MINUTES

To: Board Members

From: Financial Instruments: Liabilities and Equity Team (Arbuckle, ext. 275)

Subject: Minutes of the July 16, 2004 Liabilities and Equity Board Meeting **Date:** July 23, 2004

cc: Leisenring, Bielstein, Smith, Golden, Cassel, Project Team, Mahoney, Sullivan, Swift, Polley, Sutay, Gabriele, Petrone, Thompson, Getz, FASB Intranet

Topic: Liabilities and Equity: Principles for Distinguishing Liabilities and Assets from Equity

Basis for Discussion: Memorandum of July 9, 2004

Length of Discussion: 9:45 a.m. to 10:35 a.m.

Attendance:

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

Board members absent: Schieneman

Staff in charge of topic: Bullen and Richards

Other staff at Board table: Arbuckle, Lott

Outside participants: None

Summary of Decisions Reached:

The Board's discussion focused on a list of possible principles for distinguishing liabilities and assets from equity for financial instruments. The Board agreed with the completeness of the list and decided to begin its consideration of the principles by:

1. Further defining two of those principles:

    a. A liquidity condition—to be a liability an item must embody a present duty or responsibility to transfer or use assets.
    b. An ownership relationship condition—to be equity an item must earn returns similar to those of an owner and its holder must participate in the risks and rewards of ownership.

2. Addressing the interaction of a liquidity condition and an ownership relationship for a financial instrument embodying both characteristics.

The Board will consider the remaining possible principles at future meetings.

Objective of Meeting:

The objective of the meeting was to agree on a complete list of possible principles for distinguishing liabilities and assets from equity and begin analyzing those principles. That objective was accomplished.

Matters Discussed and Decisions Reached:

Mr. Bullen explained that the staff created a list of possible principles for distinguishing liabilities and assets from equity and that the purpose of the meeting was to determine if that list is complete or could be improved upon. Mr. Bullen noted that while each principle may seem reasonable by itself, many of the principles are inconsistent internally because they contradict other principles. He emphasized that the staff's planned objective for the next meeting would be to analyze those principles and agree on a set of principles for this project.

Ms. Schipper said that the list of principles is complete but could be organized in a different manner. She explained that some of the items on the list are innocuous, meaning that they do not have any impact on defining liabilities and equity, nor would those items be affected once definitions of liabilities and equity are determined. Ms. Schipper also said that some of the items on the list are deferrable, suggesting that those items could be addressed after the definitions are determined. She said that in her opinion there are two threshold principles, those listed in boxes 1(a) and 2 of the audience handout. Those principles are what the Board has termed (1) a liquidity criterion, meaning that to be classified as a liability the item must embody a present duty or responsibility to transfer or use assets and (2) an ownership relationship criterion, meaning that to be equity an item must earn returns similar to those of an owner and its holder must participate in the risks and rewards of ownership. Ms. Schipper noted that in FASB Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*, the Board concluded that there are circumstances in which the absence of an ownership relationship is sufficient to make an obligation to transfer shares be classified as a liability. She further explained that it is questionable whether the ownership relationship criterion should override the liquidity criterion such that an instrument would be equity if it embodies both characteristics. Ms. Schipper expressed her opinion that the threshold issue is to determine the interaction of the liquidity and ownership relationship criteria. To do so, the Board must further define ownership relationship and liquidity, and determine if a partial ownership relationship can exist, and if so, how it affects classification of a financial instrument.

Mr. Trott agreed with Ms. Schipper that the two critical principles in the audience handout are the liquidity criterion and the ownership relationship criterion. He expressed his belief that liquidity and ownership relationship need to be defined and applied to single component instruments for measurement and classification purposes, then to other financial instruments and scenarios. After doing so, he recommends considering the possible implications to all other items. He suggested that the Board direct the staff to further analyze the criteria of liquidity and ownership relationship for the Board's consideration of those two principles at its next meeting. The remaining principles should be considered after those two principles are developed further. Several other Board Members indicated their agreement with Mr. Trott [RHH, GJB, GMC, and LFS].

The Board unanimously agreed to begin its consideration of the principles by:

1. Further defining two of those principles, tentatively described as:

    a. A liquidity condition—to be a liability an item must embody a present duty or responsibility to transfer or use assets.

    b. An ownership relationship—to be equity an item must earn returns similar to those of an owner and its holder must participate in the risks and rewards of ownership.

2. Addressing the interaction of a liquidity condition and an ownership relationship for a financial instrument embodying both characteristics.

The Board will consider the remaining possible principles at future meetings.

Follow-Up Items:

None.

General Announcements:

None.

Board Meeting Handout
Liabilities and Equity
July 17, 2004

At this meeting, the Board will discuss a list of possible principles for distinguishing liabilities and assets from equity and begin analyzing those principles. The staff will ask the Board if it agrees with the list of possible principles and to provide suggestions for additions or improvement.

The attached appendix contains the possible principles evolved from a list of "touchstones" that the staff developed during deliberations of this project.

Financial Accounting Standards Board

Touchstone/Concept/Principle	Source
1. To be a **liability**, an item must meet three essential characteristics (***necessary conditions***): a. It must embody a present duty or responsibility to transfer assets or [use assets to] provide services to one or more other entities b. The duty or responsibility must obligate the entity, leaving it little or no discretion to avoid the future sacrifice c. The event obligating the entity must have already happened. Meeting all three essential characteristics is collectively ***sufficient*** to make an item a liability.	Concepts Statement 6, paragraphs 35 and 36 "liquidity" criterion "obligation" criterion "past event" criterion
1(a). The item must embody a present duty or responsibility to transfer or use assets **Expansive Alternative**: remove, or somehow expand, this necessary condition so that some items not meeting the liquidity criterion also are liabilities, perhaps by: (1) Expanding to include obligations that can be settled by issuing shares and do not establish an ownership relationship Examples of items now excluded that might be included: • Share settled written put options • Share settled fixed payables **Limiting Alternative**: remove, or somehow limit, this necessary condition so that some items meeting the liquidity criterion are not liabilities, perhaps by (2) Excluding settlement by transferring assets and establishing an ownership relationship Examples of items now included that might be exclueed: • Shares mandatorily redeemable at fair value • Cash SARs Issue: Does it need to be a *present* duty or responsibility, and if so what is present? Issue: If a financial instrument that embodies an obligation to transfer assets but earns returns similar to those of an owner is a liability, should we create a separate category on the statement of financial position for such instruments?	Concepts Statement 6 "liquidity" criterion Statement 150 FASB's 2004 decisions "liquidity/ownership relationship criterion" "pure ownership criterion"
1(b) The duty or responsibility must obligate the entity, leaving it little or no discretion to avoid the future sacrifice **Expansive Alternatives**: remove, or somehow expand, this necessary condition so that some items that do not embody obligations also can be liabilities, perhaps by: (1) Including shares that do not establish an ownership relationship Examples of items now excluded that might be included: • Perpetual preferred stock, • Noncontrolling interests in subsidiaries, • Nonvoting common stock (2) Allowing "little or no discretion" to be based on expectations Examples of items now excluded that might be included: • In-the-money physically settled purchased put option on own shares, • Increasing rate preferred stock Issue: Is an expectation based on rational behavior sufficient? For example, a focus on an issuing entity's obligation to act in the best interest of the entity, or in the best interest of its common shareholders, rather than an entity's ability or lack of ability to decide,	Concepts Statement 6 "obligation" criterion "ownership relationship criterion" "expectations criterion"

Touchstone/Concept/Principle	Source
without regard to expectations.	
1(c) The event obligating the entity must have already happened. **Expansive Alternative**: remove, or somehow expand, this necessary condition so that some items for which the obligating event has not already happened can be liabilities Examples?? Issue: How to determine whether an obligating event (the "critical event") has occurred?	Concepts Statement 6 "past event" criterion
1(d). Other possible conditions for defining liabilities: (1) Liabilities should be defined based on the presence or absence of creditor's rights (2) Financial statements should reflect expected actions (e.g., exercise of in-the-money options, expiration of out-of-the-money options), rather than changing only when the expected action occurs. That is, assets and liabilities are expected rather than probable future economic benefits and sacrifices. Issue: Would those changes to the definitions entail removal of control and obligations or, alternatively, require defining those terms differently?	Issue 00-19, ASR 268 Concepts Statement 2, *representational faithfulness*, Concepts Statement 7
2. **Equity** is the residual interest in the assets of an entity that remains after deducting its liabilities. Therefore, the only condition necessary for being an equity instrument is ***not*** to be an asset or a liability. **Limiting alternatives:** alter the definition of equity so that, to be an equity instrument: a. A ***necessary*** condition is that the counterparty earn returns similar to those of an owner (some level of participation in the results of operations, or changes in the fair value of the instrument are in the same direction as changes in the fair value of the issuer's shares). . b. A ***necessary*** condition is that the counterparty has voting rights similar to those of an owner, either now or even if those rights are conditional upon certain future events occurring. c. A ***necessary*** condition is for the item to be an outstanding share embodying no obligation to transfer assets having ownership characteristics (for example, participation in the results of operations and the existence of voting rights). Nothing else is equity. Examples of items now included that might be excluded from equity: • Share-settled obligations indexed partly to share prices and partly to something else • Call options written, nonvoting stock **Expansive alternative**: alter the definition of equity so that, to be an equity instrument Examples of items now excluded that might be included in equity: • Cash-settled obligations tied to results of operations or changes in share prices d: A ***sufficient*** condition is being a variable interest in a VIE.	Concepts Statement 6, paragraph 49 Statement 150, ¶12, FASB's 2004 decisions Interpretation 46 "Pure equity" view Interpretation 46

3. To be an **asset**, a ***necessary*** condition is control over the probable future economic benefits. **Expansive Alternatives**: alter the definition of an asset so that: a. If you can sell it, that is both ***necessary*** and ***sufficient*** to make it an asset (e.g. purchased put or call). b. Assets are distinguished from equity in purchased options in a way consistent with how liabilities are distinguished from equity in written options	Concepts Statement 6 Walter Schuetze's definition of an asset FASB's 2004 decisions
4. Transactions in one's shares shouldn't result in income or expense. **Expansive Alternative**: a. Changes in one's share price should not result in income or expense	APB 9, ¶28; ARB 43
5. Accounting and EPS for instruments with similar economic effects should be similar, (a). no matter the ***form of contract***. (b). no matter the ***form of settlement***. Issue: What economic effects matter? Does the form of the outcome matter? (For example, cash versus shares that are easily sold—are these the same to the holder? They are not the same to the issuer, if liquidity matters. What about shares that are not easily sold?)	Concepts Statement 2: *comparability*
6. Fully executory contracts should not be recorded until at least partially executed.	ARB 43
7(a). Fully executory unconditional contracts to ***purchase*** shares should be recorded as if fully executed. 7(b). Fully executory unconditional contracts to ***issue*** shares should be recorded as if fully executed. 7(c) Conditional contracts to purchase (and issue?) shares should be recorded as if expected to be executed.	Statement 150, , ¶22 For symmetry with 150? IAS 32R (for puts written)
8. There should be two and only two classes on the right side of the balance sheet—liabilities and equity. **Expansive Alternatives:** a. Temporary equity should be classified separately from other equity b. Liabilities conveying ownership relationships should be classified with equity instruments with fair value repurchase options, separately from other liabilities and equity.. Issue: Should changes in the intermediate classifications be recognized? In income??	Concepts Statements 6 and 5 SEC ASR 268 One Board Member's display suggestion
9. Equity instruments should not be recognized until paid for, even if partially executed (for example, stock subscriptions receivable and note in exchange for shares).	SEC rules and EITF 85-1
10. Equity should not change once recognized, except as the result of investments by owners, distributions to owners, or comprehensive income.	Concepts Statement 6
11. Treasury stock is a reduction of equity, not an asset.	ARB 43, SEC rules
12. Issuers and holders should account for an instrument the same way.	*financial instrument definition*, Statement 140

Those existing and alternative touchstones are collectively **inconsistent**. No solution can include all of them.