

MINUTES



**To:** Board Members

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

**Subject:** Minutes of the March 15, 2006 Board Meeting: Liabilities and Equity—Objectives and Principles for Linkage and Substantive Features

**Date:** March 23, 2006

**cc:** Leisenring, Bielstein, Smith, MacDonald, Golden, Petrone, Carney, Bossio, Sullivan, Mahoney, Beswick, Jacobs, Polley, Financial Instruments Team, Liabilities and Equity Team, Gabriele, Sutay, Fanzini, Gavin Francis (IASB), Michael Thomas (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: Liabilities and Equity: Objectives and Principles for Linkage and Substantive Features

Basis for Discussion: Board memorandum nos. 38, 39, 40, and 41; related addendum; and Board handouts

Length of Discussion: 1:05 p.m. to 2:35 p.m.

Attendance:

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

Board members absent: None

Staff in charge of topic: Richards and Carnrick

Other staff at Board table: Arveseth, Bellantoni, Bielstein, Golden, Lott, and Thuener

Outside participants: None

Summary of Decisions Reached:

The Board continued its discussion of the ownership-settlement approach to accounting for financial instruments with characteristics of equity, liability, and assets. This meeting focused on (1) the accounting for two or more instruments issued or acquired as part of the same arrangement as if they were a single instrument (linkage) and (2) the consideration of unstated and stated features in depicting an instrument's (or linked group of instruments') substantive features for classification purposes.

The Board agreed on the following scope, objective, and principles for linkage:

1. The principles of linking instruments would apply to separately issued or acquired instruments that (a) are equity instruments or have equity components or (b) have payoffs that are based on equity instruments.
2. The objective of linkage is to account for two or more instruments issued as part of the same arrangement in the same manner as a single instrument with the same or similar outcome (or set of possible outcomes with the same or similar probabilities of occurrence).
3. To achieve the objective, a reporting entity should link (account for as a single instrument) two or more instruments that are part of the same arrangement if accounting for the instruments individually differs from accounting for them as if they were a single instrument with the same or similar outcome (or possible outcomes).
4. Instruments are part of the same arrangement if at least one of the following conditions exists:
  - a. Interdependency exists between the instruments. For example, interdependency exists if (1) exercise of one depends on exercise of the other or causes the expiration of the other, (2) an instrument is specifically tied to the underlying instrument, or (3) there is contractual evidence of interacting payoff structures affecting an outcome. In these cases, the timing or the counterparty does not matter.
  - b. The instruments have interacting payoff structures and are entered into at or near the same time with the same or a related counterparty or a counterparty acting as an agent.

5. In the context of condition 4(b), the Board also decided to examine at a later date whether instruments should ever be linked if they are issued under any other circumstances, such as with different counterparties that are not related or acting as agents. Additionally, the Board directed the staff to consider its development of the above linkage principles for possible improvements to other current GAAP for which this is an issue.
6. The Board agreed to the following objectives and principles of substantive features:
  - a. The objective is to classify an instrument in the same manner as another instrument (or linked group of instruments) with the same or similar outcome (or set of possible outcomes with the same or similar probabilities of occurrence) by depicting an instrument according to its substantive features (whether stated or unstated).
  - b. To achieve the objective, an entity should classify an instrument (or a linked group of instruments) by considering stated or unstated substantive features and ignoring any features that are not substantive.
    - (1) A stated or unstated feature is substantive if it has more than a remote likelihood of affecting an instrument's outcome and more than a minimal effect as compared to other features in the instrument. For example, an unstated cash settlement feature would be included in the depiction of an instrument if there is a more than a remote likelihood that an entity would be unable to deliver shares to settle the instrument and it is more than minimal. In this case, two substantive settlement alternatives are identified—shares or cash, and the instrument would be classified as a liability.
    - (2) All other features are nonsubstantive.
7. In accordance with the Board's previous decisions, at each reporting date, an entity should re-examine the features of each instrument or group of instruments issued as part of the same arrangement to determine whether the accounting is still appropriate. If circumstances change, an instrument may need to be reclassified or remeasured. In accordance with previous decisions, no gain or loss would be recognized upon that reclassification.

Objective of Meeting:

The meeting's objective was to discuss and agree on principles for:

1. Accounting for two or more instruments issued or acquired as part of the same arrangement as if they were a single instrument
2. Consideration of unstated and stated features in depicting an instrument's (or linked group of instruments') substantive features for classification purposes.

The objective of the meeting was met.

Matters Discussed and Decisions Reached:

1. Ms. Richards opened the meeting by first discussing the linkage issue. She explained that linkage is necessary under the ownership-settlement approach because, in certain circumstances, an entity may structure an instrument in one contract versus more than one contract and obtain different accounting answers. Therefore, resolving the linkage issue would result in comparable accounting under the approach and less accounting arbitrage.
2. Ms. Richards first asked the Board to decide on the scope of linking instruments within this project. She presented three alternatives for the scope of linkage:
  - a. Alternative 1—The scope of linkage should be limited only to separately issued instruments that are equity instruments or have equity components.
  - b. Alternative 2—The scope of linkage should be limited only to separately issued instruments that are equity instruments, have equity components, or have payoffs that are based on equity. For example, the instruments that make up debt indexed to shares (straight debt and a net-cash-settled forward sales contract) would be linked, but not all instruments with underlyings unrelated to shares would be linked.
  - c. Alternative 3—The scope of linkage should include all instruments that would be subsequently measured under this project (Alternative 2 plus any other instrument that is measured under this project, such as any instrument that varies based on an underlying).
3. Ms. Richards noted that the staff recommends Alternative 2 because it limits linkage to the main issues of this project (liabilities and equity distinguishment). She further noted that Alternative 3 is too broad resulting in overriding the linkage requirements of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, in many cases, for example, separately issued notes and interest rate swaps (which, generally, are not required to be linked under Statement 133). She also explained that Alternative 1 is not broad enough because instruments with payoffs that are based on equity but that are not classified that way would not be candidates for linkage.
4. The Board unanimously agreed with the staff's recommendation to limit the scope of linkage only to instruments that are equity instruments, have equity components, or have

payoffs based on equity. Ms. Seidman stated that she supports Alternative 2, but would support Alternative 1 if the Board decided that the principles of linkage (discussed later) would require linkage of certain instruments that are issued to unrelated counterparties.

5. Ms. Schipper supports Alternative 2 because it (a) would include instruments such as debt linked to share price changes and (b) would avoid unintended consequences that may occur if Alternative 3 were adopted. Ms. Schipper further noted that both Alternatives 2 and 3 overlap the scope of Implementation Issue K1, “Miscellaneous: Determining Whether Separate Transactions Should Be Viewed as a Unit”; however, Alternative 2’s overlap would be limited to instruments that are classified as equity or that are based on equity.

6. Ms. Richards continued the discussion of linkage by introducing the staff’s recommendation for the objective and principles of linkage. She stated that the objective of linkage should be to account for two or more instruments issued as part of the same arrangement in the same manner as a single instrument with the same or similar outcome (or set of possible outcomes with the same or similar probabilities of occurrence).

7. The principles for achieving that objective would be that a reporting entity should link (account for as a single instrument) two or more instruments that are part of the same arrangement if accounting for the instruments individually differs from accounting for them as if they were a single instrument with the same or similar outcome (or possible outcomes).

8. She further noted that instruments are part of the same arrangement and, therefore, should be considered for linkage if one of the following two conditions is met:

- a. Interdependency exists between the instruments. For example, interdependency exists if (1) exercise of one depends on exercise or causes the expiration of the other, (2) an instrument is specifically tied to the underlying instrument, or (3) there is contractual evidence of interacting payoff structures affecting an outcome.
- b. Based on all facts and circumstances, there is sufficient evidence that the reporting entity entered into separate instruments in contemplation of one another instead of issuing or acquiring a single instrument, and as a result, the requirements of the proposed liabilities and equity Statement would be circumvented. An example of such evidence may be that the instruments were issued at or near the same time with the same counterparty or a counterparty acting as an agent.

9. Ms. Richards noted that the condition in paragraph 8(a) focuses on interdependency between the instruments and ignores counterparties and timing. She stated that the staff believes that many linkage candidates would fall into this category.

10. Ms. Richards further explained that if the condition in paragraph 8(a) (see page 5) is not met, then the condition in paragraph 8(b) would require a reporting entity to look further to determine if instruments are issued as part of the same arrangement. Ms. Richards stated that the staff does not recommend that both the same counterparty and timing be necessary to link instruments, because that condition may allow circumvention of the requirements. She asserted that timing and structured terms are probably more indicative of linkage under the second condition than the counterparties involved. The condition in paragraph 8(b) requires an entity to apply judgment based on the facts and circumstances of the arrangement. Ms. Richards noted that, alternatively, the Board could revise the principles of linkage to remove or further restrict the condition in paragraph 8(b); however, the staff does not recommend that revision.

11. The Board unanimously agreed with the objective and principles of linkage noted in paragraphs 6 and 7 (see page 5). Additionally, it unanimously agreed with the linkage condition in paragraph 8(a). With regard to the linkage principle in paragraph 8(b), the Board agreed that it is necessary to link instruments with interacting payoff structures that are entered into at or near the same time with the same or a related counterparty or a counterparty acting as an agent (which will be referred to hereafter as *modified paragraph 8(b)*). Three Board members (EWT, KAS, and DMY) believe modified paragraph 8(b) is necessary, but is not sufficient.

12. The Board decided to examine at a later date whether instruments that do not meet paragraph 8(a) or modified paragraph 8(b) should ever be linked if they are issued under any other circumstances. For example, whether instruments under modified paragraph 8(b) should be linked if they are issued with different counterparties that are not related or acting as agents. Additionally, Mr. Trott directed the staff to consider its development of the linkage principles for possible improvements to other current GAAP for which this is an issue.

13. Mr. Trott does not agree that the linkage condition in modified paragraph 8(b) is sufficient. He asserted that the Board should not limit linkage to arrangements with the

same counterparties if there is evidence of interacting payoff structures meaning that instruments were entered into in contemplation of one another. His belief is that the selection of the counterparty does not appear to be pertinent in determining the accounting by the reporting entity. Ms. Schipper agrees with Mr. Trott that the linkage condition in modified paragraph 8(b) is not sufficient, but she would specify that the expected behavior of the counterparties should be evaluated to determine if the counterparties as a group would act in a similar manner as would one single counterparty.

14. Mr. Young also does not agree that the linkage condition in modified paragraph 8(b) would be sufficient because it may result in different accounting for similar transactions. Mr. Young asserted that the same accounting should be used, regardless of management's intent for all equity-based transactions. Mr. Herz noted that such a principle may not be operable under the ownership-settlement approach, however may be operable under a different approach.

15. Mr. Herz stated that he agrees with modified paragraph 8(b) and that it is sufficient. He noted that companies that have high volumes of transactions in their equity are not necessarily done in contemplation of one another and may be required to perform extensive linkage analyses if the condition if paragraph 8(b) were not limited for counterparties.

16. Ms. Seidman agrees with Mr. Herz that paragraph 8(b) should be modified because, as recommended by the staff, the condition would be too broad for arrangements with unrelated counterparties in which interdependency would not exist (paragraph 8(a)). She further noted that, although differing counterparties may act similarly, that similarity would not prevent the individual counterparties from acting in their own best interest if there is no contractual requirement limiting their actions.

17. Ms. Carnrick introduced the second issue: distinguishing between substantive and nonsubstantive features of an instrument for classification purposes. She noted that the staff's proposed objective is to classify an instrument in the same manner as another instrument (or linked group of instruments) with the same or similar outcome (or set of possible outcomes with the same or similar probabilities of occurrence) by depicting an instrument according to its substantive features (whether stated or unstated). She stated that to achieve that objective, a reporting entity should classify an instrument (or a linked

group of instruments) by considering substantive but unstated features and ignoring any features that are not substantive.

- a. A stated or unstated feature is substantive if it has more than a remote likelihood of affecting an instrument's outcome and more than a minimal effect if it were invoked. For example, an unstated cash settlement feature exists if there is a more than a remote likelihood that a reporting entity would be unable to deliver shares to settle an instrument. In that case, two substantive settlement alternatives are identified—shares or cash, and the instrument would be classified as a liability.
- b. All other features are not substantive.

Ms. Carnrick stated that the principles described apply only to instruments that are known to embody legal obligations. She noted that instruments that may embody constructive obligations and other issues involving issuer discretion will be discussed at a future Board meeting.

18. Ms. Carnrick stated that the staff believes that identifying substantive features to depict an instrument for classification purposes is imperative to achieve comparable and faithful accounting under the Board's current classification model, which focuses on settlement. For indirect ownership instruments, Ms. Carnrick noted that the Board previously decided that if there were settlement alternatives consisting of shares or other consideration, other consideration would be assumed regardless of either party or conditions controlling the form of settlement. However, at the time of discussing how an instrument is settled, the Board was not asked to consider the size of the feature as compared to others or the probability of the form of settlement. Ms. Carnrick stated that the staff believes that if an asset settlement has a remote likelihood of occurring, whether stated or unstated in the contract, it should not influence the classification of the instrument. Ms. Carnrick stated that the staff believes that its recommendation results in consistent accounting for similar instruments, noncircumvention of the standard's intent, and, in certain instances, reduced complexity.

19. The Board unanimously agreed with the staff's recommendation and its reasoning for the objective and principles of substantive features.

20. Next, Ms. Carnrick recommended that linkage and substantive features should be reassessed at each reporting date. She explained that no gains or losses would be recorded upon reclassifications, which is consistent with the Board's previous decisions.

21. The Board unanimously agreed with the staff's recommended provisions for subsequent reassessment.

Follow-Up Items:

22. The Board directed the staff to consider its development of the above linkage principles for possible improvements to other current GAAP for which this is an issue. Additionally, based on further development of linkage, the Board asked the staff to examine, at a later date, whether instruments should ever be linked if they are issued under any other circumstances, such as with different counterparties that are not related or acting as agents.

General Announcements:

23. None.