

MINUTES



To: Board Members

From: Liabilities and Equity—Bergstrom (ext. 296)

Subject: Minutes of March 30, 2005 Board Meeting—Liabilities and Equity: Resource Group Issues for Milestone Draft Date: April 8, 2005

cc: Leisenring, Bielstein, Smith, Golden, Petrone, Bossio, Sullivan, Laurenzano, Mahoney, Polley, Financial Instruments Team, Liabilities and Equity Team, Gabriele, Sutay, Getz, Gavin Francis, Michael Thomas, FASB Intranet

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Topic: Liabilities and Equity: Resource Group Issues for the FASB milestone draft, *Proposed Classification for Single Component Financial Instruments with Characteristics of Equity*

Basis for Discussion: Board memorandum dated March 15, 2005 (No.19)

Length of Discussion: 9:00 a.m. to 10:00 a.m.

Attendance:

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

Board members absent: None

Staff in charge of topic: Richards and Thuener

Other staff at Board table: Bielstein, Carnrick, Bergstrom, and Hansen

Outside participants: None

Summary of Decisions Reached:

The Board discussed three issues related to classification of single component instruments and decided that:

- a. Perpetual instruments would be classified as equity even if those instruments do not meet the criteria to be direct ownership instruments.
- b. Settlement requirements of all instruments would be reevaluated at the consolidated entity level to determine the classification of those instruments by that entity. For example, perpetual instruments of a consolidated subsidiary would not be equity for the consolidated financial statements of parent entity unless those instruments would be perpetual (or direct ownership instruments) of that reporting entity.
- c. To meet one of the two necessary criteria of a direct ownership instrument, a holder's claim on an entity's net assets can neither be limited nor guaranteed either before or at liquidation. The Board also decided that instruments of nonpublic entities that are redeemable at an entity's book value or other value representing fair value would not represent a limited claim and, therefore, those instruments would be classified as equity if they otherwise qualify as a direct ownership instrument.

Objective of Meeting:

The objective of the meeting was to discuss and decide on the three issues described above. The objective of this meeting was accomplished.

Matters Discussed and Decisions Reached:

1. Ms. Richards opened the meeting by explaining that the staff would address three issues raised by the liabilities and equity resource group related to the FASB milestone draft, *Proposed Classification for Single Component Financial Instruments with Characteristics of Equity*. She further noted that a fourth and final issue for this milestone will be discussed at the next Board meeting.
2. The first issue described by Ms. Richards addressed whether perpetual instruments must meet direct ownership requirements in order to be classified as equity. She explained that, in the current version of the milestone draft, perpetual instruments are classified as equity regardless of their subordination or their returns to the holder. She

noted that under the milestone draft perpetual instruments are classified as equity by default because they do not embody a settlement requirement. Some reviewers of the milestone draft observed that certain fixed return instruments are classified as equity, and they questioned whether perpetual instruments should meet the requirements of direct ownership instruments.

3. Ms. Richards stated that the staff recommends retaining the Board's current approach in the milestone draft (referred to as the Expanded Ownership View) because perpetual instruments do not embody obligations for the issuer and, therefore, do not meet the necessary characteristics to be a liability. Ms. Richards noted that payments made to holders of perpetual instruments, whether characterized as dividends or interest, will be addressed by the Board in its discussion of multiple component instruments.

4. Ms. Seidman opposed the staff's recommendation and preferred the Pure Ownership View (the alternative view), in which perpetual instruments are liabilities (or assets) if the direct ownership requirements are not met. She explained that her preference for the Pure Ownership View was due to her belief that the Expanded Ownership View is fundamentally flawed. Ms. Seidman believes that, from a payoff standpoint, the economics of certain perpetual instruments are not equity because the value is not determined directly by the company's performance. She expressed her concern about an approach that would classify these instruments as equity.

5. Ms. Seidman also pointed out that the staff's recommendation would create asymmetry between the classification of the underlying instrument and options or forwards on that underlying instrument.

6. Mr. Young did not support the staff's position; he agreed with the Pure Ownership View. He stated that he was uncomfortable with the staff's recommendation because the classification focuses only on the lack or existence of a settlement requirement in determining whether all payments to holders (both principle and dividends/interest) would be evaluated. He does not support an approach in which the dividend and interest payments associated with the instrument are disregarded for instruments having no settlement requirement for the principle portion. Mr. Young stated that in some cases, dividend and interest payments are more valuable than the principal; therefore all instruments should be evaluated based on their total return, not just principal.

7. Five board members supported the staff's recommendation for the Expanded Ownership View (Herz, Batavick, Schipper, Trott, and Crooch). Ms. Schipper noted that, in her view, instruments that lack a settlement obligation are equity because they meet a primary determining factor in classification decisions. Because those instruments lack a settlement requirement, she does not believe that perpetual instruments are classified as equity by default.

8. Mr. Crooch and Mr. Batavick noted that perpetual instruments should not be classified as liabilities because they lack settlement requirements. They believe that these instruments are equity by default because they do not meet one of the necessary characteristics of a liability. Mr. Crooch was concerned about how to monitor perpetual instruments to ensure that they truly do not have a settlement requirement. The staff noted that this issue would be addressed in future deliberations related to subsequent reassessment.

9. Ms. Richards described the second issue: whether characteristics of a subsidiary's instruments (perpetual, indirect ownership, and direct ownership) should be used to determine the classification of those instruments within the consolidated financial statements. She noted that the milestone draft requires instruments issued or held by consolidated subsidiaries that are perpetual, direct ownership, or indirect ownership instruments to retain those same characteristics for classification in the consolidated financial statements. She further noted that this principal is based on the Board's decision in the business combinations project that a subsidiary's shares are considered to be shares of the parent. Ms. Richards explained that the staff believes that settlement requirements should be re-evaluated at the consolidated entity level such that direct and indirect ownership characteristics would be retained but settlement requirements would not. As a result of this view, perpetual instruments of finite-lived subsidiaries would be liabilities for the consolidated entity unless they are direct ownership instruments for the subsidiary or perpetual instruments for the consolidated entity.

10. Ms. Richards also described an alternative view in which all instruments should be reevaluated at the consolidated entity level for purposes of determining whether instruments would be perpetual, direct ownership, or indirect ownership instruments for the consolidated entity. Under this view, most subsidiary equity instruments would be

liabilities or assets at the consolidated level. Additionally, this view would not be consistent with the decisions reached in the business combinations project.

11. The Board unanimously agreed with the staff's recommendation on the second issue. Ms. Schipper expressed concern that instruments with parent guarantees on direct ownership instruments may not be properly classified as a result of the decision. She further explained that based on the Board's decision, if a subsidiary issues a direct ownership instrument, the instrument is classified as equity by the subsidiary and the classification will carry over to the consolidated entity. If the parent issues a separate guarantee on the instrument, the claim becomes limited and, therefore, does not meet the definition of a direct ownership instrument at the consolidated level; however, it is still classified as equity. Therefore, Ms. Schipper requested that the staff develop wording in the draft that would rectify this situation. For example, if the parent adds a feature to an instrument that is not considered by the subsidiary in determining if an instrument is direct or indirect, the instrument should be re-evaluated by the parent based on the counterparty's participation in the subsidiary's net assets.

12. Ms. Schipper further noted that the guarantee, if issued freestanding of the shares, would receive separate accounting treatment under FASB Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others*. Ms. Seidman stated this situation would be further addressed when the Board discusses linkage criteria.

13. Ms. Thuener described the third issue to the Board: whether a holder's claim could be limited prior to liquidation in determining if an instrument would be a direct ownership instrument. She noted that as it is currently worded, the definition of direct ownership instruments includes instruments with claims that are not *limited or guaranteed* and that the holder's claim would be evaluated by considering the claims prior to and at liquidation together.

14. Ms. Thuener explained that paragraph 20 of the milestone draft defines a direct ownership instrument as follows:

20. Direct ownership instruments have two characteristics:

- a. The instruments represent claims to portions of the net assets of the entity that is neither limited nor guaranteed (that is, there is no ceiling or floor).

An instrument that is redeemable at fair value and would receive a proportionate share of the net assets in liquidation meets this characteristic.

- b. The claims represented by the instruments have priority lower than or equal to any other claims if the issuer were to liquidate on the date the classification decision is being made.

15. Ms. Thuener stated that the staff and certain reviewers believe a possible loophole exists in the paragraph 20(a) requirement to evaluate the claim together over the life and at liquidation of the instrument and that the staff is proposing to amend the language in paragraph 20(a) to state that the claim on the entity's net assets can neither *be limited nor guaranteed either before or at liquidation*. As a result, an instrument with a redemption that is either fixed (not including fair value) before liquidation OR at liquidation would fail paragraph 20(a).

16. Ms. Thuener further noted that if the language were changed, a book value redemption plan with a provision allowing the holder to participate in the residual net assets upon liquidation of the entity would no longer pass the criteria in paragraph 20(a) because the holder's claim would be limited to book value before liquidation. Ms. Thuener also noted that book value redemptions and certain other formula redemptions are mainly used by nonpublic entities for practical purposes and as a result, asked the Board if they would support an exemption for nonpublic entities with book value or similar redemption plans.

17. Mr. Trott agreed with the staff but did not believe that an exemption was necessary for nonpublic entities. He believes that, for entities having no market mechanism to easily obtain the fair value of an instrument, the wording of direct ownership can be articulated to include redemption formulas meant to represent fair value. Mr. Trott believes that, for those entities, the redemption formulas are simply another way to participate in the entity's net assets without limits. Six Board members agreed with the staff's recommendation as modified by Mr. Trott (Herz, Batavick, Crooch, Schipper, Seidman, and Trott). Mr. Young agreed with the staff's recommendation but believes that nonpublic entities should be given an exception to the principle.

Follow-up Items:

18. The Board directed the staff to amend the milestone draft to be consistent with the decisions reached.

General Announcements:

None.