

MINUTES



To: Board Members
From: Lauren Belot
Subject: Revised Minutes of the May 18, 2004, Liabilities and Equity Resource Group Meeting
Date: June 3, 2004
cc: Bielstein, Smith, Petrone, Leisenring, Swift, Polley, Gabriele, Sutay, Thompson, Project Team, Intranet

Topic: REO Approach

Basis for Discussion: REO presentation and related discussion questions

Length of Discussion: 1:00 p.m. to 4:00 p.m.

Attendance:

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

Board members absent: Schieneman

Staff in charge of topic: Bullen, Richards, Belot, and Arbuckle

Other staff at Board table: Bielstein and Golden

Outside participants: Resource group members: John Althoff, David Budnick, Tim Bridges, Neri Buckspan, Patrick Garguilo, Lailani Moody, Steve Piccara, Carlo Pippolo, James Rothwell, Rich Schrader, Shannon Warren, Robert Weaver, Kevin Woodruff, and Robert Uhl.
Observers: Cathy Cole and Jenifer Minke-Girard.
By phone: Richard Forrestel, Jr., Ann Martin, Steven McEachern, Ben Neuhausen, Greg Taylor, and Sandra Thompson.

Objective of Meeting:

To discuss the Reassessed Expected Outcomes (REO) Approach with Project Resource group members.

Matters Discussed

At 1:00 p.m., Ms. Schipper welcomed resource group members present and those participating by phone, as well as observers of the meeting. After participant introductions, she introduced Ms. Richards and Mr. Bullen to present an overview of the Reassessed Expected Outcomes (REO) Approach.

Mr. Bullen and Ms. Richards spoke about approaches that were previously considered in the liabilities and equity project, as well as the principles and objectives, method details, and examples of the REO model. During that presentation, several resource group and Board members asked clarifying questions.

Mr. Trott inquired about the results of the REO model. Specifically, he asked what the asset or contra-liability piece on Day 1 represents for a written call on 8 shares (slide 18 of the presentation). Mr. Bullen suggested that it is the fair value of an instrument that will pay \$1,000 if the stock price exceeds \$125, but will pay nothing if the stock price does not exceed \$125. Mr. Garguilo inquired about the amount of interest expense that is recorded and whether it varies depending on changes in the stock price. Mr. Bullen answered that the interest expense varies with the stock price, because at each periodic reassessment the stock price affects the liability measurement, which is the basis for the next period's interest expense calculation. Mr. Bukspan also commented that the amount of interest expense measured under REO may vary from one company to another depending on the frequency of reassessment and that this would be an internal accounting policy decision.

The staff also clarified that linkage between financial instruments may be an issue in some circumstances. An example is the classification of the expected inflow of assets under a written call option as either an asset or contra-liability. The staff commented that

it seems appropriate for a written call option linked to debt to be classified as a contra-liability; however, that treatment is questionable if the written call option is freestanding.

After the staff's presentation, Ms. Schipper asked resource group members whether the valuation technique used in the proposed REO model is an approach that is widely used in the marketplace for analyzing and pricing financial instruments. Mr. Woodruff responded that the method is widely used although, in the marketplace, all inputs are reassessed after the original calculation, instead of only stock price and time remaining. Mr. Weaver added that those valuation calculations are updated daily, and even hourly, at his hedge fund.

Mr. Woodruff also commented that from an investor's perspective, convertible debt is not economically the same as puttable stock, because investors consider the bankruptcy risk of the issue, and the holders have different rights in bankruptcy. Those differences might have an effect as large as 10 percent of total value. He suggested introducing more factors into the model to accommodate that. Mr. Bukspan stated that his credit rating agency finds those two securities to be quite different for those reasons.

Ms. Schipper asked resource group members to comment on the relative importance of consistent accounting for equity-linked financial instruments relative to the importance of other factors, such as the need for liquidity information or the value of maintaining the current definitions of liabilities and equity.

Mr. Bridges suggested that liquidity/solvency information is important but could be provided through additional presentation and disclosure requirements. However, Ms. Warren questioned whether additional footnote disclosure to capture liquidity/solvency information would be sufficient to meet the needs of creditors given the length and complexity of current financial statements combined with the complexity of the REO model. Mr. Uhl expressed several concerns about the model, including the following: different results are produced depending on how often inputs are reassessed, the model's results conflict with other guidance (for example, the issue of control in FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and*

Extinguishments of Liabilities), executory contracts would be presented at their gross amounts; and the questionable meaningfulness of the yet-to-be-named measurement attribute.

Mr. Garguilo commented that the REO model challenges his notion of equity because REO classifies as equity amounts that have the *potential* to be outstanding common stock. He also noted that in order to audit financial statements, it is important to understand the goal of the accounting model, which is unclear to him at this point. Mr. Althoff questioned whether the method would be informative to users of financial statements and also expressed concern about the auditability of this method when applied to complex financial instruments. Mr. Pippolo suggested that the model may be worth considering if only for its affect on earnings-per-share calculations. Ms. Thompson asked whether the benefits from this method are sufficient to warrant a fundamental change in the definitions of assets, liabilities, and equity, for example, to recognize as assets potential cash inflows over which the entity has no control and to recognize as liabilities potential cash outflows that the entity is not obliged to make.

Ms. Schipper then asked about the potential informational value of financial statements if the REO approach were implemented, whether better alternatives exist, and whether introducing liquidity criteria into the model would be useful. Mr. Bukspan commented that creditors need to understand the *entire* financial instrument, not merely its components. Mr. Uhl remarked that he supported the REO approach goal of eliminating accounting arbitrage and suggested that that advantage of the REO approach would be undermined if liquidity criteria were included. However, several respondents said that overlaying liquidity criteria would be very useful.

Ms. Schipper commented that under the REO model instruments that have a cash payoff exactly related to movement in share price are classified as equity, and those instruments that do not have a payoff that moves with share price are classified as liabilities, even if the issuer has no obligation to transfer assets. For example, under the REO model, both mandatorily redeemable shares redeemable at fair value on a date certain to occur and cash-settled stock appreciation rights would be equity, while perpetual preferred shares

would be liabilities. Some resource group members expressed concern over those results. Mr. Uhl questioned what the fair value is based on for mandatorily redeemable shares of private companies redeemable at fair value. Mr. Neuhausen stated that he thought those results of the REO model are undesirable and that they may even outweigh the model's benefits. Mr. Herz questioned whether perpetual preferred stock with a fixed market-based return could possibly be equity, even under the REO model.

Ms. Schipper asked resource group members to comment on the application of the REO model, for example, whether arrangements that can or must be net-settled should be reported in the same way as arrangements requiring physical settlement. Mr. Bridges responded that an accounting distinction between net-settled and physically-settled instruments would create accounting arbitrage opportunities.

Ms. Schipper then asked group members to identify possible issues relating to implementation of the REO model in small businesses. Mr. Forrestel commented that the guidance would only affect the accounting for his company's shares that are mandatorily redeemable at fair value. Other group members remarked that some small businesses enter into complex financial instrument transactions and that the REO model may be difficult for them to implement.

Ms. Schipper requested any final comments from group members. Mr. Rothwell cautioned Board members to take care in amending the definitions of equity and liabilities because many credit agreements are based on those definitions. Ms. Moody suggested that if the staff pursues the REO approach, thorough implementation guidance will be necessary, since complex, cutting edge instruments are issued even by many smaller companies. She also commented that these companies would have greater difficulty in determining the probability of either settlement alternative when little or no information is available about current stock price, volatility, etc.

At 4:00 p.m., Ms. Schipper concluded the meeting by thanking all participants.

Follow-up Items:

None.

General Announcements:

None.