

MINUTES



To: Board Members

From: Liabilities and Equity—Arveseth (ext. 384)

Subject: Minutes of the January 3, 2007 Board Meeting: Liabilities and Equity—Short-Term Improvements Based on Certain L&E Decisions **Date:** January 5, 2007

cc: Leisenring, Bielstein, Smith, Golden, MacDonald, Bossio, Polley, Financial Instruments Team, Liabilities and Equity Team, Gabriele, Carney, Allen, Sutay, Glotzer, Financial Statement Presentation Team, Gavin Francis (IASB), Michael Thomas (IASB), Caron Hughes (IASB), FASB Intranet

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Topic: Liabilities and Equity: Short-Term Improvements Based on Certain L&E Decisions

Basis for Discussion: Board Memorandum Nos. 51 and 52

Length of Discussion: 9:00 a.m. to 9:20 a.m.

Attendance:

Board members present: FASB: Herz, Batavick, Crooch (by phone), Linsmeier, Seidman, Trott, and Young
IASB: Leisenring

Board members absent: None

Staff in charge of topic: Carnrick

Other staff at Board table: Arveseth, Bielstein, Detling, Lott, and Stevens

Outside participants: None

Summary of Decisions Reached:

The Board discussed a suggestion made by the Emerging Issues Task Force (EITF) that the FASB undertake a project to make targeted, short-term improvements to existing standards of accounting for financial instruments with characteristics of both a liability and equity. After considering various alternatives, the Board decided to focus its resources on the existing modified joint project on liabilities and equity and not to add a short-term improvements project to its agenda.

Objective of Meeting:

The objective of the meeting was for the Board to decide whether it would make short-term improvements to existing standards for distinguishing between liabilities and equity. The objective of the meeting was met.

Matters Discussed and Decisions Reached:

1. Ms. Carnrick opened the meeting by stating that at the September 2006 EITF meeting, the Task Force requested that the Board consider addressing accounting issues related to convertible debt in the near term. The Task Force cited existing practice problems and the duration of the liabilities and equity project as a basis for its request.
2. Ms. Carnrick explained that, in response to the Task Force's request, the staff developed four alternatives, which are as follows:
 - a. **Alternative 1:** Amend APB Opinion No. 14, *Accounting for Convertible Debt and Debt Issued with Stock Purchase Warrants*, to separate convertible debt into liability and equity components, and continue with the modified joint project.
 - b. **Alternative 2:** Issue an Exposure Draft of the ownership-settlement approach and continue with the modified joint project.
 - c. **Alternative 3:** Officially disband the modified joint project and issue an Exposure Draft of the Board's preferred approach.
 - d. **Alternative 4:** Commit both the FASB and the IASB Boards to an aggressive timeline for the modified joint project (do not follow any of the above alternatives).
3. Ms. Carnrick noted that Alternative 1 would require issuers to recognize the economic interest cost of convertible debt whether in the form of interest payments in cash or through an

equity option. She further noted that scope issues arise under this alternative because other instruments, for example, a prepaid written call option to issue shares, could be issued to achieve the same economic outcome as convertible debt and circumvent the amendment. Ms. Carnrick explained that the objective of Alternative 2 is to eliminate (a) complexity that exists in the current accounting literature and (b) the structuring opportunities that will arise under Alternative 1.

4. Ms. Carnrick stated that the objective of Alternative 3 is to resolve current U.S. practice problems in a timelier manner. She further noted that a consequence of this alternative is that the IASB would have no input on which approach is chosen. Therefore, convergence would be achieved only if the IASB would support the approach that the FASB chooses.

5. Ms. Carnrick stated that proponents of Alternative 4 believe that staff and Board time would be better utilized through a commitment to issue a final converged Statement in a timely manner. The staff believes this can be accomplished by jointly considering and choosing among all three liabilities and equity approaches (ownership-settlement, ownership, and REO).

6. Ms. Carnrick explained that the staff has mixed views on the alternatives. She noted that one staff member recommends Alternative 1. That staff member believes that amending Opinion 14 to require separation of convertible debt would result in a substantial improvement to current financial reporting and increased international convergence. She further noted that other staff members are concerned that an amendment to Opinion 14 could have a detrimental effect on the liabilities and equity project. Ms. Carnrick stated that if the Board decides to amend Opinion 14 and continues to work on the liabilities and equity project, it will do so without understanding whether the amendment has been a change in the right direction. Conversely, if the Board amends Opinion 14 and stops working on the liabilities and equity project until it is able to understand the effect of the amendment, and the results do not turn out to be satisfactory, the Board has lost valuable time in moving the liabilities and equity project forward.

7. Ms. Carnrick noted that some staff members recommend Alternative 4. She stated that in addition to the potential implications the short-term improvements could have on the liabilities and equity project, certain staff members also believe that short-term improvements should be

consistent with decisions made in the liabilities and equity project. She further noted that the Board is considering three possible approaches in the liabilities and equity project, one of which does not require separation of convertible debt. A short-term improvement to separate convertible debt followed by a different decision in the major project would require changes to the same area of accounting in the span of a few years, which would be difficult for preparers.

8. Four Board members (Herz, Batavick, Linsmeier, and Young) agreed with Alternative 4. Two Board members (Crooch and Seidman) stated that although they preferred one of the other alternatives, they did not object to Alternative 4. One Board member (Trott) preferred Alternative 2 and objected to Alternative 4.

9. Messrs. Batavick and Linsmeier acknowledged that many practice issues exist that are related to the accounting for convertible debt. However, they believe the Board should continue to develop its knowledge related to the liabilities and equity project and postpone amending current accounting guidance until the Board has a better understanding of its preferred approach in the liabilities and equity project. Once the Board has selected and sufficiently developed a preferred approach, short-term improvements to the current accounting guidance should only be made if they are consistent with the Board's preferred approach. In addition, both Messrs. Batavick and Linsmeier stated that the Board should consider the developments in the conceptual framework project before making any short-term improvements related to the liabilities and equity project. Mr. Batavick pointed out that the feedback received from respondents to the forthcoming proposed Preliminary Views also would be useful in making short-term improvements to the current accounting guidance.

10. Mr. Young also supported Alternative 4 and added that he does not believe that there is any empirical evidence that indicates that the separation of convertible debt under Alternative 1 would provide better financial information to investors. Moreover, he does not support Alternative 2 because he prefers an approach that provides a narrow view of equity.

11. Mr. Herz agreed with Messrs. Batavick, Young, and Linsmeier and supported Alternative 4. He believes that neither Alternatives 1 nor 2 would be a sufficient improvement that would

merit allocation of staff resources in a manner that would slow down the liabilities and equity project.

12. Mr. Crooch supported Alternative 2. However, he stated that he would not object to Alternative 4. Mr. Crooch believes that a short-term comprehensive solution to the accounting for convertible debt and other financial instruments with characteristics of both liabilities and equity is necessary given the duration of the liabilities and equity project. He also believes that the Board will probably ultimately adopt the ownership-settlement approach.

13. Mr. Trott supported Alternative 2 as he believes that the Board will ultimately select the ownership-settlement approach as its preferred approach. He believes that Alternative 2 is the best alternative because the ownership-settlement approach is consistent with the current accounting guidance, addresses current practice issues, and is convergent with international accounting standards. He further noted that Alternative 2 provides a more comprehensive solution than Alternative 1.

14. Ms. Seidman supported Alternative 1, however, she did not object to Alternative 4. She noted that Opinion 14 provides the following two reasons for not separating convertible debt: (a) the debt security and the conversion option are inseparable and (b) because the debt security and the conversion option are inseparable, neither can be reliably measured. She further noted that in subsequent accounting literature the Board has determined that the instruments can be separated and measured separately. She stated that although the Board may ultimately select an approach that does not require separation, a short-term project is justified in order to (1) conform the accounting for convertible debt to the accounting for instruments with detachable features and (2) converge with international accounting standards. Moreover, Ms. Seidman noted that although issuing convertible debt is not the only way to arbitrage the accounting rules for liabilities and equity, it is a pervasive issue and should be addressed currently with a limited-scope, short-term project. Ms. Seidman does not support Alternative 2 as it would introduce new concepts for accounting for liabilities and equity before the major project is completed.

Follow-up Items:

None.

General Announcements:

None.