MINUTES

Financial Accounting Standards Board

To:	Board Members
From:	Financial Instruments: Liabilities and Equity Team (Belot, ext. 363)
Subject:	Minutes of the January 14, 2004 Liabilities and Equity Board Meeting
Date:	January 29, 2004
cc:	Leisenring, Bielstein, Smith, Golden, Cassel, Project Team, Mahoney, Swift, Polley, Sutay, Gabriele, Petrone, Thompson, FASB Intranet

<u>Topic</u>: Liabilities and Equity: Unconditional simple instruments

<u>Basis for Discussion</u>: Memorandums 3 and 4

<u>Length of Discussion</u>: 9:00 a.m. to 10:45 a.m.

<u>Attendance</u>:

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:	Leisenring (IASB)

Summary of Decisions Reached:

The Board considered the following issues that arise for classifying previously discussed "simple" instruments (options and forward contracts) under the proposed approaches for distinguishing equity from liabilities and assets.

- Whether the additional criteria required in EITF Issue No. 00-19, "Accounting for Derivative Instruments Indexed to, and Potentially Settled in, a Company's Own Stock," should be incorporated into the liquidity and ownership relationship model. The Board decided to provide high-level guidance that an obligation indexed to and potentially settled in a company's own stock could be classified as equity only if:

  1. The issuer has the ability to deliver the shares
  2. The instrument does not require cash payments if a contingent event occurs
  3. The holders' rights are not dissimilar to those of an owner.

- Whether an instrument under which the amount of cash (or shares) to be received varies based on a floating interest rate or is adjusted for stock splits or dividends establishes an ownership relationship. The Board decided it that it can.

- Whether an option or forward contract with a fair value strike or contract price establishes an ownership relationship. The Board decided that it does not, but plans to continue to discuss at future meetings how to account for a fair value redemption feature in a host instrument.

- The effect of provisions for loss reimbursement, for example, cash- or share-settled "make-whole" provisions or protective provisions for stock borrowing costs that seem to result in more than one obligation or in both ownership and non-ownership components on the classification of an instrument. The Board decided to address instruments that embody such provisions broadly when it discusses compound instruments at a future meeting.

The Board also discussed the application of the proposed approaches to further "simple" instruments, including shares that are not the only common class of stock, shares incorporating unconditional rights to receive assets, and unconditional rights to receive shares.

- The Board decided that shares that are not the only common class of stock, for example, shares with reduced or no voting rights, noncontrolling interests in consolidated subsidiaries, and tracking stock, would be equity under a liquidity and ownership relationship approach. The Board noted that such shares do raise issues under a narrower view of equity approach (one of the alternative approaches under consideration) and directed the staff to continue to refine such an approach.

- The Board also directed the staff to provide more information about unconditional rights to receive assets and decided to address unconditional rights to receive shares in the part of its deliberations addressing compound instruments and the unit of accounting.

Matters Discussed and Decisions Reached:

Mr. Bullen briefly described the surviving approaches for distinguishing equity from liabilities and assets. He stated that the Board will continue to consider an approach that is based on liquidity and ownership relationship criteria (Approach A), alternative approaches based on a narrower view of equity (Approach B) and on the revised IAS 32, *Financial Instruments: Disclosure and Presentation* (Approach E). Ms. Richards then introduced subissues that arise under the ownership relationship/liquidity test for Approach A, and possibly Approach E. She stated that those subissues are relevant for previously discussed "simple" instruments (options and forward contracts).

Ms. Richards introduced the first subissue of whether the additional criteria required in Issue 00-19 should be incorporated into the liquidity and ownership relationship model. Specifically, that guidance states that an obligation indexed to and potentially settled in a company's own stock can be classified as equity only if it meets certain criteria. Those criteria can be categorized as follows:

a. The issuer has the ability to deliver shares
b. The instrument does not require cash payments if a contingent event occurs
c. The holders' rights are similar to those of an owner

Ms. Richards stated the staff's recommendation of providing high level guidance similar to categories a, b, and c above to address this issue (except possibly under "make-whole" provisions, which might result in a compound instrument). All Board members agreed with that recommendation.

Ms. Richards introduced the next subissue of the effect of provisions for loss reimbursement on the classification of an instrument. The example given was cash- or share-settled "make-whole" provisions or protective provisions for stock borrowing costs that seem to result in more than one obligation or in both ownership and non-ownership components. She then recommended that those provisions be addressed broadly and that instruments containing those provisions be analyzed as compound instruments. All Board members agreed with that recommendation, and the staff plans to address such provisions when it discusses compound instruments at a future meeting.

Ms. Richards then presented the issue of whether an instrument under which the amount of cash (or shares) to be received varies based on a floating interest rate or is adjusted for stock splits or dividends establishes an ownership relationship. She recommended that it does establish an ownership relationship. Some Board members [RHH and KAS] reasoned that the described circumstances, if anything, may reinforce an ownership relationship. For example, when the amount of cash (or shares) to be received varies based on LIBOR, the counterparty is not exposed to interest rate changes, and therefore, the ownership payoff relationship is reinforced. All Board members agreed with the staff's recommendation.

Lastly, Ms. Richards asked the Board to decide whether an option or forward contract with a strike or contract price set at the fair value of the shares on the exercise date establishes an ownership relationship. She expressed the staff's view that it does not establish an ownership relationship because the counterparty's payoff does not move in the same direction as changes in the issuer's share price—it does not move at all. The Board agreed with the staff's recommendation, but will continue to discuss at future meetings how to account for a fair value redemption feature in a host instrument.

Mr. Bullen introduced the next topic, the application of the proposed approaches for distinguishing equity from liabilities and assets to further "simple" instruments, including shares that are not the only common class of stock, shares incorporating unconditional rights to receive assets, and unconditional rights to receive shares. He first asked the Board to decide how to classify shares that are not the only common class of stock, for example, shares with reduced or no voting rights, noncontrolling interests in consolidated subsidiaries, tracking stock, and perpetual preferred stock. He recommended that those types of shares be classified as equity under Approaches A and B. Mr. Herz expressed concern that some forms of preferred stock, for example cumulative preferred stock, may be similar to liabilities because of economic compulsion to pay dividends. The staff stated that economic compulsion will be discussed at a future meeting and is not expected to be a determining factor in liability classification. Board members agreed that common shares are not the only class of stock that would be equity under a liquidity and ownership relationship approach (Approach A). However, the Board noted that such shares do raise issues under a narrower view of equity approach (Approach B) and directed the staff to continue to refine such an approach.

Mr. Bullen asked the Board to decide how to classify shares that include or are tied to unconditional rights to receive assets. The staff recommended recognizing legally enforceable receivables for stock subscriptions, notes receivable, and assessments as assets and the related shares as outstanding equity instruments. In general, Board members expressed concern about determining whether such rights, even though legally enforceable, should be considered unconditional and therefore be recognized as assets. Therefore, the Board directed the staff to provide more information about unconditional rights to receive assets.

Finally, Mr. Bullen asked the Board to decide how to classify unconditional rights to receive shares (either a variable or a fixed number). He stated that examples include a note receivable to be paid with a variable number of shares or a prepaid forward purchase contract for a fixed number of shares. He also stated the staff's recommendation to account for an unconditional right to receive shares as an asset, unless it puts the counterparty into an ownership relationship. Mr. Trott expressed a preference to account for such a right as a reduction to equity. However, the Board decided to address unconditional rights to receive shares (for example, prepaid forward purchase contracts) in the part of its deliberations relating to compound instruments and the unit of accounting. Mr. Herz noted that an unconditional right to receive a variable number of shares worth a fixed monetary amount seems to be a simple instrument. The staff will analyze that type of right to receive shares in a future meeting before moving on to compound instruments.

Follow-Up Items:

The staff will refine the approach for distinguishing equity from liabilities and assets based on a narrower view of equity (Approach B). The staff also will provide more information to the Board relating to unconditional rights to receive assets.

General Announcements:

None.