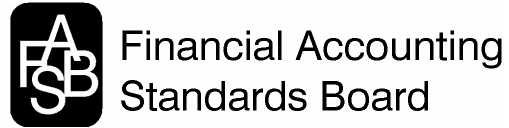


MINUTES



**To:** Board Members

**From:** Liabilities and Equity—Hansen (ext. 298)

**Subject:** Minutes of the May 11, 2005 Board Meeting: Liabilities and Equity—  
Display/Measurement, Issuance Costs, Recognition of Forward Contracts, etc. **Date:** May 31, 2005

**cc:** Leisenring, Bielstein, Smith, Golden, Petrone, Bossio, Sullivan, Mahoney, Polley, Financial Instruments Team, Liabilities and Equity Team, Gabriele, Getz, Sutay, 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 or Interpretation.*

**Topic:** Liabilities and Equity: Display and Measurement, Issuance Costs, Recognition of Forward Contracts, Subsequent Reclassification Assessments

**Basis for Discussion:** Board memorandums No. 21, 22, 23, and 24

**Length of Discussion:** 8:30 a.m. to 10:15 a.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, Carnrick, Thuener, and Hansen

Other staff at Board table: Bielstein, Lott, and Bergstrom

Outside participants: None

Summary of Decisions Reached:

The Board discussed issues related to single component instruments including display and measurement, issuance costs, recognition of forward contracts, subsequent classification assessments, and accounting for a change in the classification of an instrument after its issuance.

The Board made the following decisions related to display and measurement of single-component instruments:

- a. All single-component instruments in the scope of the proposed Statement would initially be measured at the transaction price, which would generally be the amount of proceeds (unless there are other elements embedded in the proceeds, for example, issuance costs). Instruments accounted for under FASB Statement No. 123 (revised 2004), *Share-Based Payment* would not be subject to those initial measurement requirements.
- b. Direct and indirect ownership instruments that are classified as equity but which by their terms will ultimately be settled with cash, other assets, services, or the use of assets would be separately displayed within the equity section of the statement of financial position. That display requirement is illustrated as Method 3 of the appendix to the Board meeting handout (available on the FASB website at [http://www.fasb.org/board\\_handouts/05-11-05.pdf](http://www.fasb.org/board_handouts/05-11-05.pdf)). Subsequent to their initial recognition at fair value, those instruments would be subsequently measured at the amount that results from applying the redemption formula at the reporting date (applied in the same manner it would be applied at the redemption date).
- c. All other equity instruments (including direct and indirect ownership instruments that ultimately would be settled with perpetual instruments and other instruments classified as equity) would not be remeasured subsequent to their initial recognition. The Board also decided not to change the presentation practices for such instruments.

- d. Entities would not be required to display, as separate line item or caption within the statement of financial position, those instruments that are classified as liabilities or assets but would be settled or ultimately settled by the issuance or receipt of equity instruments.
- e. Liabilities that are in the form of mandatorily redeemable shares that by their terms have both fixed redemption amounts and fixed settlement dates would be subsequently remeasured at the present value of the amounts to be paid, with changes in value reflected in net income.
- f. Liabilities that are in the form of mandatorily redeemable shares that by their terms have varying redemption amounts or settlement dates would subsequently be remeasured at fair value with changes in value reflected in net income. Additionally, other single component instruments classified as liabilities for which the redemption amount varies based on the changes in the value of the issuer's direct ownership instruments (for example, debt indexed to common shares) would be measured at fair value.
- g. All remaining single component instruments classified as liabilities or assets that are not included in the above measurement requirements should be subsequently measured at fair value with changes reflected in earnings, unless other accounting guidance specifies another measurement attribute.

The Board also made the following decisions:

- a. Issuance costs for all debt and equity instruments would be recognized as an expense when incurred.
- b. Forward contracts to issue or repurchase an entity's own shares should be recognized in the statement of financial position "net" and measured at fair value. Forward contracts that are liabilities or assets would subsequently be remeasured at fair value and the changes in value reflected in net income. Forward contracts that are equity instruments would not subsequently be remeasured.

- c. The classification of all single component instruments would be reassessed at each reporting date. If the instrument's classification changes as a result of events during the reporting period, the instruments should be reclassified as of the date of the events that caused the reclassification. There is no limit on the number of times instruments may be reclassified.
- d. Upon reclassification, instruments reclassified to assets, liabilities, or separately displayed equity should be measured at the attributes at which they would have been measured as if they had previously been classified that way. No gain or loss should be recognized through income on the date of reclassification. For example, a direct ownership instrument separately displayed in equity and measured at settlement value that subsequently becomes a fixed-price liability would be reclassified at the present value of the liability using the implicit discount rate at the date of reclassification. Any difference in those values would remain in equity. Instruments reclassified to equity (not separately displayed) should be reclassified at their current carrying amounts. Previously recognized gains or losses should not be reversed, and there is no limit on future gains or losses.

Objective of Meeting:

The objective of the meeting was to discuss and decide how to (a) measure and display certain instruments within the scope of the project, (b) account for debt and equity issuance costs, (c) recognize forward contracts, and (d) reassess and remeasure instruments for classification purposes. The objective of the meeting was accomplished.

Matters Discussed and Decisions Reached:

1. Ms. Carnrick opened the meeting by introducing the first issue: measurement and display of single component instruments. She stated that the staff recommends establishing initial measurement requirements for all single component instruments within the scope of the project except for stock compensation arrangements accounted for under Statement 123(R). She then stated that the staff recommends establishing subsequent measurement requirements only for certain instruments—mandatorily

redeemable shares, instruments not otherwise within the scope of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, or for which there is no explicit measurement guidance, and certain items that are required to be displayed in a separate section within equity. Additionally, Ms. Carnrick stated that the staff recommends that all remaining instruments not measured under the proposed statement would follow other applicable GAAP for subsequent measurement.

2. Six Board members agreed with the staff's recommendation [Herz, Batavick, Crooch, Schipper, Seidman, and Trott]. However, Mr. Young thought that this project should first look at total display and measurement for all liabilities and equity, and then look at the exceptions.

3. Ms. Richards pointed out that the main purpose of the liabilities and equity project is the classification of instruments within its scope. She stated that the purpose is not to create subsequent measurement guidance for all instruments, only for those instruments in which additional guidance is needed.

4. Ms. Carnrick introduced the next topic for the first issue: presentation for single component instruments. She stated that the staff believes the objective of special display should be to provide information about the magnitude of a reporting entity's possible cash (or asset) outflows. She also stated that the staff recommends that the equity section be separated, such that instruments with cash and other asset settlement requirements should be displayed in a separate section within equity. Ms. Carnrick then described three methods for displaying the equity accounts and recognizing changes in the value for instruments requiring special display. Illustrations of the three methods are in Appendix A. She said that the staff recommends Method 3 because it presents the most useful information to the user and would generally be compliant with regulatory requirements.

5. Ms. Carnrick stated that the staff considered other alternatives such as (a) separate display for instruments classified as liabilities or assets settled with shares, (b) separate display for instruments classified as equity that have share-settlement requirements, and (c) no special display for any equity instruments. She stated that the staff rejected these methods because they do not provide additional useful information to users. For

example, the staff believes that constituents would still have to examine footnote disclosures to fully understand and assess any possible cash impact for derivatives settled with shares and for those that have multiple settlement alternatives involving cash or shares.

6. The Board unanimously decided that instruments classified as equity with cash and other asset settlement requirements should be shown in a separate section within equity. The Board also decided that Method 3 would be used for presenting the equity accounts and recognizing changes in the value. Ms. Schipper suggested that Method 3 could be improved with some editorial changes that will be given to the staff. Additionally, the Board will consider if the footnote disclosures will be necessary under that method.

7. Ms. Seidman stated that she would like to ask constituents in the next public document whether they believe it would be useful to separately display on the face of the balance sheet liabilities that have obligations to settle with shares. Ms. Seidman believes that users would want to know that a liability would not require a cash outflow. Mr. Leisenring believes that the IASB also would be interested in separately displaying liabilities with share settlement requirements.

8. Ms. Carnrick then presented the staff recommendations for measurement of instruments with characteristics of equity and liabilities as follows:

- a. All single component instruments within the scope of the document should be initially measured at the transaction price unless other applicable GAAP explicitly requires otherwise (for example, stock compensation arrangements accounted for under Statement 123 (R)).
- b. Mandatorily redeemable shares classified as liabilities or equity should be subsequently remeasured in one of two ways:
  - i. If both the amount to be paid and the settlement date are fixed, measure at the present value of the amount to be paid.

- ii. If either the amount to be paid or the settlement date varies, measure the obligation at current settlement value and reflect changes in earnings for instruments classified as liabilities or assets and in equity for instruments separately displayed as equity.
  - c. All other single component instruments classified as assets or liabilities that are within the scope of the milestone draft and not covered by other measurement guidance should be subsequently measured at fair value.
  - d. Other single component instruments classified as equity and direct and indirect ownership instruments that would be ultimately settled with perpetual instruments should not be subsequently remeasured.
9. Ms. Carnrick stated that the transaction price is generally indicative of the initial fair value. She noted, however, that there are times when the transaction price will not be the fair value, for example, if it is a multiple element transaction (as in embedded issuance costs) or for shares issued upon exercise of an option.
10. Ms. Carnrick further explained that settlement value for mandatorily redeemable shares is the amount that would have resulted from the redemption formula on the reporting date. For example, book value redemption plans would be the book value on that date and fair value redemption plans would be the fair value on that date. She continued to explain that if an entity knows it is going to liquidate on a certain date and it is consolidated, an orderly liquidation date would be used (that amount would not include prepayment penalties applied to liabilities or liquidity discounts that are applied to assets unless the entity plans to incur those charges on the actual redemption date). Ms. Carnrick stated that the staff considered measuring those mandatorily redeemable instruments subsequently at the projected fair value, however, it believes the current result of the redemption formula provides users with better information and is less complex.
11. Ms. Carnrick also explained that the staff recommended consistent measurement for mandatorily redeemable shares with varying terms at settlement value regardless of how

they are classified. However, she stated that the staff would not object to such mandatorily redeemable shares that are liabilities being measured at fair value consistent with other liabilities that have uncertainties, such as an asset retirement obligation or contingent consideration in a business combination. She also noted that measuring those liabilities at fair value would likely simplify bifurcation issues.

12. The Board unanimously agreed with the staff's recommendations on measurement except for the subsequent measurement of mandatorily redeemable shares with varying terms that are classified as liabilities.

13. Ms. Schipper observed that, depending on the choice, an inconsistency in measurement would exist either for mandatorily redeemable shares or for liabilities with uncertainties in redemption amount. She believes that it is more appropriate to accept an inconsistency in measurement for mandatorily redeemable shares so there would be consistency across liabilities that have uncertainties with respect to redemption dates or amounts. For example, she clarified that this decision would be for liabilities that do not have current guidance; this would not include instruments measured under FASB Statement No. 5, *Accounting for Contingencies*.

14. Mr. Trott stated that settlement amount works well for the allocation of net assets, but would be confusing and inconsistent for liability measurement. He stated that fair value is a more relevant measure for liabilities to determine future cash flow requirements. Mr. Young believes that, from a user's point of view, consistent treatment of mandatorily redeemable shares is not very important. The Board unanimously decided that mandatorily redeemable shares with varying redemption dates or amounts that are classified as liabilities would be measured at fair value with changes reflected in earnings. Additionally, to avoid focusing on the form of an instrument, the Board decided that other similar instruments classified as liabilities that have varying redemption amounts based on the issuer's share price also would be classified at fair value.

15. Ms. Richards introduced the second issue: how to account for debt or equity issuance costs. She pointed out that APB Opinion No. 21, *Interest on Receivables and Payables*,

states that issuance costs are a deferred charge and that debt issuance costs have been traditionally accounted for as a contra liability and amortized. She stated that in practice, treatment of equity issuance costs is not consistent. Ms. Richards pointed out that business combination literature says to record issuance costs as part of additional paid-in capital. However, for equity found in the mezzanine section of the balance sheet, some preparers set up a contra equity account and amortize through equity and EPS; others record those costs in additional paid-in capital. She stated that this especially becomes an issue upon transition or reclassification of equity to a liability.

16. Ms. Richards pointed out that the business combinations project has been moving toward recording the transactions and pieces of the transaction at fair value. However, she said that they are silent on the issue of what to do with issuance costs. She stated that the fair value measurement project also is silent on this issue, adding that the transaction price is usually representative of the initial fair value (for liabilities and assets). Ms. Richards pointed out that this decision does not clarify whether the transaction price includes or does not include issuance costs. She presented four alternatives:

- a. Issuance costs should be recorded as a deferred charge asset.
- b. Issuance costs should be recorded as a deferred charge contra liability or equity.
- c. Issuance costs should be recorded as part of the initially measured proceeds.
- d. Issuance costs should be expensed at inception.

17. Ms. Richards stated that the staff recommends expensing issuance costs at inception regardless of (a) whether they are debt or equity issuance costs and (b) whether they are part of the transaction or separate. She pointed out that this may necessitate imputing those costs and the yield, if there is a yield adjustment, for the issuance costs. She stated that the staff believes that this is the conceptually correct answer and is less complex.

18. Six Board members agreed with the staff's recommendation and that it would apply to all debt and equity issuance costs [Herz, Batavick, Crooch, Schipper, Trott, and Young]. Mr. Trott stated that, conceptually, the issuer has paid for a service and received

a service. He added that the issuance of instruments does not give rise to an asset or net proceeds. He reiterated that it is important to make clear that the issuance cost, and not yield, is expensed. Mr. Trott stated that separating the issuance cost from the yield may be complicated, but expensing the issuance cost would significantly simplify the accounting for debt going forward.

19. Mr. Crooch supported expensing issuance costs at inception because it is consistent with decisions made in other projects. For example, in the business combinations project services rendered for purchasing a company are expensed. He also appreciated that it would simplify the accounting for debt. Ms. Schipper stated that it is important to separate the financing portion of the transaction from the payment for services portion. She acknowledged that it may be complicated to measure the issuance cost if it is embedded in the yield, but stated that it results in a better representation of the actual interest charges.

20. Ms. Seidman disagreed with the staff recommendation and stated that direct incremental costs of issuing debt or equity are costs that are necessary to access capital markets. She stated that in the fair value measurement project the Board distinguished between transportation costs and transaction costs. Transportation costs were characterized as costs to access the market, whereas transaction costs were incremental costs within the market. She believed that issuance costs are transportation costs. She also considered the issue from the capital provider's perspective and views issuance costs as similar to origination or underwriting fees. She believes that the Board is underestimating the complexity of distinguishing between the part that is yield related and the part that is service related. Ms. Seidman believes that it would be simpler to treat issuance costs as a reduction of proceeds and that the conceptual arguments are debatable.

21. Ms. Thuener introduced the third issue: whether physically settled forward contracts to purchase or sell an issuer's own stock should be presented gross or net on the balance sheet. She stated that FASB Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*, currently requires

forward purchase contracts to be presented gross. Ms. Thuener noted that in Statement 150 the Board reasoned that the unconditional contractual obligation inherent in a forward purchase contract was very similar to the repurchase obligation in mandatorily redeemable stock and that the accounting should be similar.

22. Ms. Thuener stated that the staff recommends that forward contracts to issue or repurchase an entity's own shares should be initially presented net at fair value. Contracts that are liabilities or assets also should be presented subsequently net at fair value with changes reflected in earnings. Forward contracts classified as equity should not be remeasured. She said that the staff believes that the form of settlement, that is, physical settlement versus net-cash- or net-share-settlement, should not cause different presentation. Further, the staff does not believe that the shares should be accounted for as if they were repurchased or issued prior to that transaction actually occurring, as is done in gross presentation. Ms. Thuener acknowledged the similarity in the unconditional obligation inherent in the forward contract and the mandatorily redeemable share. However, gross accounting automatically links the forward contract to the underlying share, which effectively trumps any linkage criteria that may be later developed by the Board.

23. No Board members objected to the staff recommendation. However, Mr. Herz stated that gross presentation of forward contracts and present value measurement are more relevant, but he does not object to the staff's recommendation.

24. Ms. Schipper preferred having consistent accounting for forward contracts and freestanding puts as opposed to consistency for mandatorily redeemable shares and separately issued forward contracts and shares. Ms. Seidman stated that she views forward contracts as executory contracts.

25. Mr. Hansen introduced the fourth issue by asking the Board whether single component instruments should be subsequently reassessed for classification purposes. He pointed out that in milestone one of the project, the Board decided to subsequently reassess instruments with multiple settlement alternatives to determine whether those instruments would be settled with direct ownership instruments and thus be classified as

equity. He stated that a similar issue exists for all instruments that appear to have equity characteristics, in subsequently determining whether those instruments are liabilities, assets, or equity. Mr. Hansen stated that the staff recommends that all instruments should be reassessed for classification purposes at each reporting date and reclassified as of the date of the event that caused the reclassification. The staff also recommends that there be no limit on the number of times instruments may be reclassified.

26. The Board unanimously agreed with the staff's recommendation.

27. Mr. Hansen introduced the fifth issue by asking how instruments should be accounted for upon reclassification. He stated that the issue contains two related questions:

- a. How should instruments be remeasured upon reclassification?
- b. Remeasurement at the reclassification date might affect equity or earnings, that is, there might be a gain or loss due to remeasurement. How should the effect of that remeasurement be reported?

28. Mr. Hansen presented two ways to measure reclassified instruments that are liabilities, assets, or separately displayed equity:

- a. Measure reclassified instruments at fair value
- b. Measure reclassified instruments using the same measurement attribute at which they will be subsequently measured—that is—as if the instrument had been classified and measured that way prior to reclassification.

29. Mr. Hansen stated that the staff recommends that a reclassified instrument be remeasured on the reclassification date at the same amount at which it would have been measured on that date if it had previously been classified that way. For example, on the reclassification date, an instrument that was equity and becomes a liability would be measured at the amount at which it would have been measured if it had always been a liability using the discount rate implicit at the date of reclassification. Mr. Hansen stated that the staff would not object to measuring reclassified instruments at fair value;

however, doing so may cause an entity to report a gain or loss that arises from using a different subsequent measurement attribute. Mr. Hansen noted that a liability, asset, or separately displayed equity would be carried over to equity at its carrying amount.

30. Ms. Richards clarified that instruments that are reclassified to an asset, liability, or separately displayed equity would be carried over at the fair value with the change in value recorded in equity, but if the instrument is reclassified to equity it would be carried over at its current carrying amount. She said that no gain or loss would be recognized when an instrument is reclassified.

31. The Board unanimously agreed with the staff's recommendation.

Follow-up Items:

None.

General Announcements:

None.

**All shares mandatorily redeemable at book value  
Measured and displayed at settlement value**

	Method 1			Method 2			Method 3	
	Per. 1	Per. 2		Per. 1	Per. 2		Per. 1	Per. 2
<b><u>Balance Sheet</u></b>			<b><u>Balance Sheet</u></b>			<b><u>Balance Sheet</u></b>		
<b><u>Assets</u></b>			<b><u>Assets</u></b>			<b><u>Assets</u></b>		
Cash	150	180	Cash	150	180	Cash	150	180
AFS Securities	100	110	Available-for-Sale Securities	100	110	Available-for-Sale Securities	100	110
PP&E	300	275	Property, Plant, & Equipment	300	275	Property, Plant, & Equipment	300	275
<b><u>Total Assets</u></b>	<b><u>550</u></b>	<b><u>565</u></b>	<b><u>Total Assets</u></b>	<b><u>550</u></b>	<b><u>565</u></b>	<b><u>Total Assets</u></b>	<b><u>550</u></b>	<b><u>565</u></b>
<b><u>Liabilities</u></b>			<b><u>Liabilities</u></b>			<b><u>Liabilities</u></b>		
Liabilities	200	190	Liabilities	200	190	Liabilities	200	190
<b><u>Equity</u></b>			<b><u>Equity</u></b>			<b><u>Equity</u></b>		
Mandatorily redeemable shares*	350	375	Mandatorily redeemable shares	350	375	Mandatorily redeemable shares*	350	375
<b><u>Total Liabilities and Equity</u></b>	<b><u>550</u></b>	<b><u>565</u></b>	<b><u>Total Liabilities and Equity</u></b>	<b><u>550</u></b>	<b><u>565</u></b>	Cumulative change in shares subject to mandatory redemption	(250)	(275)
<b><u>Notes to Financial Statements:</u></b>			APIC	80	80	APIC	80	80
*Shares, all subject to redemption upon X consist of:			AOCI	60	70	AOCI	60	70
Common Stock	100	100	Retained Earnings*	(140)	(150)	Retained Earnings	110	125
APIC	80	80	<b><u>Total Liabilities and Equity</u></b>	<b><u>550</u></b>	<b><u>565</u></b>	<b><u>Total Liabilities and Equity</u></b>	<b><u>550</u></b>	<b><u>565</u></b>
AOCI	60	70	<b><u>Notes to Financial Statements:</u></b>			<b><u>Notes to Financial Statements:</u></b>		
Retained Earnings	110	125	*Retained Earnings consists of:			*Mandatorily Redemable Shares		
	<b><u>350</u></b>	<b><u>375</u></b>	Cumulative change in shares subject to mandatory redemption	(350)	(375)	Consist of:		
			Par value of redeemable shares	100	100	Shares	100	100
			Cumulative net income	110	125	APIC	80	80
				<b><u>(140)</u></b>	<b><u>(150)</u></b>	AOCI	60	70
						Retained Earnings	110	125
							<b><u>350</u></b>	<b><u>375</u></b>