MINUTES

Financial Accounting Standards Board

To:	FASB Board Members
From:	Financial Instruments with Characteristics of Equity Team (Schonefeld x442, Davis x447)
Subject:	Minutes of the August 27, 2009, Board Meeting: *Financial Instruments with Characteristics of Equity*
Date:	September 8, 2009
cc:	Leisenring, Bielstein, Golden, Bossio, Lott, McGarity, Klimek, Chookaszian, Posta, Mills, Ampofo, Sangiuolo, Glotzer, C. Smith, Stoklosa, Proestakes, Sutay, Mechanick, Petrone, Schonefeld, Hood, Davis, Gabriele, Finden (GASB), Liz Figgie (IASB), Gavin Francis (IASB), Joanna Yeoh (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:	Describing the classification approach and classification of a subsidiary's equity instruments in consolidation
Basis for Discussion:	FASB Memo 66 FASB Memo 67
Length of Discussion:	9:30–11:00 a.m.
Attendance:	
FASB Board members present:	Herz, Seidman, Siegel, Linsmeier, and L. Smith
IASB Board members present:	Leisenring
Staff in charge of topic:	Switter
Other staff at Board table:	Lott, Schonefeld, and Davis

Summary of Decisions Reached:

The Board reviewed its past decisions, expressed continuing support for them, but did not reach conclusions about how best to describe them.

The Board did decide that equity instruments issued by a subsidiary would retain their classification in the consolidated financial statements unless the nature of the instrument changes. The nature of an instrument may change in consolidation because of arrangements between the instrument holder and another member of the consolidated group. If the nature of the instrument changes in consolidation, classification should be reconsidered in the consolidated financial statements.

Objective of the Meeting

The objectives of the meeting were to discuss (1) a draft set of principles based on tentative classification decisions the Board has made in earlier Board meetings and (2) whether instruments that are classified as equity in the financial statements of a subsidiary should maintain that classification in the consolidated financial statements. The objectives were met.

Matters Discussed and Decisions Reached:

1. Ms. Switter stated that the Board meeting materials summarized the Boards' tentative classification decisions in a principles-based manner. She added that some of the terms used to describe the approach are different from what the staff has used in the past, but the approach has not changed. She further noted that because the classification approach is based on the subordination of a particular claim and the distinction between the redemption of equity instruments and settlement of liabilities, it was named the subordination-redemption approach.

Issue 1: Subordination-Redemption Approach

2. Ms Switter asked the Board if the subordination-redemption approach is understandable and if it expected to support the classification approach if the following issues can be resolved:

    a. Accounting for share-based payments
    b. Classification of subsidiaries' equity instruments in consolidation
    c. Classification of preferred shares that are mandatorily convertible to equity instruments.

3. **Board vote:** All Board members expressed continuing support for the decisions reached to date, but did not reach conclusions about how best to describe them.

4. **Board comments:** Mr. Linsmeier stated that some aspects of the approach need further clarification. These aspects include (a) whether the issuer should focus on subordination, redemption, or settlement, (b) the order in which the principles in the subordination-redemption approach should be applied, and (c) whether any of the principles influence other principles in determining classification of equity instruments. He stated that he is not clear how subordination, redemption, and settlement interrelate. He added that one way to describe the approach would be to list all claims of an entity in order of subordination and then classify as liabilities the instruments that have settlement features. The residual claims would be classified as equity.

5. Mr. Leisenring stated that the Board's model suggests that creditors have more priority than shareholders, even when the creditors do not necessarily have claims on the entity's assets. Those creditors often have claims solely to an entity's *shares* when settled. He stated that the Board's model presents a different notion of *subordination* because it says that a holder of a call option on common shares has a higher claim than a common shareholder when all the option gives the holder is the right to common shares. Mr. Lott stated the staff is using the term *subordination* in a specialized way. If an issuer cannot perform the requirements of an instrument because of another claim, that instrument is subordinated to the other claim. Mr. Lott

added that the focus should be to make sure only the most subordinated claims are equity, rather than making sure the least subordinated claims are liabilities. He also noted that the term *subordination* may be confusing and that the Board might want to consider another word to describe the relationship.

6. Mr. Smith suggested that another way to improve the description of the approach is to clarify that there could be more than one class of equity instruments. Equity holders do not necessarily have to be the most residual claim, as is the case in the basic ownership approach. Equity instruments only need to be subordinated to all liability instruments.

7. Mr. Herz stated that the basic ownership approach would require equity holders to participate in the gains and losses of the entity, which would include instruments that are redeemable at fair value or book value. However, under the subordination-redemption approach, the timing of the payment (not the payment method or fair value) determines an instrument's classification. Mr. Lott stated that the point is that creditors should not be subordinated to owners.

8. Mr. Herz said that perpetual preferred shareholders normally get paid a fixed amount for dividends, and the perpetual preferred shares would not have been equity under the basic ownership approach. He stated that in the subordination-redemption approach, both common shares and perpetual preferred shares would be classified as equity. He added that a preferred shareholder does not participate in the losses of the entity unless there are no shares subordinated to preferred shares. Mr. Lott stated that under the subordination-redemption approach, preferred and common shareholders still have to participate in losses of the entity because they would lose money if settlement of their claims is dilutive to creditors. In other words, an owner cannot be paid until creditors receive payment in full.

9. Mr. Herz stated that the term *subordination* may not be appropriate. He stated that people may argue that an entity's own equity derivatives are not liabilities but are, instead, another class of equity because they are subordinated to other claims. Mr. Lott stated that the staff uses the word *subordination* to mean the order in which the

entity will perform its obligations, not necessarily the order in which holders have claims to the entity's assets. Further, he stated that if the holder of an instrument has no counterparty risk, it follows that the issuer will perform its obligation, and that instrument is not subordinated.

10. Ms. Seidman stated that she wants to make sure that the subordination-redemption approach does not conflict with the Board's classification decisions related to partnership issues; for example, a member's shares in a credit union held by a partner in which members of the Board do not have to make payments to the partner if certain events occur, but if and when the partner wants to redeem the share, he gets the balance in the account plus interest. Mr. Leisenring stated that he has considered some of those issues and does not think the subordination-redemption approach results in different classification.

11. Mr. Herz gave an example of an instrument in which a holder has a $100 fixed membership interest that gives him the right to receive $100 plus interest when he leaves the entity. He asked how the instrument would be classified under the subordination-redemption approach if the entity (a) has plenty of money to pay the instrument, (b) issues a note in lieu of the payment owed the member when he leaves, and (c) does not have the money to pay but is forced to pay anyway. Mr. Lott stated that if the entity has the money to pay the member, the instrument would be equity under the subordination-redemption approach. If a note is issued when the member leaves the entity, the instrument would be equity until the note is issued, at which point the note would be a liability. If the entity does not have the ability to pay but was forced to pay, then the instrument would be a liability.

12. Mr. Herz asked why a puttable share would be separated into a liability and an equity component when a member has the right to put a share back to the issuer and the issuer has the option not to pay the member but can instead issue a note to the member. Mr. Lott stated that such a put would not be separated because if the entity is not required to pay, the entire instrument will be equity. He stated that if the entity

does not have the right to refuse payment, then the instrument would not be separated because the whole instrument would be a liability.

13. Mr. Herz stated that he does not understand why all puttable shares are not separated into liability and equity components. Mr. Leisenring said that separating puttable shares into two components would ensure that embedded and freestanding puts are accounted for similarly. He stated that under IAS 32, *Financial Instruments: Presentation*, an entity can write a put on outstanding shares and report a reduced number of shares outstanding, even though the shares are still held and outstanding until the put is exercised. In other words, the accounting does not faithfully represent the number of shares outstanding.

14. Mr. Herz asked why a share issued with an embedded forward purchase contract would not also be separated into liability and equity components. Mr. Leisenring stated that when a forward is issued with a share, it is considered a mandatorily redeemable instrument and is accounted for completely as a liability. He added that when a put is written on the share, the same accounting results whether the put is issued together or separately from the share. However, a forward receives different accounting depending on whether it is issued together with or separately from the share.

15. Mr. Herz stated that there are four possible cases involving shares issued with forwards and puts when two entities are involved (a single issuer and a single holder). Entities can:

    a. Issue a share with an embedded put option
    b. Issue a share and write a separate put to the same counterparty
    c. Issue a redeemable share (a forward purchase contract embedded in a share)
    d. Issue a share and separately enter into a forward to purchase it from the same party.

16. Mr. Herz expressed concern that the scenarios described above do not result in consistent classification. In some circumstances, a share with an embedded put option is separated into liability and equity components. In other circumstances, the put option is not separated from the share. If the stock and put option are issued

separately, the put option would be classified as a liability and the share would be classified as equity.

17. The subordination-redemption approach would require a mandatorily redeemable share to be classified as a liability. However, if the share and the forward contract are issued separately, the issuer would classify the forward as a liability and the share as equity.

18. Mr. Leisenring stated that the mandatorily redeemable share should be separated into an equity share and a forward contract to achieve consistency. Mr. Herz suggested that the Board consider a linkage principle to ensure instruments issued as part of the same arrangement are accounted for consistently.

19. Mr. Lott stated that the Board would have to create a principle that requires issuers to link the put options to the shares issued to make the outcomes consistent. He suggested that the principle could be that when an issuer writes a put or forward on its own shares, it has to link it with the same party in which it issued the shares. Mr. Linsmeier said that there would be possible implementation issues with that principle because there is a distinction between (a) a mandatorily redeemable instrument in which the holder would have to return that instrument when it is redeemed and (b) an instrument in which the issuer writes a forward in a separate contract than the stock issuance. That is because the holder of the instrument would not be required to receive settlement upon giving back the exact shares that it originally brought; the holder could easily purchase other stock from the same issuer. The holder of the instrument might not even be required to return the stock at all upon settlement.

20. Mr. Lott stated that the only way to solve this problem is to link or separate the instruments. Mr. Herz said that if issuers are required to link everything, the instruments would still be subject to other criteria, such as how to treat the shares when they are puttable or redeemable solely upon reformation or dissolution of the entity.

21. Mr. Linsmeier stated that if a mandatorily redeemable instrument is required to be separated, the majority of the value will be assigned to the liability component.

Mandatorily Convertible Shares

22. Mr. Leisenring explained that the Boards' subordination-redemption approach would require liability classification for preferred shares that are required to be converted into common shares. The instrument is classified as a liability because the issuer is required to settle in shares. He further stated that some people object to classifying mandatorily convertible preferred shares as liabilities because before conversion, the issuer has a preferred share outstanding and, subsequent to conversion, the issuer has a common share outstanding. Both a preferred share and a common share would be classified as equity under the Boards' approach. Mr. Leisenring added that if Board members do not support classifying preferred shares that are required to be converted into common shares as liabilities, they may not believe any share-settled instrument should be classified as a liability.

23. Ms. Seidman stated that she would prefer to classify a preferred share that is required to be converted into common shares as equity in its entirety. She does not want to separate the instrument into a liability and equity component because an issuer will have to account for an embedded equity derivative as a liability until the conversion option is exercised.

Share-Based Payment Awards

24. Mr. Leisenring stated that he does not understand why share-based payment awards would not be in the scope of this project. He acknowledged that stock options do not meet the definition of a financial instrument until after the vesting date. He stated that he understands the staff may want to clarify when a stock option becomes a financial instrument, but he does not want to give share-based payments an exception to the classification principles developed in this project.

25. Ms. Seidman stated that the display in the income statement of the change in the value of a stock option is very important. She stated that she is not convinced that all

changes in the value of share-based payments should be reported as compensation expense (for example, after vesting is complete).

Issue 2: Accounting of Subsidiaries' Instruments in Consolidation

26. Ms. Switter explained that, to date, the Board has focused on the classification in the issuer's financial statements. This issue addresses how a subsidiary's equity instruments should be classified in the consolidated financial statements. She presented the following alternatives for the Board's consideration:

    a. **Alternative 1**—Always reconsider classifications of instruments issued by a subsidiary in the consolidated financial statements, regardless of how the instruments are classified by the subsidiary.
    b. **Alternative 2—**Carry over the classification from subsidiary financial statements into consolidated financial statements unless the nature of the instrument changes in consolidation because of arrangements between the instrument holder and another member of the consolidated group. If the nature of the instrument changes in consolidation, classification should be reconsidered in the consolidated financial statements.
    c. **Alternative 3—**Carry over the classification from subsidiary financial statements into consolidated financial statements unless the instrument is issued by a limited life entity or is an equity instrument that has redemption requirements.

27. **Staff Recommendation:** Ms. Switter stated that the staff recommends Alternative 2 because retaining the subsidiary's classification in consolidated financial statements more faithfully represents the substance of a noncontrolling interest. She said that the staff acknowledges that the recommendation could create possibilities for structuring opportunities, but added that the staff believes the Board can provide examples of structures that would be inconsistent with the principles of the Board's intent.

28. **Board Comments:** Mr. Herz stated that the problem with the staff's recommendation is that firms could create five-year subsidiaries that issue instruments that are settled only at the end of the life of the subsidiary. He stated that these instruments would receive equity treatment because they are redeemable only when the issuer winds its operations; however, the parent would continue its operations and be required to pay. Mr. Herz stated that the principles in the subordination-redemption approach could be narrowed down and that additional rules

could be created to reduce the number of structuring opportunities. He said that although rules and exceptions are undesirable, they may be necessary.

29. Mr. Herz asked how the staff's recommendation compared to the requirements in IAS 32. Ms. Switter said that the guidance in IAS 32 says to carry over classification from the subsidiary to the consolidated financial statements, unless equity classification results only under the puttables amendment. In that case, she said that the instruments would be a liability in consolidation. She stated that if a limited life entity issues a common share, it would be a liability under IAS 32 unless it meets the exception under the puttables amendments. However, in consolidation, it would still be a liability.

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

None.

<u>General Announcements:</u>

None.