MINUTES

To:	Board Members
From:	Hansen (ext. 298)
Subject:	Liabilities and Equity: Summary of November 24, 2004 Board Meeting
Date:	December 1, 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: Ownership/Settlement Approach—Determining a Direct Ownership Relationship and Settlement Alternatives
Basis for Discussion:	Board memorandums dated November 12, 2004, (No. 16) and November 22, 2004 (No. 17)
Length of Discussion:	9:00 a.m. to 9:30 a.m.
Attendance:	
Board members present:	Herz, Batavick, Crooch (by phone) Schieneman, Schipper, Seidman, and Trott
Board members absent:	None
Staff in charge of topic:	Richards
Other staff at Board table:	Lott, Thuener, Carnrick, and Hansen
Outside participants:	None

<u>Summary of Decisions Reached</u>:

The Board continued to develop the Ownership/Settlement Approach for distinguishing liabilities and assets from equity for single component instruments by discussing (a) characteristics of a direct ownership relationship and (b) determining the form of settlement that should be assumed for instruments with multiple settlement alternatives.

The Board decided that a direct ownership relationship is established by an instrument of an entity or consolidated subsidiary (reference instrument) if the instrument has two essential characteristics:

a. ***A claim to a share of the net assets*** of the entity or consolidated subsidiary that is not limited in amount (that is, there is no floor or ceiling on the holder's claim to a share of net assets). Sharing in the net assets includes evaluating the holder's returns over the instrument's lifetime and at liquidation. Instruments with fixed or specified terms that do not share in the excess net assets upon liquidation do not meet this condition.

b. ***Subordination in a hypothetical liquidation***; that is, if the entity or consolidated subsidiary were to liquidate (a hypothetical liquidation) at the assessment date, the holder of the instrument would be last in line to receive their share of the net assets. An instrument that must be converted to another instrument to be subordinated in a hypothetical liquidation at the assessment date would not meet this condition.

Those two essential characteristics of a direct ownership relationship replace the original characteristics that were decided on at the October 6, 2004 Board meeting.

The description of a direct ownership relationship *generally* results in the following:

a. Options and forward contracts would not establish a direct ownership relationship. (However, they might establish an indirect ownership relationship).

b. Mandatorily redeemable instruments that include a claim to a share of the net assets of an entity would establish a direct ownership relationship if they are, or together with other instruments are, the most subordinated interests in a hypothetical liquidation at the assessment date.

c. Mandatorily redeemable instruments that include a claim to a share of the net assets of a consolidated subsidiary would establish a direct ownership relationship if they are the most subordinated interests of the subsidiary in a hypothetical liquidation at the assessment date.

The Board also discussed single component instruments embodying settlement obligations or rights that have multiple settlement alternatives—those that would be settled by the issuer delivering or receiving assets or shares—modifying the decision made at its November 3, 2004 meeting. The Board decided that if the issuer or counterparty has a choice of settling with assets or shares, an instrument establishing an indirect ownership relationship might not be settled with shares and, therefore, the issuer should assume asset settlement and classify the instrument as a liability or asset. Examples are a written call or purchased put option that can be net cash- or share-settled at the choice of the issuer or counterparty.

Additionally, the Board confirmed its prior decision that the issuer should assume delivery of assets if the form of settlement is determined by conditions outside the control of the issuer and the counterparty. The Board also decided that subsequent reassessment is required for those instruments to determine whether the condition is present or has been resolved such that the instrument would be settled with shares and could be reclassified as equity.

The Board directed the staff to prepare a milestone draft of its decisions to date relating to single component instruments under the Ownership/Settlement Approach. The Board requested that the staff obtain input on the approach from the liabilities and equity resource group members.

<u>Objective of Meeting</u>:

The objective of the meeting was to further refine the Ownership/Settlement Approach for distinguishing liabilities and assets from equity for single component instruments by determining the characteristics of a direct ownership relationship and what form of settlement should be assumed if there are multiple settlement alternatives. The objective of the meeting was accomplished.

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

1. Ms. Richards opened the meeting by discussing the staff's plan to prepare a milestone draft of the Ownership/Settlement Approach for single component instruments, including the basis for conclusions. She then introduced the first issue of defining the characteristics of a direct ownership relationship. She proposed two essential characteristics:

a. ***A claim to a share of the net assets*** of the entity or consolidated subsidiary that is neither a fixed amount nor is limited (that is, there is no floor or ceiling on the share of net assets). Sharing in the net assets includes evaluating the holder's returns over the instrument's lifetime and at liquidation. Instruments with fixed or specified terms that do not share in the excess net assets upon liquidation do not meet this condition.

b. ***Subordination in a hypothetical liquidation***. That is, if the entity or consolidated subsidiary were to liquidate (a hypothetical liquidation) at the assessment date, instruments that convey a direct ownership relationship would be last in line to receive their share of the net assets. An instrument that must be converted to another instrument to be subordinated in a hypothetical liquidation at the assessment date would not meet this condition.

2. Ms. Richards also presented an alternative to the subordination condition that would limit direct ownership to perpetual shares or to instruments of an entity that had no perpetual shares.

3. Mr. Trott supported the two essential characteristics of a direct ownership relationship. He stated his preference for the staff's proposed description of subordination in a hypothetical liquidation and did not support the alternative perpetual requirement. He also stated that the staff should continually test whether the two characteristics, as worded, are operational in distinguishing a direct ownership relationship.

4. Ms. Schipper also supported the two essential characteristics. She noted that the reference to a claim on net assets in the definition of subordination in a hypothetical liquidation is not circular. She pointed out that the definition determines the status of the

instrument (in terms of direct ownership relationship), not the amount. Ms. Schipper also noted that the objective is to determine the status of an instrument. She stated that the two characteristics appear to be properly described and are an improvement over the prior description of direct ownership relationship. However, she noted that the two characteristics must be tested to ensure that they are sufficient. She agreed that there should be no perpetual requirement.

5. Mr. Herz, Mr. Schieneman, Ms. Seidman, Mr. Crooch, and Mr. Batavick also affirmed their support for the two essential characteristics describing a direct ownership relationship. However, Mr. Batavick stated that he was uncomfortable with the use of the term *hypothetical* in the subordination condition. He stated his preference for using a different word to describe the assessment.

6. Ms. Richards introduced the second issue of what form of settlement should be assumed for an instrument that can be settled in either assets or shares. She stated that the issue is relevant for instruments that establish an indirect ownership relationship. She noted that the Board previously decided to assume share settlement unless there would be sufficient evidence that settling in shares is a remote possibility (Method 2 below). Ms. Richards stated that the staff further analyzed the issue and is presenting a new method (Method 4 below). She presented the four methods:

a. Method 1: Assume settlement in shares.

b. Method 2: Assume settlement in shares unless there is sufficient evidence that settling in shares is a remote possibility.

c. Method 3: Assume settlement in assets.

d. Method 4: Assume settlement in assets unless there is sufficient evidence that settling in assets is a remote possibility.

7. Ms. Richards stated that the staff members recommend Method 3 because they believe that method is the most compatible with the Ownership/Settlement Approach. She stated that issuer discretion would not be overridden for this method because discretion would be used in determining if an issuer is obligated. Ms. Richards stated that because a settlement obligation would include settling in assets or shares, the issuer is obligated. She further explained that an instrument establishing an indirect ownership

relationship can be equity only if the settlement results in a direct ownership relationship being established. Since the issuer does not know how the instrument will be settled, asset settlement should be assumed and, therefore, the instrument would be classified as a liability or asset. Ms. Richards also stated that Method 3 would best limit accounting arbitrage and would not be as complex as other intent-based methods. She said that the staff would not object to Method 4 with strict evidence of share settlement.

8. Mr. Crooch, Ms. Schipper, and Mr. Trott reaffirmed their support for Method 3 and agreed with the staff's reasoning.

9. Ms. Seidman also supported Method 3, only because it is consistent with the classification scheme that has been developed and in the interest of making progress. However, she stated her ongoing concern with a model that is dependent on form of settlement in determining classification. She explained that the issuer choice of settlement is a symptom of a basic flaw in the Ownership/Settlement Approach—which is that instruments that have similar economic substance would be accounted for differently. She observed that the points made by the project resource group suggesting that settlement options are generally nonsubstantive raises broader concern about any classification approach that results in different accounting for contracts that *require* settlement in cash vs. contracts that *require* settlement in shares, but the payoffs are the same. She also expressed concern with choosing a method based on past practice and intent. She stated that the FASB should have extensive discussions with credit and equity analysts to determine if the output of the approach provides useful information before moving on to the next milestones in the project.

10. Mr. Schieneman stated that he favored Method 4. If past practice indicates that an instrument will be settled in shares, Mr. Schieneman said that he is concerned with accounting for the instrument as if it will be settled with assets because the gains and losses on that instrument would be recognized through earnings. He did not object to Method 3, with the provision that the staff obtain input from analysts.

11. Mr. Batavick supported Method 4 because it would allow entities to asses the economic reality of the arrangement. He believes that Method 4 is compatible with the

Ownership/Settlement Approach and is more representationally faithful. He stated he would not object to Method 3.

12. Mr. Herz stated that under the existing model he prefers Method 4, but would not object to Method 3. He believes that it is better to treat all instruments with an indirect ownership relationship as liabilities. He requested that the staff investigate circumstances where a cash settlement alternative may have to be inserted into a contract even though settlement would be in shares.

13. Mr. Leisenring stated that Method 3 is convergent with the revised IAS 32, *Financial Instruments: Disclosure and Presentation*, and has a better chance of support from the IASB.

14. Ms. Richards introduced two subissues of the settlement assumption for multiple settlement alternatives: (a) what form of settlement to assume for instruments with rights to receive shares or assets, and (b) whether subsequent reassessment would be required. She stated that with Method 3 the staff recommends consistent treatment for a right to receive assets or shares such that the issuer should assume asset settlement. She also recommended that subsequent reassessment would be necessary only for instruments in which the form of settlement is determined by conditions outside the control of the issuer and the counterparty to determine if the condition is present.

15. All Board members supported the staff's recommendation.

16. The Board directed the staff to prepare a milestone draft of its decisions to date relating to single component instruments under the Ownership/Settlement Approach. The Board requested that the staff obtain input on the approach from the liabilities and equity resource group members.

Follow-up Items:

The staff will prepare the milestone draft and obtain input from the resource group members and analysts.

General Announcements:

None.