that an issuer would use the following approach for distinguishing whether a single component instrument would be classified as a liability or equity (words in italics are defined as described below):

1. An instrument that does not embody a *settlement obligation* is equity (unless it is an asset). An example is a share (common or preferred) that is not subject to redemption requirements.
2. An instrument that establishes a *direct ownership relationship* between the issuer and the holder is equity, even if it embodies a settlement obligation. An example is a common share that is mandatorily redeemable at fair value.
3. An instrument that establishes an *indirect ownership relationship* that would be settled or ultimately settled by issuing an instrument that establishes a direct ownership relationship is equity (such as a physically settled written call option). Otherwise, the instrument is a liability (such as a net cash-settled written call option).
4. An instrument that embodies a settlement obligation and does not establish either a direct or indirect ownership relationship is a liability. An example is a written put option.

The Board agreed on the following definitions in applying the approach:

1. A *settlement obligation* is a present obligation of an entity settled prior to liquidation to:
  - a. Transfer or provide use of assets
  - b. Use assets to provide services
  - c. Stand ready to use assets to provide services or transfer or provide use of assets
  - d. Issue shares or other instruments (fixed or variable number).
2. A *direct ownership relationship* is established by an instrument of an entity or consolidated subsidiary (reference instrument) that:
  - a. Is (or together with other instruments is) the most subordinated interest(s) issued by the entity or consolidated subsidiary, and

- b. Shares pro rata in the earnings and losses of the entity with other instruments meeting characteristic 2(a).
3. An *indirect ownership relationship* is established by an instrument of an entity in which the counterparty's payoff at settlement is based on and varies in the same direction as the fair value of the reference instrument and does not contain a contingency provision that is based on an external market or index.

Objective of Meeting:

The objective of the Board meeting was to choose one approach for distinguishing liabilities from equity for single component instruments. The objective of the meeting was accomplished.

Matters Discussed and Decisions Reached:

Ms. Richards noted that the purpose of the meeting was for the Board to select one approach one for distinguishing liabilities from equity for single component instruments. She described the proposed definitions of settlement obligation and ownership relationship and the three proposed approaches that determine how settlement obligation and ownership-relationship characteristics interact. Ms. Richards explained that the three approaches are the Base Approach, Narrowed Base Approach, and Expanded Base Approach.

1. The Base Approach: An instrument is a liability if it requires or may require the issuer to settle in assets, shares, or other instruments and does not establish an ownership relationship (direct or indirect). A direct ownership relationship is established by the most subordinated interests in the entity sharing pro rata in the earnings and losses of an entity (the reference instrument). An instrument establishing a direct ownership relationship is considered equity<sup>1</sup> regardless of any settlement obligation. An indirect ownership relationship is established by an instrument indexed to, and in the same direction as, the reference instrument. An instrument establishing an indirect ownership

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<sup>1</sup> Instruments having settlement requirements that are classified as equity may be presented as a separate part of equity. This will be determined at future Board meetings.

relationship is a liability if its' settlement or ultimate settlement would not result in establishing a direct ownership relationship.

2. Narrowed Base Approach: Same as the Base Approach except an instrument establishing an indirect ownership relationship is a liability regardless of its form of settlement.

3. Expanded Base Approach: Same as Base Approach except an instrument establishing an ownership relationship (direct or indirect) is equity regardless of a settlement obligation or its form of settlement.

The staff recommended the Base Approach because the staff believes that neither a settlement obligation nor an ownership relationship should be disregarded for instruments establishing an indirect ownership relationship. Both should be considered in determining the classification. Ms. Richards noted that the staff believes that for a direct ownership relationship, the holders of the instruments would be owners of the entity, and the settlement obligations for those direct interests would be a transaction between the owners and the entity.

Ms. Richards asked the Board if they had questions regarding the approaches and which approach the Board would prefer to distinguish liabilities from equity for single component instruments.

Mr. Trott supports the Base Approach because he believes that both the settlement requirement and ownership relationship should be considered in determining liabilities and equity. He believes the Base Approach properly considers both the settlement requirement and the ownership relationship features of financial instruments. Mr. Trott observed that settlement of financial instruments is an important aspect under FASB Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*. Mr. Trott also supports the Base Approach because it treats as equity the most subordinated instrument of an entity that shares pro rata in the earnings and losses of the entity. He said that this is important because it solves issues that arise for nonpublic enterprises under Statement 150.

Ms. Schipper supports the Base Approach because it balances the form of the payoff and the economic determinants of the payoff. She stated that she is not in favor of any special display considerations that may arise using the other approaches. She believes that the elements of the definitions of liabilities and equity should be robust enough that special display in the financial statements is not necessary. Ms. Richards noted that the Base Approach also would require special display considerations for instruments that establish direct ownership relationships embodying settlement obligations (to be discussed at future meetings); however, the other approaches would rely more on special display. Ms. Schipper acknowledged that the Base Approach may be more difficult to explain than the other approaches and more amenable to transaction structuring, but noted that that has not been ascertained as of yet. Mr. Crooch agreed with Ms. Schipper and Mr. Trott and supported the Base approach.

Ms. Seidman said that her first choice of the three approaches is the Expanded Base Approach. She said that her primary reason for supporting that approach is to accomplish the objective of having instruments with a payoff that relate to an ownership interest be accounted for consistently. Ms. Seidman said it was the only pure way to prevent enterprises from structuring transactions to get different accounting treatment for economically similar instruments. She stated that market participants view an instrument as an equity instrument if it has a payoff, whether in cash or shares, similar to that of an equity share. Ms. Seidman expressed concern that the Board may select an approach that would result in reporting certain transactions of an entity's own stock in the income statement. She also said that it should not matter how an instrument is settled, whether by cash or shares, if there is an ownership relationship. While recognizing her concerns that the Base Approach would classify certain instruments differently although they would have the same payoff to the counterparty, Ms. Seidman said that her second choice would be the Base Approach. She also expressed concern that, by using the Base Approach, enterprises may be able to structure transactions for a particular accounting treatment.

Mr. Schieneman supports the Narrowed Base Approach. Mr. Schieneman views the settlement obligation as the key aspect of classifying instruments and believes that

whether the instrument is settled with cash or shares is not significant for classification purposes. Mr. Schieneman was not in favor of the Base Approach because it provides different classification of instruments that have similar payoffs to the counterparty. He stated that the settlement obligation should override the ownership relationship of financial instruments, and therefore favored the Narrowed Base Approach. Mr. Schieneman also said that, in his opinion, many analysts would not find any of the three approaches beneficial to their analysis and would prefer a mezzanine level so they can classify the instruments as they see fit. To that extent, Mr. Schieneman supported an approach that would allow for special classification of the financial instruments. He stated that he would classify instruments that could be settled with shares in a separate section in the liabilities section, before shareholders equity, and let the user make adjustments as desired. He believes the Narrowed Base Approach is very operational and is easier to understand than the Base Approach.

Mr. Batavick acknowledged that each approach has different trade-offs. He believes the notion of indirect ownership is a significant factor to consider and that the manner in which an instrument is settled also is crucial to its classification. Therefore, Mr. Batavick supported the Base Approach.

Mr. Herz observed that the Base Approach would be an improvement to current accounting. However, he said his preference is the Narrowed Base Approach, although there are many issues to explore with that approach. He stated that he was troubled that the Base Approach would facilitate transaction structuring to avoid certain accounting consequences. Mr. Herz also said that he was not persuaded by the notion of an indirect ownership relationship, noting that the common stock or most residual shares result in a direct ownership relationship and the other instruments are all derivatives of that residual instrument. Although the Narrowed Approach creates measurement and display issues for those derivative instruments, Mr. Herz stated he was interested in exploring the alternatives. He also expressed support for the Narrowed Base Approach because it would be difficult for enterprises to exploit, but observed that he would support the Base Approach and not object the Board's choice.

The Board unanimously decided to pursue the Base Approach for distinguishing liabilities from equity for single component instruments.

Follow-Up Items:

None.

General Announcements:

None.