MINUTES

Financial Accounting Standards Board

To:	FASB Board Members
From:	Financial Instruments with Characteristics of Equity Team (Clark x443)
Subject:	Minutes of the June 10, 2009, Board Meeting: *Financial Instruments with Characteristics of Equity*
Date:	June 18, 2009
cc:	Leisenring, Bielstein, Golden, Bossio, Lott, McGarity, Klimek, Chookaszian, Posta, Malcolm, Mills, Ampofo, Glotzer, C. Smith, Stoklosa, Proestakes, Sutay, Mechanick, Petrone, Schonefeld, Hood, Clark, Gabriele, Finden (GASB), Liz Figgie (IASB), Michael Mueller (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:	Measurement
Basis for Discussion:	Agenda Papers 9A and 9B
Length of Discussion:	10:35–11:05 a.m.
Attendance:	
Board members present:	Herz, Seidman, Siegel, Linsmeier, and Smith
Board members absent:	None
Staff in charge of topic:	Switter
Other staff at Board table:	Lott, Golden, Clark, and Schonefeld

Summary of Decisions Reached:

The Board discussed measurement requirements for freestanding equity, liability, and asset instruments and equity hybrids instruments (instruments that are separated into an equity component and a liability or asset component).

The Board made the following decisions:

Transaction costs

1. An entity should expense as incurred all transaction costs or fees arising from the issuance of a financial instrument.

Initial measurement of a freestanding equity instrument

2. An entity should initially measure a freestanding equity instrument at its transaction price. The term *transaction price* does not include transaction costs or fees.

Initial measurement of the components of a separated equity hybrid instrument

3. An entity should initially measure components of a separated equity hybrid instrument as follows. The liability or asset component should be measured at fair value as if it were a freestanding liability or asset. The remainder of the transaction price for the hybrid instrument as a whole should be allocated to the equity component.

Subsequent measurement of a freestanding equity instrument and an equity hybrid instrument

4. An entity should not remeasure a freestanding equity instrument or equity component of a hybrid instrument that it cannot be required to redeem.

5. At each reporting date, an entity should remeasure at current redemption value an equity instrument or a separated equity component of a hybrid instrument that has a redemption requirement. The current redemption value is the amount that should have resulted from applying the redemption formula as if redemption was required at the measurement date. Changes in current redemption value should be recorded as a transfer between retained earnings and the redeemable equity instrument or component.

6. An entity should remeasure the liability or asset component of a separated hybrid instrument on the basis of the requirements of U.S. generally accepted accounting principles (GAAP) that should apply if it were a freestanding instrument.

Measurement of freestanding liabilities and assets

7. An entity should present a physically settled forward repurchase contract on a net basis in the statement of financial position and remeasure that instrument at fair value as of the subsequent reporting date. Changes in value should be reported in income.

8. An entity should report convertible debt as a liability in its entirety and subsequently measure that liability at fair value at each reporting date. Changes in value should be reported in income.

9. All other freestanding liability and asset instruments should be remeasured as required by existing U.S. GAAP. For example, all derivatives should be subject to the measurement requirements in Statement 133.

The Board also discussed and expressed general support for the following broad measurement requirements for liability and asset instruments. The requirements are intended to be consistent with existing measurement requirements.

1. A freestanding instrument should be initially measured at fair value, unless another initial measurement basis is specified in other U.S. GAAP.

2. An instrument with a fixed maturity date and a settlement amount that is fixed or that changes only because of variable interest rates should be reported at a accreted (or amortized) cost amount.

3. An instrument that has a varying or uncertain settlement amount should be remeasured at fair value at each reporting date.

The Board's measurement decisions for freestanding liabilities and assets are subject to change as a result of future deliberations in the financial instruments recognition and measurement project.

Objectives of Meeting:

The objectives of the meeting were to discuss the measurement requirements for (1) freestanding equity instruments and equity hybrids and (2) instruments classified as liabilities and assets. The objectives were met.

Matters Discussed and Decisions Reached:

MEASUREMENT REQUIREMENTS FOR FREESTANDING EQUITY INSTRUMENTS AND EQUITY HYBRIDS

1. **Staff recommendation:** Ms. Switter summarized the staff's recommended measurement requirements for freestanding equity instruments and equity hybrids as follows:

   Transaction costs

   a. Transaction costs or fees incurred to issue freestanding equity instruments and equity hybrids should be expensed immediately. The term *transaction price* as used in this handout does not include transactions costs or fees.

   Initial measurement of freestanding equity instruments

   b. Freestanding equity instruments should be initially measured at their transaction prices.

   Separation of equity hybrids

   c. Separated components of an equity hybrid should be measured as follows. First, the liability or asset component should be measured at the fair value as if it were a freestanding liability or asset. Second, the remainder of the transaction price for the hybrid instrument should be allocated to the equity component.

   Subsequent measurement

   d. Equity instruments and separated components that the entity cannot be required to redeem should not be remeasured.

   e. At each reporting date, equity instruments and separated equity components with redemption requirements should be remeasured at current redemption value. Changes in current redemption value should be recorded as a transfer between retained earnings and the redeemable equity instruments or components.

   f. The liability or asset component of a separated instrument should be subsequently remeasured as if it were a freestanding instrument.

2. **Board vote:** All Board members voted unanimously in favor of the staff recommendation.

MEASUREMENT REQUIREMENTS FOR INSTRUMENTS CLASSIFIED AS LIABILITIES OR ASSETS

Physically Settled Forward Repurchase Contracts on an Entity's Own Shares

3. Ms. Switter stated that under the Board's classification model, all derivatives would be classified as liabilities and assets and would be subject to the measurement requirements in FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, and measured at fair value with changes recorded in profit and loss unless they qualify and are designated as cash-flow hedging instruments.

4. Ms. Switter stated that FASB Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*, requires that forward contracts that require an entity to repurchase its own shares be reported broad; that is, as a liability for the fair value of the shares on the contract date offset by a debit to contra equity. She added that because Statement 150 will be superseded by this project, that requirement will be eliminated.

5. **Staff recommendation**: Ms. Switter noted that the FASB Preliminary Views, *Financial Instruments with Characteristics of Equity*, would have required that physically settled forward repurchase contracts be accounted for net and subject to the fair value measurement requirement in Statement 133. The staff asked the Board to affirm its position, as stated in the Preliminary Views.

6. **Board vote:** All Board members voted unanimously in favor of the staff recommendation.

Convertible Debt

7. Ms. Switter said that as currently written, Statement 133 would require convertible debt to either be (a) separated into two liability components, or (b) measured at fair value through the fair value option. She added that separating convertible debt will result in a derivative liability component (a written call), which would be measured at fair value, and a debt component, which would be measured at amortized cost.

8. **Staff recommendation:** Ms. Switter stated that, in the staff's view, separating an instrument into two liability components would add complexity to the proposed

standard (or actually perpetuate and exacerbate complexities that already exist but are not currently prevalent). The staff recommended classifying convertible debt as a liability in its entirety and measuring it at fair value because measurement will be simpler despite the issues that may arise in determining fair value.

9. **Board vote:** All Board members voted unanimously in favor of the staff recommendation.

10. **Board comments:** Mr. Linsmeier stated that the Board also would have to discuss how the changes in fair value should be presented in the income statement. He stated that he would prefer to display the cost of capital separately from the other changes in fair value.

11. The Board acknowledged that its tentative decision to measure convertible debt at fair value may change as a result of future decisions in the Board's financial instruments recognition and measurement project.

Additional U.S. Generally Accepted Accounting Principles Measurement Requirements

12. Ms. Switter stated that upon completion of the Boards' project on financial instruments with characteristics of equity, there will be several instruments for which there are no measurement requirements within U.S. generally accepted accounting principles (GAAP). Some examples are:

    a. Financial instruments that are indexed to an entity's own stock and require physical settlement with an instrument that is not readily convertible to cash (for example, non-traded equity securities).

    b. Financial instruments that would be equity except that they are required to be redeemed on a specific date or on an event that is certain to occur (for example, many mandatorily redeemable common or preferred shares).

    c. Instruments that would meet the definition of a derivative in Statement 133 except that they are net settled with shares instead of cash and the shares are not readily convertible.

13. **Staff recommendation:** Ms. Switter stated that, in the staff's view, the Board should consider including some broad measurement principles to liability and asset instruments to ensure each instrument in the scope of this project has measurement

requirements under U.S. GAAP. She recommended the Board consider the following broad measurement principles:

a. All freestanding instruments should be initially measured at fair value, unless initial measurement is specified in other U.S. GAAP.

b. Instruments with fixed maturity dates and settlement amounts that are fixed or that change only because of variable interest rates should be accreted (or amortized).

c. Instruments that have varying or uncertain settlement amounts should be measured at fair value.

14. Ms. Switter noted that if the financial instruments recognition and measurement project results in establishing general requirements that would include the instruments identified in paragraphs 12(a)-(c), no specific action would be needed in this project. The staff asked the Board if the financial instruments with characteristics of equity project should provide additional measurement requirements to fill holes in current U.S. GAAP and, if so, which measurement attributes does the Board want to use.

15. **Board vote:** The Board unanimously agreed to use the broad measurement principles as tentative conclusions.

16. **Board comments:** Ms. Seidman asked the staff why it recommended fair value as an initial measurement attribute for liabilities and assets, but recommended transaction price for initial measurement of equity instruments. Ms. Switter stated that, in the staff's view, fair value is not an appropriate initial measurement attribute for equity instruments. She further stated that the staff's intention was to propose broad measurement principles for liabilities and assets that are consistent with current measurement requirements. She further noted that Statement 133, Statement 150, and EITF Issue No. 00-19, "Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock," currently require initial measurement at fair value.

17. Ms. Seidman stated that going forward, it would be ideal to measure transactions at transaction prices (as opposed to fair value) to avoid the recognition of "day 1" gains and losses. Mr. Smith stated that he shares the same concerns as Ms. Seidman.

18. Mr. Linsmeier stated that he would prefer to defer making decisions regarding the needed measurement guidance until the Boards assess the direction the financial instruments recognition and measurement project is headed.

19. Ms. Seidman stated that other than recommendation in paragraph 12(a), she believes that the staff's broad measurement principles are generally consistent with existing GAAP requirements. Mr. Herz stated that a transaction price is normally assumed to be fair value unless certain circumstances surround the transaction.

Transaction Costs

20. **Staff recommendation:** Ms. Switter stated that the staff did not address the accounting for issuance costs for liability and asset instruments in Board papers because the Board plans to address it in its financial instruments recognition and measurement project. She added that given the short time line in the financial instruments recognition and measurement project, the staff is not sure if the Board and the staff will have the opportunity to address the issue. The staff asked the Board if it wanted to address the accounting for issuance costs for liabilities and assets within the financial instruments with characteristics of equity project.

21. **Board vote:** All Board members voted unanimously to expense all transaction costs for liability and asset instruments.

22. **Board comments:** Mr. Linsmeier stated that he did not understand why the issue would not be addressed in the Board's financial instruments recognition and measurement project. Ms. Seidman noted that the issue has not been mentioned by the financial instruments recognition and measurement project, and she does not see reason why the issue should not be resolved in the financial instruments with characteristics of equity project.

23. Mr. Herz stated that issuance costs for liabilities and assets should be expensed. Mr. Lott stated that under International Financial Reporting Standards (IFRS), transaction costs for liability and asset instruments are expensed if the instrument is subsequently measured at fair value and capitalized if the instrument is subsequently amortized or accreted. Mr. Linsmeier stated that he does not want to use the IFRS requirements.

In Mr. Linsmeier’s view, the accounting for transaction cost should be the same regardless of the classification of the instrument.

Follow-up Items:

None.

General Announcements:

None.