

## MINUTES



**To:** Board Members

**From:** Financial Instruments: Liabilities and Equity Team (Arbuckle, ext. 275)

**Subject:** Corrected Minutes of the May 26, 2004 Liabilities and Equity Board Meeting **Date:** June 15, 2004

**cc:** Leisenring, Bielstein, Smith, Golden, Cassel, Project Team, Mahoney, Swift, Polley, Sutay, Gabriele, Petrone, Thompson, FASB Intranet

Topic: Liabilities and Equity: decision regarding the Reassessed Expected Outcomes approach

Basis for Discussion: Memorandums of May 13, 2004, and May 25, 2004

Length of Discussion: 9:00 a.m. to 10:50 a.m.

Attendance:

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

Board members absent: None

Staff in charge of topic: Bullen and Richards

Other staff at Board table: Arbuckle, Belot, Bielstein, and Lott

Outside participants: None

### **Summary of Decisions Reached:**

The Board decided that the proposed Reassessed Expected Outcomes (REO) approach for classification, unit of account, measurement, and EPS should:

- a. Be considered as a possible method for bifurcating compound financial instruments
- b. Not be considered for classification and measurement of simple instruments
- c. Be considered as an approach for determining earnings per share (EPS) for all financial instruments.

The Board also decided to retain the ownership relationship approach for classification of simple instruments and, at future meetings, to revisit whether the liquidity test should apply for financial instruments that establish an ownership relationship.

### **Objective of the Meeting:**

The objective of the meeting was to reach a decision regarding whether and to what extent to base further work in this project on the REO approach. That objective was accomplished.

### **Matters Discussed and Decisions Reached:**

Ms. Richards explained that the REO approach is an approach for determining classification, unit of account, measurement, and EPS for all financial instruments involving an issuer's shares. She then presented three alternatives for applying the REO approach for purposes of the liabilities and equity project. The first alternative would be to base further work in the project on the REO approach (or a modified form of the REO approach). The second alternative would revert to the project plan before the staff had begun to research the REO approach and consider REO as one of the possible bifurcation methods. The third alternative would be to not pursue REO any further. Ms. Richards summarized several implications of applying the REO approach that had been discussed at previous meetings. Mr. Bullen explained that the REO approach would require changes to the definitions of liabilities and assets, but noted that the Board had already decided that those definitions needed to be changed and that the changes would apply only for financial instruments involving an issuer's equity shares. Ms. Richards stated that the staff recommended

the first alternative and noted the staff's reservations of placing restrictions on that alternative. The staff said its main reservations were that applying the REO approach only to compound instruments would be problematic because of (a) the linkage issues, (b) defining the population of compound instruments that would be subject to REO, and (c) the existence of differing accounting methods for compound and simple instruments.

Mr. Trott expressed concern that the REO approach would significantly impact the definitions of assets, liabilities, and equity. He questioned whether those changes would be appropriate for all transactions and not just transactions involving equity-linked financial instruments. Mr. Trott therefore supported the use of the REO approach as a possible means of bifurcation for compound instruments, but not as a means to analyze all financial instruments nor as a means of determining definitions within the conceptual framework. He also questioned whether EPS issues should be a part of the liabilities and equity project. Mr. Batavick also supported using the REO approach as a bifurcation method and added that it may be employed for other uses such as disclosure.

After articulating the strengths and weaknesses of the REO approach, Ms. Seidman expressed concern regarding the necessary changes to the definitions of assets and liabilities that would arise from the REO approach. Ms. Seidman did not favor basing further work on the REO approach for all financial instruments primarily because she did not favor the gross accounting treatment of the debits and credits for simple options. Additionally, Ms. Seidman stated her preference that all transactions on an issuer's shares be presented net in equity. She also noted her reluctance of applying REO only as a bifurcation method as she would prefer its use not be limited to only a particular group of equity derivatives.

Mr. Herz expressed concern about what implications the REO approach would have on accounting for transactions that do not involve financial instruments. Mr. Herz agreed with Ms. Seidman that he did not favor the gross accounting treatment under REO for simple options; however, he would support net equity treatment for options conveying an ownership relationship. For other options, he would support net liability or asset accounting treatment. Additionally, Mr. Herz noted that he did not agree with liability classification under REO for perpetual preferred

stock. He supported using the REO approach as a bifurcation method while recognizing this would create linkage problems and other issues that the Board would need to address.

Mr. Schieneman also was not in favor of basing further work on the REO approach for all financial instruments due to the accounting results it produces for certain instruments and because it does not value financial instruments at fair value. He expressed his preference for a narrow definition of equity and not bifurcating compound instruments, but said he would prefer to keep REO as a bifurcation approach if the Board does decide to bifurcate compound financial instruments. He also noted that the REO approach might have disclosure benefits.

Mr. Crooch supported basing further work on the REO approach. He observed that the REO approach has issues that would need to be overcome, but that it was superior to the other approaches the Board has been considering, such as the fundamental components approach. He noted that restricting the application of REO to compound instruments would create accounting inconsistencies.

Ms. Schipper explained that the REO approach was created for a specific type of investor and purpose and questioned whether the approach was appropriate for issuers of financial instruments and for classification purposes. She questioned whether the Board would want the principles of the REO approach to apply to nonfinancial arrangements as well as financial arrangements. Ms. Schipper also noted that for the fair value project the Board decided to put the dispersion of possible outcomes resulting from a transaction in measurement and not in recognition of the transaction. She observed that the REO approach takes the dispersion of outcomes and puts it in classification. She also expressed concern that the REO approach abandons the liquidity notion that liabilities arise from an obligation to transfer assets. Ms. Schipper noted that the REO approach does have its advantages and supported continued exploration of the REO approach for all financial instruments, but noted that modifications would need to be made to the approach.

After emphasizing that his views were his own and not necessarily those of the IASB, Mr. Leisenring commented that his first thoughts regarding the REO approach were that it represents

the search for a concept that fits an attractive set of answers, and that the consequences of using the model are unacceptable. Mr. Leisenring objected to the continued use of the model questioning whether the principles underlying the REO approach would be suitable for all transactions, not just those involving an ownership relationship. He specifically was concerned about recognition of an asset or liability based on probabilistic outcomes that ignores the issuer's control or existence of an obligation and the lack of a liquidity requirement for classification purposes. Mr. Leisenring noted that there are questions regarding the technical merits of the model. Mr. Leisenring also was concerned that the REO approach would act as an impediment to measuring financial instruments at fair value.

The Board [RHH, GJB, GSS, EWT] decided that the proposed REO approach for classification, unit of account, measurement, and EPS should:

- a. Be considered as a possible method for bifurcating compound financial instruments
- b. Not be considered for classification and measurement of simple instruments
- c. Be considered as an approach for determining EPS for all financial instruments.

The Board also decided to retain the ownership relationship approach for classification of simple instruments and, at future meetings, to revisit whether the liquidity test should apply for financial instruments that establish an ownership relationship.

**Follow-Up Items:**

None.

**General Announcements:**

None.