MINUTES

Financial Accounting Standards Board

To:	Board Members		
From:	Liabilities and Equity—Bergstrom (ext. 296)		
Subject:	Minutes of March 2, 2005 Board Meeting (L/E: Resource Group Comments)	Date:	March 14, 2005
cc:	Leisenring, Bielstein, Smith, Golden, Petrone, Bossio, Sullivan, Laurenzano, Mahoney, Swift, Polley, Financial Instruments Team, Liabilities and Equity Team, Gabriele, Sutay, Thompson, Getz, Sandra Thompson (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 comments on the FASB milestone draft, *Proposed Classification for Single Component Financial Instruments with Characteristics of Equity*

Basis for Discussion: Board memorandum dated February 25, 2005 (No.18)

Length of Discussion: 1:00 p.m. to 1:45 p.m.

Attendance:

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

Board members absent: None

Staff in charge of topic: Richards, Carnrick, Hansen

Other staff at Board table: Bielstein, Lott, Thuener, and Bergstrom

Outside participants: None

Summary of Decisions Reached:

The Board discussed comments received from resource group members on a draft of the proposed guidance communicating the Board's decisions on the classification for single component instruments.

The Board decided to make the following clarifications to the draft of the proposed guidance:

a. Add a list of topics to the summary that will be covered and a brief summary of related literature that may be affected.

b. Clarify the definition and application of the term *counterparty payoff* by adding examples to the definition.

c. Clarify the definition and application of the term *contingent settlement provision*.

d. Further explain why a written call option would not be a direct ownership instrument.

e. Clarify the scope of instruments that would be subject to the classification requirements.

Additionally, the Board decided to deliberate the following four issues:

a. Should perpetual instruments be subject to the direct ownership instrument requirements?

b. Should characteristics of a subsidiary's instrument carry over to the consolidated entity?

c. How should instruments settled with a consolidated entity's shares be classified by a subsidiary of that consolidated entity?

d. Should instruments with claims that are limited prior to liquidation be direct ownership instruments?

The Board decided to consider the issue of distinguishing between substantive and nonsubstantive or remote settlement requirements after it addresses the definition of *multiple component instruments*.

The Board also decided that it would not reconsider the classification requirements for rights to receive assets or shares. The Board will revisit that issue after it develops its overall classification approach for both single- and multiple-component instruments.

The Board plans to post to the FASB website under its liabilities and equity project a summary of the Board's decisions relating to the classification of single component instruments, and the basis for those decisions, in a format similar to a proposed Statement of financial accounting standards.

Objective of Meeting:

The objective of the meeting was to summarize resource group member comments about the milestone draft and, as a result, identify any clarifications to be made and issues to be resolved either before or in the next milestone. The objective of this meeting was accomplished.

Matters Discussed and Decisions Reached:

1. Ms. Richards opened the meeting by explaining that the recent milestone draft, *Proposed Classification for Single Component Financial Instruments with Characteristics of Equity*, was released to the liabilities and equity resource group for comments. She stated that after reviewing the comments received, the staff categorized the issues raised by the reviewers as either being part of the current milestone or part of the next milestone. Ms. Richards explained that issues related to the current milestone would be resolved prior to posting the milestone draft to the FASB website.

2. After Mr. Herz thanked resource group members for their input, Mr. Hansen reported that the reviewers believe the milestone draft is operational, but needs clarification in a few areas. Mr. Hansen presented the significant clarifications the staff recommends making to the milestone draft as follows:

a. Many reviewers commented on topics the Board plans to address in a future milestone, for example, multiple component instruments, measurement, and display of single component instruments. In order to avoid confusion, the summary of the milestone draft should include a list of topics that will be covered in the next milestone and a brief summary of related literature that may be affected.

b. Many reviewers were confused by the definition of the term *counterparty payoff*. The definition should include examples similar to the explanation of the term *monetary value* in FASB Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*.

c. Many reviewers were confused by the term *contingent settlement provision*. An example should be added to Appendix A to clarify the definition and application of the term as meaning a contingent exercise provision.

d. Some reviewers did not understand why a written call option would not be a direct ownership instrument. This should be further explained in Appendix A.

e. Several resource group members commented that the scope was difficult to understand or excluded instruments that should have been included. The scope should be clarified.

3. The Board unanimously agreed with the staff's proposed changes.

4. Mr. Hansen reported that several resource group members disagreed with the conclusion that a purchased call option on an entity's own shares should be classified as an asset, and possibly marked-to-market. He reported that some reviewers noted various structuring opportunities created by this classification and measurement. He also stated that many reviewers commented that classification of a purchased call is not consistent with the classification of treasury stock. Mr. Hansen stated that the staff recommends the Board not reconsider the classification requirements for rights to receive assets or shares because the Board decided in a prior meeting to apply the approach consistently to assets. The staff believes the structuring transactions raised by the reviewers cannot be fully analyzed for consistency until the complete approach is developed.

5. The Board unanimously agreed with the staff recommendation. However, Ms. Seidman stated that she had the same concerns expressed by those reviewers. She agreed to wait until the issues of multiple component instruments, linkage, and measurement are addressed by the Board to see if some of the concerns are resolved or mitigated before suggesting that the Board reconsider how the approach is applied to assets.

6. Ms. Carnrick reported that the staff has identified four issues that it recommends the Board address before moving on to the next milestone. The first issue is whether perpetual instruments should be subject to the direct ownership instrument requirements to be equity. She stated that paragraph 17 of the milestone draft requires equity

classification for all perpetual instruments regardless of meeting the direct ownership test. She further stated that the Board should reconsider this decision as it relates to fixed return structuring opportunities. Ms. Carnrick explained that under the milestone draft, a company could create a special purpose entity with a finite life and that the perpetual instrument of the subsidiary would carry forward to the reporting entity. Mr. Crooch pointed out that this example also demonstrates the staff's second issue, which is whether or not characteristics of a subsidiary's instrument should carry over the consolidated entity.

7. The Board unanimously agreed with the staff's recommendation that the Board should reconsider whether all perpetual instruments should be classified as equity and how to evaluate a subsidiary's instruments at the consolidated entity level.

8. Ms. Carnrick described the third issue—how instruments settled with the parent's shares should be classified by the subsidiary in their stand-alone financial statements. She explained that the draft requires indirect ownership instruments issued by the consolidated entity settled with a subsidiary's direct ownership instruments to be classified as equity. She reported that the draft does not address how a subsidiary's indirect ownership instruments settled with the parent's shares should be classified for the subsidiary's stand-alone financial statements. That circumstance appears to be different because the counterparty does not ultimately become an owner of the subsidiary. The staff recommended the Board discuss this issue as part of this milestone.

9. The Board unanimously agreed with the staff's recommendation.

10. Ms. Carnrick introduced the fourth issue, which relates to the definition of a direct ownership instrument. Specifically, the issue is whether instruments with claims that are limited prior to liquidation should be direct ownership instruments. She stated that one of the characteristics of a direct ownership instrument is that it represents a claim to portions of net assets of the entity that is neither *limited nor guaranteed*. The claim is to be evaluated together at liquidation and prior to liquidation. She stated that an entity may issue an instrument with a fixed redemption and insert a provision which entitles the holder to participate in the entity's fair value in liquidation even though the possibility of liquidation prior to the redemption would be remote. By adding this provision, the issuer

can classify the instrument as equity. Ms. Carnrick recommended that the Board discuss this issue as part of this milestone.

11. The Board unanimously agreed with the staff's recommendation.

12. The final issue that Ms. Carnrick discussed related to identifying non-substantive (or remote) and substantive settlement methods and requirements. She stated that there are mixed views among the staff as to whether the issue should be addressed near the beginning or end of the next milestone. She explained that some staff members believe it should be addressed after the Board decides on both multiple and single component classification models. She further pointed out that this issue may result in identifying a multiple component instrument, a term which the Board has not yet defined.

13. Mr. Lott stated that he would prefer that the Board discuss substantive and nonsubstantive settlement requirements as well as those that are statutory as early as possible, so that problems can be identified and rectified earlier in the project.

14. Mr. Trott suggested that the issue of substantive settlement be addressed after the Board defines multiple component instruments. The Board unanimously agreed.

15. Lastly, Ms. Richards discussed the staff's future plans, which include posting the milestone draft to the FASB website after deliberating the remaining issues and revising the draft.

Follow-up Items:

None.

General Announcements:

None.