MINUTES

Financial Accounting Standards Board

To:	Board Members		
From:	Liabilities and Equity—Hansen (ext. 298)		
Subject:	Minutes of the April 6, 2005 Board Meeting: Liabilities and Equity—Resource Group Issues for the Milestone Draft	**Date:**	April 18, 2005
cc:	Leisenring, Bielstein, Smith, Golden, Petrone, Bossio, Sullivan, Mahoney, Polley, Financial Instruments Team, Liabilities and Equity Team, Gabriele, Getz, Sutay, Gavin Francis (IASB), Michael Thomas (IASB), FASB Intranet		

The Board meeting minutes are provided for the information and convenience of constituents who want to follow the Board's deliberations. All of the conclusions reported are tentative and may be changed at future Board meetings. Decisions become final only after a formal written ballot to issue a final Statement or Interpretation.

Topic:	Liabilities and Equity: Resource Group Issues for the FASB milestone draft, *Proposed Classification for Single Component Financial Instruments with Characteristics of Equity*
Basis for Discussion:	Board memorandum dated April 1, 2005 (No. 20)
Length of Discussion:	9:00 a.m. to 9:50 a.m.
Attendance:	
Board members present:	Herz, Batavick, Crooch, Schipper, Seidman, Trott, and Young
Board members absent:	None
Staff in charge of topic:	Thuener
Other staff at Board table:	Bielstein, Richards, Lott, Carnrick, Bergstrom, and Hansen
Outside participants:	None

Summary of Decisions Reached:

The Board discussed two issues relating to the classification of indirect ownership instruments and decided the following:

a. An indirect ownership instrument must be indexed to a direct ownership instrument and settled with that same instrument to be classified as equity. Otherwise, it is classified as a liability or asset.

b. From the perspective of the subsidiary and other entities in a consolidated group, shares of a parent entity, or other subsidiaries of that parent, would not be considered shares of the stand-alone subsidiary.

The Board's decisions result in liability classification for (a) instruments indexed to one class of shares and settled with a different class of shares and (b) instruments indexed to a subsidiary's shares and settled with the parent entity's shares.

Objective of Meeting:

The objective of the meeting was to discuss and decide how instruments indexed to and settled with an entity's shares should be classified. The objective of the meeting was accomplished.

Matters Discussed and Decisions Reached:

1. Ms. Thuener introduced the first issue of whether an indirect ownership instrument must be settled with the same instrument the payoff is based on in order to be classified as equity. For example, if an indirect ownership instrument is indexed to Class A common stock, can that instrument be settled in Class B common stock and still be classified as equity (assuming both classes of shares are direct ownership instruments)? Ms. Thuener stated that, under a linked view, the instrument in that example must be settled in Class A shares to be classified as equity. In contrast, under an unlinked view, the instrument could be indexed to and settled in either Class A shares or Class B shares and be classified as equity.

2. Ms. Thuener also described a view in which an indirect ownership instrument's payoff and settlement could be with perpetual instruments and be classified as equity (even if the perpetual instrument is not a direct ownership instrument). She stated that, with a narrow view, an indirect ownership instrument must be settled with and be based on direct ownership instruments to be equity. Under a broad view, indirect instruments may have payoffs and settlements in either direct ownership or perpetual instruments and be classified as equity.

3. Ms. Thuener presented the four views based on variations of the Linked/Unlinked and Narrow/Broad Views:

a. **View A (Narrow Unlinked View)—**An indirect ownership instrument is classified as equity if the instrument's payoff is based on a direct ownership instrument and settlement would result in the issuance of a direct ownership instrument. However, those two instruments do not have to be the same class of direct ownership instrument.

b. **View B (Broad Unlinked View)—**An indirect ownership instrument is classified as equity if the instrument's payoff is based on an instrument that is classified as equity (direct ownership instrument or perpetual instrument) and settlement would result in the issuance of an instrument classified as equity (direct ownership instrument or perpetual instrument). However, those two instruments do not have to be the same class of equity instrument.

c. **View C (Narrow Linked View)—**An indirect ownership instrument must be settled with the instrument its payoff is based on for the instrument to be classified as equity. Further, that instrument must be a direct ownership instrument.

d. **View D (Broad Linked View)—**An indirect ownership instrument must be settled with the instrument its payoff is based on for the instrument to be classified as equity. The payoff could be based on and settled with any instrument classified as equity (direct ownership instrument or perpetual instrument).

4. Ms. Thuener stated that the staff would be supportive of either View A or View C. She stated that the staff believes View C is a conceptually pure approach because an indirect ownership instrument would be a step on the path toward becoming a direct ownership instrument. She noted that certain structuring opportunities might result under View A by mixing the indexation and the settlement. Ms. Thuener stated, however, that the staff would support View A because it believes that if the holder of an indirect

ownership instrument is subject to the risks and rewards and ultimately becomes an owner of the reporting entity, the instrument should be classified as equity.

5. Five Board members preferred View C [Herz, Batavick, Crooch, Schipper, and Trott]. Ms. Schipper stated that Views B and D would require the definition of indirect ownership instruments to be changed—the instrument would no longer be a step on the path to ownership, it would be a step on the path toward equity. She stated that because she agrees with the current definition of indirect ownership instruments, she does not support Views B and D. Her support of View C is predicated on similar reasoning used in paragraph 12(b) of FASB Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*, which pertains to settlement in an instrument that is something other than the underlying. Ms. Schipper noted that under View A, if an indirect ownership instrument becomes a direct ownership instrument, the payoff could be determined by something other than changes in the fair value of the instrument that it is indexed to.

6. Ms. Schipper further noted that there may be situations in which the instruments used to settle are viewed as a form of currency that changes the structure of the payoff to the holder of the indirect ownership instrument. She pointed out that the Board previously rejected voting rights as a characteristic of a direct ownership instrument; however, in cases where two classes of common shares differ only in their voting rights, an indirect ownership instrument indexed to one class and settled in the other will be classified as a liability under View B. Ms. Schipper recognized that this liability classification is troublesome. However, she did not think it was appropriate to create a correlation condition between two classes of direct ownership instruments that would allow equity classification in that circumstance.

7. Mr. Batavick thought it was important to establish an approach that is consistent with the Board's previous decisions. He also was troubled by the example where an instrument indexed to one class of common stock and settled in another class of common stock that was only slightly different (because of different voting rights) would be classified as a liability; however, he supported View C.

8. Ms. Seidman stated that View A was consistent with the Ownership/Settlement Approach. She said that to the extent that subsidiaries are under the common control of the parent, the subsidiaries' direct ownership instruments would be viewed as equity and direct ownership instruments in the consolidated statements of the parent. Since the parent can control the activities of the subsidiaries, she believes that indirect ownership instruments that can be settled in the direct ownership shares of any subsidiary should be equity. She stated that the Board should not distinguish between transactions that settle in different classes of stock because both are considered direct ownership instruments. Ms. Seidman believed it is better to classify indirect ownership instruments based on their payoff rather than the instrument the indirect ownership instrument is settled in. Further, she believes that View C has more structuring opportunities than View A through the issuance of multiple but related transactions.

9. Mr. Trott stated that, in the scenario where there are two subsidiaries of one parent, the holder of an indirect ownership instrument that is indexed to one subsidiary's shares and settled in the other subsidiary's shares can be based on and settled in two distinct economic instruments. He noted that the value, opportunities, and risk of one subsidiary could be significantly different from those of the other subsidiary. He believes it is sufficient to classify an indirect ownership instrument that is indexed to one subsidiary's shares and settled in the other's as a liability until the instrument is settled, at which point it would be reclassified. Mr. Trott was concerned with structuring opportunities in View A and View C, but supported View C. He explained that under View A, a parent company would be able to choose which subsidiary it would prefer to dilute the parent company's shares in by issuing an instrument indexed to one subsidiary's shares and settled in the other subsidiary's shares. Mr. Herz agreed with the basis presented by Ms. Schipper and Mr. Trott. Mr. Crooch also supported View C.

10. Mr. Young preferred View B. He stated that an indirect ownership instrument indexed to equity should be classified as equity if the holder of the instrument ultimately becomes an equity owner.

11. Next, Ms. Thuener introduced the second issue by asking the Board how instruments issued within a consolidated group should be classified by subsidiaries and their consolidating parent entities. She presented two approaches:

a. **Approach 1 (Ownership only flows upstream)—**From the perspective of the subsidiary and other entities in a consolidated group, shares of a parent entity, or other subsidiaries of that parent, are <u>not</u> considered shares of the stand-alone subsidiary.

b. **Approach 2 (Ownership flows up, down, and across controlled entities)**—From the perspective of the subsidiary and other entities in the consolidated group, shares of the parent entity and other entities within the group <u>are</u> considered shares of the stand-alone subsidiary.

12. Ms. Thuener stated that the staff supports Approach 1. She said the staff believes that from a stand-alone subsidiary perspective, shares of the parent entity do not meet the characteristics of direct ownership instruments of the reporting entity**—**that is**—**of the subsidiary. She noted that while the subsidiary is part of the parent, the parent is not part of the subsidiary. She also noted that no ownership relationship is established between the holder and the subsidiary (reporting entity) when a subsidiary issues an indirect ownership instrument with a payoff based on and/or settled with parent company shares.

13. Ms. Thuener pointed out that neither Approach 1 or 2 is entirely consistent with current stock compensation accounting. She noted that under current stock compensation accounting rules, there is an exception provided under FASB Interpretation No. 44, *Accounting for Certain Transactions involving Stock Compensation*, that states that if a subsidiary issues options to its employees that will be settled in parent company shares, those options will be classified as equity by the subsidiary. She stated that this exception is not applicable to options on or settled with sister company shares; therefore, that accounting is not as broad as in Approach 2 nor narrow as in Approach 1. She asked the Board to consider whether it would like to continue to allow the current exception for stock compensation accounting under either approach (even though Interpretation 44 no longer is applicable, Ms. Thuener stated that she believes constituents continue to apply that guidance as it relates to this issue).

14. Six Board members agreed with the staff's recommendation for Approach 1 [Herz, Batavick, Crooch, Schipper, Trott, and Young]. Mr. Trott noted that in the case where a

parent issues options to the employees of the subsidiary on the parent company's shares, the granting of the options is an investment in the subsidiary and would appear as equity on the parent's books. He continued by stating that the subsidiary records a contribution; therefore, classification of the options as liabilities or equity by the subsidiary is not applicable. Mr. Batavick added that Approach 1 was consistent with View C from the previous issue.

15. Ms. Seidman preferred Approach 2 or the current stock compensation approach because it would simplify the guidance—that is—the Board would not have to make exceptions for stock compensation accounting. Mr. Trott said that he viewed Interpretation 44 as a practical exception, and that he does not believe the Board should make any decisions at this time regarding the interaction of stock compensation with the classification model.

16. The Board unanimously agreed that all classification interaction with stock compensation and other guidance will be considered after the Board develops its overall model.

Follow-up Items:

None

General Announcements:

None