MINUTES

To: Board Members

From: Financial Instruments: Liabilities and Equity Team (Belot, ext. 363)

Subject: Minutes of the December 3, 2003 Liabilities and Equity Board Meeting

Date: December 10, 2003

cc: Leisenring, Bielstein, Smith, Cassel, Lott, Project Team (Arbuckle, Belot, Bullen, Laurenzano, and Richards), Mahoney, Swift, Polley, Sutay, Gabriele, Petrone, Thompson, FASB Intranet

Topic: Liabilities and Equity: Equity Distinction

Basis for Discussion: Memorandums of November 20 & 26, 2003

Length of Discussion: 2:40 p.m. to 3:40 p.m.

Attendance:

Board members present: Herz, Batavick, Crooch, Schieneman, Schipper, Seidman, and Trott

Board members absent: None

Staff in charge of topic: Bullen and Richards

Other staff at Board table: Arbuckle, Belot, and Bielstein

Outside participants: None

Summary for ACTION ALERT:

The Board discussed various approaches to distinguish equity from liabilities and assets for simple financial instruments, such as options and forward contracts. The Board decided to pursue an approach that considers both liquidity (form of settlement and discretion) and whether an ownership relationship is established by the financial instrument between the issuer of the shares and the counterparty. Under that approach, an instrument potentially settled by issuing (or redeeming) an entity's own shares can be equity (or reduce equity) only if it cannot require net cash settlement and the counterparty's payoff at settlement moves in the same direction as the issuer's share price. For purposes of comparison, the Board also decided to continue to consider an approach that would narrowly define equity by potentially limiting the definition to nonredeemable common shares. Additionally, in the interest of international convergence, the Board also decided to continue to consider the proposed approach in the forthcoming revised IASB Statement No. 32, *Financial Instruments: Disclosure and Presentation.*

Matters Discussed and Decisions Reached:

Mr. Bullen and Ms. Richards described the five approaches for distinguishing equity from liabilities and assets for simple financial instruments, as described in the staff's memorandum to the Board. Those approaches are as follows:

- Approach A: Something like an owner approach (Exposure Draft approach)
- Approach B: "Pure Equity" approach
- Approach C: Eliminate the equity distinction altogether
- Approach D: Transactions with owners approach
- Approach E: The IASB's approach in the forthcoming IAS 32 (amended)

The staff conceded that the five approaches presented do not represent every possible approach for distinguishing equity from liabilities and assets; however, those approaches described represent the viable alternatives. Mr. Bullen stated that the staff recommends the Board pursue Approach A (an approach that combines liquidity and ownership relationship criteria) because that approach provides consistent accounting treatment among instruments with similar economic characteristics. As an example of the ownership relationship criterion, if the counterparty's payoff on a fixed-price option or forward contract varies directly with changes in the issuer's share price, indicated graphically by a slope upward and to the right on a payoff diagram, the instrument is accounted for as equity unless net cash settlement is required or could be required. Conversely, if that payoff varies inversely with changes in the issuer's share price, indicated graphically by a slope downward to the right, the instrument must be classified as an asset or liability. Therefore, the recommended approach provides a conceptual basis for distinguishing equity from liabilities and assets based both on the economics of the instrument and the current definitions of liabilities and assets in FASB Concepts Statement No. 6, *Elements of Financial Statements.* Mr. Bullen also noted that the staff does not oppose the pursuit of Approach E. The staff then asked the Board to choose an approach to apply for instruments (both simple and complex) going forward in Phase 2 of the liabilities and equity project or, at least, to eliminate some of the approaches.

Board members expressing a preference for Approach B [GSS and GMC] reasoned that the approach is superior because it provides a clear and simple definition of equity, while other proposed alternatives merely define the distinction between equity and assets or liabilities. In addition, Messrs. Schieneman and Crooch agreed that Approach B potentially limits opportunities to structure transactions to achieve desirable accounting treatment. Finally, those Board members noted that Approach B provides a simple method of analyzing complex financial instruments. Ms. Schipper disagreed, stating that Approach B is conceptually difficult to defend, because the approach does not reflect the enterprise's unique position with regard to issuance of its own shares.

Board members favoring Approach A [KAS, EWT, RHH, LFS, and GJB] expressed general agreement with the staff that this approach is consistent with the diagrams of the counterparty's payoff for the simple financial instruments that have been analyzed. Those Board members noted that Approach A considers both liquidity (form of settlement and discretion) and whether an ownership relationship is established by the financial instrument between the issuer of the shares and the counterparty. Therefore, it provides an internally consistent model that is based on both the current definitions of the elements and the economics of the instrument. Some Board members in favor of Approach A [RHH and GJB] said that they preferred to continue to consider Approach B as a point of comparison throughout the decision-making process.

All Board members stated that the preferred approach also should be continually compared to Approach E, in the interest of international convergence. However, Ms. Seidman expressed concern that Approach E may lend itself to transaction structuring opportunities, more so than Approach A, because it stresses the form of settlement. Additionally, Ms. Schipper suggested, and the staff confirmed, that sub-issues arising with the application of Approach A for the effect of various features in financial instruments (to be discussed at a future meeting) also are inherent in the application of Approach E.

The Board decided to pursue Approach A for distinguishing equity from liabilities and assets. [Five members agreed; GSS and GMC disagreed] The Board also decided to continue to consider Approach B [Four members agreed; KAS, EWT and LFS disagreed] and Approach E [All Board members agreed] for purposes of comparison between approaches during deliberations.

Follow-Up Items:

None.

General Announcements:

None.