MINUTES

Financial Accounting Standards Board

To:	Board Members
From:	Liabilities and Equity Team (R. Richards, Ext. 303)
Subject:	Minutes of the October 30, 2002 Board Meeting
Date:	November 6, 2002
Time Code	A: FI-LE
Cc:	Bielstein, Bullen, Cassel, Financial Instruments Team, Gabriele, Leisenring, Mahoney, Martin, Petrone, Polley, Smith, Sutay, Swift, Thompson, FASB Intranet

Topics:	Additional Equity Criteria and Application of the Ownership Relationship Model
Basis for Discussion:	Staff memorandums dated October 11 and October 28, 2002
Length of Discussion:	Starting Time: 9:45 a.m. Concluding Time: 12:15 p.m.
Attendance:	
Board members present:	Crooch, Foster, Herz, Schieneman, Schipper, Trott, and Wulff
Board members absent:	None
Staff in charge of topics:	B. Richards, Bullen, and Martin
Other staff at Board table:	Bielstein, Nesta, and R. Richards
Outside participants:	Leisenring (IASB)

MATTERS DISCUSSED, DECISIONS REACHED, AND FOLLOW-UP ACTION

The Board discussed whether or not to include the additional equity criteria in paragraphs 12–32 of EITF Issue No. 00-19, “Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company’s Own Stock,” in a final Statement. The Board tentatively agreed that certain of the criteria should be incorporated into a Statement that addresses obligations potentially settleable in a company’s own stock that are classified as equity, but noted that the guidance may or may not be necessary in its planned limited-scope Statement, depending on the scope of that Statement.

The Board also discussed the application of the ownership relationship model to both simple and complex freestanding derivative instruments indexed to an entity's own stock (derivative instruments to sell an issuer's own stock). For simple instruments, the Board initially decided that an ownership relationship could exist if the holder of a financial instrument only participates in one side of the risk or return of ownership (for example, an issuer-written call option on its own stock). However, the Board did not conclude on how the model would apply to complex derivative instruments that effectively combine options or options and forward contracts to issue an entity's own stock. Therefore, the Board directed the staff to explore the feasibility of a narrower scope for Phase One that would be limited to its decisions reached to date for the following financial instruments:

- Written put options and forward purchase contracts to repurchase an entity's own stock
- Mandatorily redeemable instruments
- Financial instruments that are not derivatives in their entirety that must, or at the issuer's discretion, could be settled by issuance of a variable number of the issuer's shares
- Derivative financial instruments that embody an obligation that must or could, at the issuer's discretion, be settled by issuance of an entity's own stock, but that are indexed to an additional underlying.

The Board directed the staff to draft language covering that proposed scope at its November 13, 2002 meeting, when it will discuss whether to issue a limited-scope Statement based on those decisions.

BASES FOR BOARD DECISIONS

Additional Equity Criteria

The Board tentatively agreed to include certain of the equity criteria from Issue 00-19 into a Statement that addresses obligations potentially settleable in a company's own stock that are classified as equity. Mr. Wulff stated that he would have preferred that none of the additional equity criteria be included in the Statement. He stated that, in a principles-based standard setting environment, a clear definition of the ownership relationship notion should be sufficient. Board members in favor of including the additional criteria in the Statement stated that the criteria would be useful in communicating the Board's intent, and the criteria would ensure that a company with obligations settleable in its own stock would receive equity classification only if it has the actual ability to deliver the necessary shares and would not be obligated to transfer assets to settle its obligations. The Board also tentatively favored adding, as an additional criterion for determining the classification of those obligations, consideration of a company's past practice of settling such obligations with shares. Under such a criterion, companies with a history of settling obligations that are potentially settleable in shares by transferring cash or other assets would not be afforded equity classification. The Board agreed to discuss this issue further after deciding what instruments would be included in the scope of Phase One.

Application of the Ownership Relationship Model

The Board discussed eight examples of simple and more complex equity instruments. The Board tentatively decided that an ownership relationship could exist for simple equity instruments even if the holder of the financial instrument only participates in one side of the risk or return of ownership. Mr. Wulff dissented, stating that he did not believe that an ownership relationship exists if the holder only participates in one side. Board members that voted in favor of the existence of an ownership relationship for the aforementioned instruments stated that (1) the Board never intended to require a complete ownership relationship for those instruments, (2) an ownership relationship exists in the relevant range of outcomes (when the contract is in-the-money from the holder's perspective for an issuer-written call option or warrant and across all ranges for a forward sales contract), and (3) not allowing an ownership relationship for instruments such as written call options would have wide implications and result in unintended consequences.

The Board discussed the agreed-upon application of the ownership relationship for simple instruments in the context of applying that concept to complex derivatives that are a combination of options or of options and forwards that alter the number of shares that the issuer would be obligated to deliver based on the stock price at the date of settlement. The Board discussed two alternatives focusing on whether the number of shares to be delivered should be established at inception of the contract or can fluctuate due to the interaction of the components of the contract, as long as the shares underlying each component and the resulting obligation would be indexed only to the issuer's equity shares.

The Board also considered three radical alternatives that would change the direction of Phase One. Those alternatives included following the approach the IASB has proposed, substantially narrowing the scope of Phase One to concentrate on obligations that may be settled by issuing a variable number of shares representing a fixed monetary amount, and reconsidering the decision to split the project into phases.

The Board agreed that complex derivatives raise issues that would better be considered in Phase Two along with separation issues. Therefore, the Board directed the staff to explore a narrower scope for Phase One that would only include those financial instruments that the Board has decided should be classified as liabilities. The Board also decided to consider issuance of a narrower scope Statement without issuing the planned amendment to Concepts Statement No. 6, *Elements of Financial Statements*, partially to avoid the possibility of a need to further amend that Concepts Statement in Phase Two. The Board directed the staff to present the results of its exploration of the proposed narrower scope at the November 11, 2002 educational session and the November 13, 2002 Board meeting.

SUMMARY FOR ACTION ALERT

Same as Matters Discussed…

GENERAL ANNOUNCEMENTS

None.