MINUTES

Financial Accounting Standards Board

To: FASB Board Members

From: Financial Instruments with Characteristics of Equity Team (Schonefeld x442)

Subject: Minutes of the May 6, 2009, Board Meeting: *Financial Instruments with Characteristics of Equity*

Date: May 20, 2009

cc: Leisenring, Bielstein, Golden, Bossio, Lott, McGarity, Klimek, Chookaszian, Posta, Malcolm, Mills, Ampofo, Glotzer, C. Smith, Stoklosa, Proestakes, Sutay, Mechanick, Bhave, Petrone, Schonefeld, Hood, Clark, Gabriele, Finden (GASB), Liz Figgie (IASB), Gavin Francis (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:	Developing a Classification Model
Basis for Discussion:	Agenda Papers 2, 2A, and 2B
Length of Discussion:	9:15–10:10 a.m.
Attendance:	
Board members present:	FASB: Herz, Seidman, Siegel, Linsmeier, and Smith
Board members absent:	None
Staff in charge of topic:	Switter (FASB) and Figgie (IASB)
Other staff at Board table:	FASB: Lott, Clark, and Schonefeld

Summary of Decisions Reached:

The Board discussed and expressed support for a set of draft principles that could be used to distinguish between equity and liabilities and a related set of decision rules to operationalize those principles. The principles are as follows:

1. Equity instruments are always subordinated to all liability instruments but may be senior to other classes of equity.
2. An instrument is equity if the issuer cannot be required to settle it unless the issuer winds up its operations and distributes all of its remaining assets. (That is a sufficient but not necessary condition for equity classification.)
3. A settlement requirement that becomes effective when the holder has died, retired, resigned, or otherwise ceased to take an interest in the activities of the entity does not cause an instrument to be classified as a liability if the holder was required to hold the instrument in order to transact with the entity or otherwise engage in the activities of the entity.
4. Settlement requirements other than those described in item (3) indicate that an instrument is a liability or a liability-equity hybrid instrument (part equity and part liability).
5. An instrument should be separated into liability and equity components if the instrument has two separate or alternative outcomes, one of which would require equity classification if it were the only outcome and one of which would require liability classification if it were the only outcome.
6. Claims to percentages of remaining assets are neither necessary nor sufficient to identify an equity instrument. However, they may help to classify otherwise borderline instruments.

The decision rules to produce results consistent with the principles are as follows:

1. An entity must classify as equity retained earnings and capital contributed without the contributor receiving a claim against the entity in exchange even if that entity has issued no equity instruments.
2. An issuer must classify an instrument as a liability if the instrument has a fixed settlement date or must be settled on the occurrence of an event that is certain to occur, excluding those described in item 3(a) and 3(b) below.
3. An issuer must classify the following other instruments as equity:
    a. Instruments that the issuer cannot be required to settle before winding up its operations and distributing all of its assets (regardless of the amount of the claim).
    b. Instruments that the holder is required to own in order to do business with or otherwise actively engage in activities of the issuer and that are redeemable only if the holder dies, retires, resigns, or otherwise ceases to actively engage in the activities of the issuer. (This would include

holdings, the amounts of which vary based on volume of business transacted by the holder.)

4. An instrument should be separated into liability and equity components if the instrument has two separate or alternative outcomes, one of which would require equity classification if it were the only outcome and one of which would require liability classification if it were the only outcome.

The Board will continue to refine the principles in future Board meetings.

Objectives of Meeting:

The objective of the meeting was to discuss a set of draft classification principles. The objective was met.

Matters Discussed and Decisions Reached:

1. Ms. Switter stated that both the FASB and the IASB have generally focused on three characteristics when discussing how to distinguish between liability and equity instruments. Those characteristics are:
   a. Subordination
   b. A settlement requirement or lack thereof
   c. Claims to a percentage of the assets that remain after all other claims against the issuer have been satisfied.
2. Ms. Switter stated that to date the Board's deliberations have focused only on characteristic (b). She further stated that the staff developed a set of draft principles that considered all three characteristics described in paragraph 1. The following is a summary of the general principles that underlie the staff's proposed approach:
   a. Equity instruments are always subordinated to all liability instruments but may be senior to other classes of equity.
   b. An instrument is equity if the issuer cannot be required to settle it, unless the issuer winds up its operations and distributes all of its remaining assets. (A sufficient but unnecessary condition for equity classification.)
   c. A settlement requirement that becomes effective when the holder has died, retired, resigned, or otherwise ceased to take an interest in the activities of the entity does not cause an instrument to be classified as a liability if the holder was required to hold the instrument in order to transact with the entity or otherwise engage in the activities of the entity.
   d. Settlement requirements other than those described in item (c) indicate that an instrument is a liability or a liability-equity hybrid instrument (part equity and part liability).
   e. An instrument shall be separated into liability and equity components if the instrument has two separate or alternative outcomes, one of which would require

equity classification if it were the only outcome and one of which would require liability classification if it were the only outcome.

f. Claims to percentages of remaining assets are neither necessary nor sufficient to identify an equity instrument. However, they may help to classify otherwise borderline instruments.

3. Those general principles cannot be distilled into a single rule, but they can form the basis for a set of decision rules to implement the principles as follows:

   a. An entity must classify as equity retained earnings and capital contributed without the contributor receiving a claim against the entity in exchange, even if that entity has issued no equity instruments.
   b. An issuer must classify an instrument as a liability if the instrument has a fixed settlement date or must be settled on the occurrence of an event that is certain to occur, excluding those described in items (c)(1) and (c)(2) below.
   c. An issuer would classify the following other instruments as equity:
      (1) Instruments that the issuer cannot be required to settle before winding up its operations and distributing all of its assets (regardless of the amount of the claim)
      (2) Instruments that the holder is required to own in order to do business with or otherwise actively engage in activities of the issuer and that are redeemable only if the holder dies, retires, resigns, or otherwise ceases to actively engage in the activities of the issuer. (This would include holdings, the amounts of which vary based on volume of business transacted by the holder.)
   d. An instrument shall be separated into liability and equity components if the instrument has two separate or alternative outcomes, one of which would require equity classification if it were the only outcome and one of which would require liability classification if it were the only outcome.

3. Ms. Switter clarified the meaning of the term *outcome* in principle 2(e) above. She stated that an otherwise perpetual instrument that permits the holder to require the issuer to repurchase it has two alternative outcomes. The instrument (a) could remain outstanding in perpetuity if the put option is not exercised, which is an equity outcome or (b) the embedded put option could be exercised, which would create a liability outcome. Because the instrument has both a liability outcome and an equity outcome, the instrument would be separated into liability and equity components. She further explained that another example of an instrument with alternative outcomes is convertible debt. The issuer may be required (1) to pay a fixed amount of cash, which is a liability outcome, (2) to settle in shares if the conversion option is exercised, which also is a liability outcome. In the case of convertible debt, it is the exercise of the option that the staff is focusing on, which would be a liability

outcome. Convertible debt would not be separated because it has two liability outcomes.

4. **Board vote:** All Board members expressed support for the set of draft principles and related decision rules to operationalize those principles. The Board directed the staff to further refine the principles.

5. **Board comments:** Mr. Linsmeier stated that he is not sure why subordination is not included in the staff's set of decision rules. Mr. Lott stated that subordination is not explicitly included in the decision rules, but it is a key factor in determining whether an instrument is a liability or an equity instrument. He further noted that the concept of subordination is included in principle 2(b). If the holder of an instrument is the last person to receive assets, the instrument is inherently the most subordinated instrument.

6. Ms. Seidman stated that she interprets decision rule 3(c)(1) as a question of whether an instrument is perpetual. Ms. Seidman stated that she believes the staff has moved from a principle that focuses on subordination to a principle that focuses on whether an instrument is perpetual. Ms. Switter stated that the staff believes subordination is important but has placed less focus on whether the instrument is *most* subordinate, such as the basic ownership approach. She stated that she thinks subordination is inherent in the notion of whether an instrument is perpetual.

7. Mr. Herz asked how an instrument that is redeemable upon the holder's death or retirement is classified when the event occurs. Mr. Lott stated that at the point that the event occurs, it would probably be classified a liability. He stated that there are instruments that do not allow the holder to redeem the security until the issuer has enough assets to meet its liabilities. Mr. Lott stated that in that example, the instrument would likely be classified as equity because it is subordinated to all liabilities.

8. Mr. Linsmeier stated that he may support an approach that would require only the most subordinate instrument to be classified as equity. Mr. Lott stated that a similar approach was described in the FASB Preliminary Views, *Financial Instruments with Characteristics of Equity,* and users seemed to support that approach. Mr. Lott stated

that the staff has not had any support for that approach from either the IASB or the FASB.

9. Ms. Seidman stated that she is generally supportive of the staff's separation principle. She stated if a share is puttable at fair value, the liability component (the put option) would have a minimal value. She stated that separation would therefore mainly apply to instruments that are puttable at a fixed price and instruments with two separate outcomes, such as a share with a registration rights penalty.

10. Ms. Seidman stated that she is uncomfortable with separating a convertible preferred share into liability and equity components. She noted that if the instrument is not converted the holder has a preferred share, which would be classified as equity. She further noted that if the holder chooses to convert the instrument into a common share, the holder also will have an equity instrument. Mr. Smith agreed with Ms. Seidman's concern. Ms. Switter stated that a convertible preferred share would be subject to separation because if the conversion option were classified on its own as a freestanding instrument, it would be a derivative and classified as a liability. Mr. Lott stated that classification of the instrument does not depend on whether the settlement is in equity or cash.

11. Mr. Lott stated that the staff's approach would classify a preferred share that is required to be converted into a common share as a liability. He stated that some Board members may find that classification result troubling. However, he believes the Board could make a narrow exception for that specific instrument. Mr. Siegel stated that if an instrument is mandatorily convertible, it must be settled in shares, and he is not concerned about classifying that instrument as a liability. Ms. Seidman asked why it would make sense for these instruments to be marked through earnings before being converted to common stock. Mr. Linsmeier and Mr. Siegel stated it was because they are not equity shares at the time they are being marked.

12. Mr. Golden stated that convertible debt would be a liability and asked if it would be measured at fair value. Mr. Lott stated that the Board has not discussed measurement yet; however, if the Board were to make no changes to existing measurement requirements, he believes convertible debt would be either (a) separated under the

requirements of FASB Statement No. 133, *Accounting for Derivatives and Hedging Activities*, or (b) fair valued through the fair value option.

13. Mr. Linsmeier stated that he did not support separation in the past because he believes separation will lead to measurement problems. He stated that he does not agree with the staff's assertion that two instruments entered into separately often have the same value together as a single instrument with the same two outcomes. He stated that he thinks the principle proposed by the staff that states that an instrument classified as equity should not be senior to an instrument classified as a liability is important. He would be willing to require separation to achieve that outcome.

14. Mr. Siegel stated that he agrees with the recommended separation principle. He stated that he does not think there are many purely perpetual instruments in the market. He believes many otherwise perpetual instruments contain features that require dividend or interest payments. He stated that separation is important to ensure those instruments are classified correctly. Mr. Siegel stated that his preferred underlying classification principle is based on dilution. Specifically, if an instrument dilutes the common shareholder then it is a liability and the changes in the instrument's value should be reported in net income.

15. Mr. Herz stated that he sees preferred shares as a cushion to the debt holders against losses, but that from a solvency point of view, the preferred shares represent equity. He stated that an option that allows a preferred shareholder to convert to equity shares is dilutive to common shareholders. He stated that a freestanding call is a liability for the same reason, so it makes sense that the conversion option component in a convertible preferred share would be separated as a liability. Mr. Siegel and Mr. Linsmeier agreed.

16. Mr. Herz stated that the staff's decision rules were all logical, and he agreed with the classification outcomes. He asked the staff to further refine the principles that support the decision rules. All Board members supported Mr. Herz's comments.

Follow-up Items:

None.

General Announcements:

None.