MINUTES

Financial Accounting Standards Board

To: FASB Board Members

From: Financial Instruments with Characteristics of Equity Team (Clark x443)

Subject: Minutes of the October 21, 2008 Joint Board Meeting: *Financial Instruments with Characteristics of Equity*

Date: October 29, 2008

cc: Leisenring, Bielstein, Golden, Bossio, Lott, Allen, Klimek, Chookaszian, Posta, Malcolm, Mills, Glotzer, C. Smith, Stoklosa, Proestakes, Sutay, Mechanick, Bhave, Petrone, Prince, Clark, Gabriele, Finden (GASB), Liz Figgie (IASB), Gavin Francis (IASB), LiLi Lian (IASB), Rebecca Villmann (IASB), Ian Hague (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, Interpretation, or FASB Staff Position.

Topic:	Selecting an Approach
Basis for Discussion:	Agenda Paper 7
Length of Discussion:	9:30 a.m.–10:30 a.m.
Attendance:	
Board members present:	FASB: Herz, Linsmeier, Seidman, Siegel, and L. Smith IASB: Tweedie, Barth, Cooper, Danjou, Engstrom, Garnett, Gelard, Jones, Leisenring, McGregor, J. Smith, Yamada, and Zhang
Board members participating by phone:	None
Board members absent:	None

Staff in charge of topic:	Switter (FASB), Figgie (IASB)
Other staff at Board table:	FASB: Golden, Lott, Prince, Clark IASB: Upton, Francis

Summary of Decisions Reached:

The Boards decided to begin future deliberations using the principles underlying the perpetual and basic ownership approaches. Under the perpetual approach, an instrument would be classified as equity if it:

1. Lacks a settlement requirement
2. Entitles the holder to a share of the entity's net assets in liquidation.

Under the basic ownership approach, an instrument would be classified as equity if it:

1. Is the most subordinated claim
2. Entitles the holder to a share of the entity's net assets.

The Boards acknowledged that they may decide to make exceptions to the basic principles as they continue to develop an approach to identify equity instruments.

Objective of Meeting:

The objective of the meeting was to decide which approach (or approaches) should be used as a starting point for future deliberations. The objective was met.

Matters Discussed and Decisions Reached:

Issue 1: Deciding the Approach

1. Ms. Switter stated that the objective of the meeting was to decide which approach should be used as a starting point for future deliberations.

2. **Staff Recommendation:** Ms. Figgie stated that the staff does not believe the Boards should pursue the following six approaches: (a) the reassessed expected outcome approach, (b) the loss absorption approach, (c) the participation approach, (d) the ownership-settlement approach, (e) IAS 32, *Financial Instruments: Presentation* (without modification), and (f) a modified IAS 32 approach. Ms. Figgie further noted that there may be features of the six approaches that could be incorporated into the selected approach. For example, many cooperative entities stated that their instruments would not meet the definition of a basic ownership instrument because there is an

upper limit to the members' rights to net assets on liquidation. Incorporating some aspects of one of the six approaches could resolve that issue.

3. **Board Vote:** The Boards decided that the perpetual and basic ownership approaches should be used as starting points for future deliberations. Four members of the FASB and 12 members of the IASB supported the decision. Mr. Leisenring and Mr. Cooper did not support the decision. Mr. Siegel abstained.

4. **Board Comments:** Mr. Cooper stated that he is uncomfortable with classifying a written call option as a liability and measuring it at fair value. He explained that he is concerned about including changes in the fair value of financial instruments in income. He also questioned whether employee stock options would be scoped out of the final standard. Mr. Lott reiterated the staff's desire to select a starting point for future deliberations. He added that the Boards would have the opportunity to discuss exceptions and/or additions to the underlying principles of the basic ownership and perpetual approaches at a later date.

5. Mr. McGregor stated that he believes it is unlikely that the final standard will be a pure reflection of either the perpetual approach or the basic ownership approach. He supported beginning with the perpetual approach. He believes the perpetual approach would provide the Boards with a better opportunity to develop a principles-based standard. He added that if the Boards believe they are going to end up with an approach similar to IAS 32, then the starting point should be IAS 32 as currently written.

6. Sir Tweedie stated that he initially supported the ownership-settlement approach. He noted that he no longer supports that approach because it is complicated. He raised concerns about how the Boards would develop guidance that appropriately deals with puttable instruments. Mr. Leisenring suggested that the Boards require practitioners to account for synthetic instruments by separating instruments into basic elements. For example, a puttable share would be separated into a share and a put option.

7. Ms. Barth stated that she supports the staff's recommendation to eliminate the six approaches. She also supported moving forward with the perpetual approach as a starting point for future deliberations. She expressed her discontent with the IASB's February 2008 amendment to IAS 32, *Puttable Financial Instruments and Obligations Arising on Liquidation*. Ms. Barth also noted that she does not believe one principle will appropriately classify all

instruments. She also stated that if the Boards decide to classify an instrument as equity that does not meet the classification principle, it is an exception and should be described in that manner.

8. Mr. Linsmeier stated that he supported the staff's recommendation to eliminate the six approaches. He also supported using the perpetual approach as a starting point for future redeliberations. He added that he believes that both the basic ownership and perpetual approaches have merit. However, he believes the perpetual approach is more principles based and conceptually pure.

9. Mr. Cooper agreed with Mr. Linsmeier's statement that the perpetual approach is conceptually pure. However, he questioned whether the approach would provide financial statement users with useful information. He stated the he believes a written call option has more equity characteristics than debt characteristics. He stated that he would prefer the ownership-settlement approach or a modified version of it. He also stated that he is comfortable with the current requirements in IAS 32, but acknowledges that there are issues with them. He noted that if the Boards use IAS 32 as a starting point, they would have to address those issues.

10. Mr. Cooper also questioned whether simplicity should be a reason for selecting the basic ownership approach or the perpetual approach as a starting point. He noted that in a comment letter, a rating agency stated that although the basic ownership approach is simple (and its preferred approach), it will continue to analyze financial statements based on their own approach regardless of what the Boards decide in this project. Mr. Linsmeier pointed out that the letter also stated support for the basic ownership approach because it minimizes separation.

11. Mr. J. Smith stated that he supports eliminating the six approaches. He also supported using the perpetual approach as a starting point for future deliberations. He suggested that the final standard provide classification results that are consistent with the IASB's February 2008 amendment to IAS 32.

12. Ms. Seidman stated that based on the feedback received from comment letter respondents and roundtable participants, she believes the Boards should develop an approach that is simple and easy to understand. She further stated that she believes three of the approaches have a simple principle: the basic ownership approach, the perpetual approach, and the participation approach. Ms. Seidman stated that she supports using the perpetual approach as a starting point;

however, she is concerned about including the change in the value of an entity's stock in net income.

13. Mr. Garnett stated that he supports the staff recommendation to eliminate the six approaches. Mr. Garnett further stated that he would support either the basic ownership or the perpetual approach as a starting point for future deliberation. However, he expressed concern about starting with a principle that the Boards already know will require exceptions. He stated he prefers the basic ownership approach; however, he acknowledged that it would be difficult to define a liability under that approach. Mr. Linsmeier stated that he shares Mr. Garnett's concern about starting off with a principle that the Boards know will require exceptions. Mr. Linsmeier also stated that if the Boards start with a principle that requires numerous exceptions, the final standard will not be principles based. Mr. Gelard stated that he agreed with the comments made by Mr. Garnett. Mr. Gelard also stated that the Boards must address the issue of economic compulsion.

14. Mr. Zhang stated that it was important that the Boards consider presentation and disclosure requirements and the ramifications of the current economic crisis when deliberating any approach in this project. Ms. Seidman stated that the Boards also must consider the interaction with the Boards' the financial statement presentation project. She added that income statement disaggregation requirements will be especially important.

15. Ms. Barth stated that she believes Mr. Cooper's concerns about classifying a written call option as a liability and reporting the changes in the instrument's fair value in income can be addressed through appropriate presentation and disclosure. She stated that not wanting to report the changes in fair value of the instrument in the profit and loss statement is not sufficient justification for rejecting the perpetual approach as a starting point for future deliberations. She further noted that stock appreciation rights and bonuses are currently expensed through the profit and loss statement.

16. Mr. Yamada stated that he supports the staff recommendation to eliminate the six approaches. He stated that he prefers the basic ownership approach because of its simple "most residual" principle. However, he stated that the basic ownership approach and perpetual approach are not mutually exclusive. He further noted that it may be prudent to combine the best aspects of the two approaches into one approach.

17. Mr. Leisenring stated that he supports the Boards moving forward with the ownership-settlement approach and the basic ownership approach or the perpetual approach. He stated that he did not see a substantive difference between the basic ownership approach and the perpetual approach other than the classification of perpetual preferred shares as equity. He added that he believes that if the Boards choose to start out with the basic ownership approach or the perpetual approach, there will be so many exceptions to the basic principle that the final approach will be similar to the ownership-settlement approach.

18. Mr. L. Smith stated that he initially supported the basic ownership approach because of its simplicity. However, based on the feedback from comment letter respondents and roundtable participants, he believes that simplicity is not a sufficient justification for the approach. He added that the staff's objective for the meeting is to find an appropriate starting point for further analysis, and that he believes the perpetual approach should be used as the starting point. He believes there will be some exceptions to the principle and the Boards must attempt to minimize those exceptions.

19. Mr. Cooper suggested that the Boards also address the issue of economic compulsion. Ms. Switter stated that the staff plans to raise that issue in a future meeting.

<u>Follow-up Items:</u>

None.

<u>General Announcements:</u>

None.