

MINUTES



To: Board Members

From: Liabilities and Equity—Cornett (ext. 442)

Subject: Minutes of the June 27, 2007 Board Meeting: Liabilities and Equity—Economic Compulsion **Date:** June 27, 2007

cc: Leisenring, Bielstein, Smith, Golden, MacDonald, Bossio, Polley, Financial Instruments Team, Liabilities and Equity Team, Gabriele, Carney, Allen, Sutay, Glotzer, Gavin Francis (IASB), Michael Thomas (IASB), Caron Hughes (IASB), FASB Intranet

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Topics: Liabilities and Equity: Economic Compulsion

Basis for Discussion: Board Memorandum No. 59

Length of Discussion: 10:15 to 11:00 a.m.

Attendance:

Board members present: FASB:Batavick, Crooch, Linsmeier, Seidman, Trott, and Young

IASB: Leisenring

Board members absent: Herz

Staff in charge of topic: Carnrick

Other staff at Board table: Bielstein, Lott and Cornett

Summary of Decisions Reached:

The Board modified the classification principle under the ownership approach. The Board decided that only instruments that meet the definition of a direct ownership instrument should be classified as equity. All perpetual instruments that do not meet the definition of a direct ownership instrument should be classified as liabilities.

Objective of Meeting:

The objective of the meeting was for the Board to consider what effect, if any, economic compulsion should have on the classification of instruments under the ownership approach.

Matters Discussed and Decisions Reached:

1. Ms. Carnrick stated that the purpose of the meeting was to address the issue of economic compulsion under the ownership approach. She described economic compulsion as any situation in which an entity is compelled to settle (although there is no explicit or implicit settlement requirement) because the economic consequences of not settling are so onerous. She noted that a commonly cited example is increasing-rate preferred stock.
2. Ms. Carnrick noted that most issues of economic compulsion arise under the Board's current ownership approach because perpetual preferred stock is classified as equity. Entities wishing to issue debt disguised as equity for accounting purposes often issue preferred shares with a fixed dividend return. She further noted classifying perpetual instruments that do not meet the definition of a direct ownership instrument as liabilities would resolve economic compulsion issues. Ms. Carnrick stated that this alternative would simplify the application of the ownership approach from a classification standpoint and may alleviate many structuring opportunities. However, she noted that the staff was concerned that measurement requirements for perpetual instruments may add complexity

to the approach. Ms. Carnrick asked the Board whether it wished to reconsider the classification of perpetual instruments as equity under the ownership approach.

3. Messrs. Crooch and Trott believe all perpetual instruments should be classified as equity regardless of meeting the definition of a direct ownership instrument. Mr. Trott noted that classifying perpetual instruments as liabilities would strain the definition of a liability, because there is no present obligation inherent in a perpetual instrument. Mr. Linsmeier further noted that the ownership approach has implications for the conceptual framework, and that the Board would need to reconsider whether a liability should continue to be defined in the conceptual framework with equity being determined as all right-hand-side items on the balance sheet not classified as liabilities or whether equity needs to be defined in the framework and liabilities be determined as non-equity items on the right-hand-side of the balance sheet. In addition, if equity is defined and liabilities become the remainder, standard setters will need to develop guidance within either the conceptual framework or within GAAP standards to ensure that liabilities for which an entity has an obligation to pay are limited to those for which the entity has a present (not future) obligation.

4. Five Board members (Linsmeier, Seidman, Young, Batavick and Herz) supported modifying the classification principle under the ownership approach, so that only direct ownership instruments would be classified as equity. Mr. Linsmeier noted that he supports a definition of a direct ownership that identifies instruments that have the most residual claim on the net assets of an enterprise. He believes perpetual instruments that do not meet the definition of a direct ownership instrument should be excluded from equity classification under the ownership approach because under the going concern basis of accounting holders of perpetual instruments that do not meet the definition of direct ownership instruments are typically not the most residual claimants on the net assets of the enterprise. .

5. Ms. Seidman noted that the ownership approach does not consider settlement when determining an instrument's classification, and therefore does not believe classifying all perpetual instruments as equity because they lack a settlement requirement is conceptually consistent. She believes the Board will receive more constructive feedback

if the approach is based on clear principles. She agrees that classifying instruments with no settlement requirements could create difficulties in defining other liabilities. She further noted that there is not a lot of traditional perpetual preferred stock currently in the marketplace.

6. Mr. Young agreed with Ms. Seidman that removing perpetual instruments that do not meet the definition of a direct ownership instrument from equity provides a more conceptually sound classification principle. He further noted that he believes 100 year bonds, which exist in the current marketplace, also put pressure on the definition of present obligations.

7. Mr. Batavick agreed with Ms. Seidman and Mr. Young and noted that there would be difficulties associated with the definition of a liability and the measurement of perpetual instruments classified as liabilities. Mr. Trott noted that Mr. Herz submitted a proxy stating he prefers to classify only direct ownership instruments as equity under the ownership approach.

8. Mr. Leisenring questioned whether loosening the definition of a liability might not create more problems than it solved by loosening the accounting for provisions and restructuring reserves by management in an attempt to manage earnings. Ms. Seidman noted that perpetual instruments were contractual arrangements, whereas typically restructuring charges were not.

9. Mr. Trott further noted that defining a direct ownership instruments as the most residual or the most subordinated interests was increasingly important given the decision made by the Board. Ms. Carnrick noted that the current ownership approach defined the direct ownership instrument as the most residual interest in the net assets of an enterprise. Mr. Trott questioned whether the definition should be reconsidered.

10. Mr. Leisenring noted that there was a difference between the terms *subordinated* and *residual*. Describing an instrument as having the most residual claim implies that the holder of the instrument enjoys upside potential, whereas describing an instrument as the most subordinated claim does not necessarily contemplate upside potential beyond a stated principal amount.

11. Mr. Trott encouraged the staff to conduct research on the measurement of certain perpetual instruments as liabilities, including whether fair value was an appropriate measurement attribute, and how to arrive at a value for cumulative and noncumulative instruments.

12. Ms. Bielstein stated that the Board should endeavor to release the Preliminary Views document by September 30, 2007. She noted that the staff should attempt to accomplish as much as possible prior to that time.

Follow-Up Items:

13. The Board directed the staff to proceed to a draft of the Preliminary Views document. While drafting, the Board directed the staff to consider the measurement attributes of perpetual instruments classified as liabilities and the specific wording of the definition of a direct ownership instrument.

General Announcements:

None.