



# Financial Accounting Standards Board

## MINUTES



## Financial Accounting Standards Board

**To:** Board Members

**From:** Liabilities and Equity—Arveseth (ext. 384)

**Subject:** Minutes of the August 16, 2006 Board Meeting: Liabilities and Equity—**Date:** August 22, 2006  
Display under the Ownership Approach

**cc:** Leisenring, Bielstein, Smith, Golden, Petrone, Bossio, Beswick, Jacobs, 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: Recognition and Display for Gains and Losses Occurring Under the Ownership Approach

**Basis for Discussion:** Board Memorandum No. 47

**Length of Discussion:** 9:00 a.m. to 9:20 a.m.

**Attendance:**

Board members present: FASB: Herz, Batavick, Crooch, Linsmeier, Seidman, and Trott  
IASB: Leisenring

Board members absent: Young

Staff in charge of topic: Carnrick and Richards

Other staff at Board table: Arveseth, Bielstein, Detling, Lott, and Stevens

Outside participants: None

### Summary of Decisions Reached:

At the June 2006 education sessions, the Board discussed two alternatives for describing the narrow view of equity approach. The Board directed the staff to further develop one of those alternatives—the ownership approach—for future comparison to the ownership-settlement approach and the reassessed expected outcomes approach. The ownership approach modifies the ownership-settlement approach by classifying all indirect ownership instruments as liabilities or assets. Other aspects of the ownership-settlement approach are retained.

At this Board meeting, the Board discussed further details of the ownership approach including the financial statement location and display for gains and losses arising from remeasurement of equity derivative instruments. The Board made the following decisions:

1. Under the ownership approach, all fair value changes in equity derivative instruments (and any other instruments that are measured at fair value) should be recognized in net income. Equity derivative instruments include those that are freestanding or that are embedded (for example, convertible debt is considered an equity derivative instrument for this purpose).
2. Although the Board believes display is important under the ownership approach, presentation issues arising from measuring instruments at fair value will not be addressed at this stage of the project. The Board will address those issues in the Exposure Draft process by considering (a) input from other projects addressing financial statement display and (b) constituent input from the proposed forthcoming Preliminary Views on liabilities and equity.

### Objective of Meeting:

The objectives of the meeting were to determine (1) the appropriate method for recognizing equity derivative instrument gains and losses occurring under the ownership approach and (2) whether and when to address the financial statement display for those gains and losses. The objectives of the meeting were met.

## Matters Discussed and Decisions Reached:

### **PART I: RECOGNITION**

1. Ms. Richards opened the meeting by stating that the objective of the meeting is to discuss the final details of the ownership approach—one of the approaches that the Board will compare to the ownership-settlement and reassessed expected outcomes (REO) approaches. Ms. Richards noted that the next step will be to further develop the REO approach before the comparisons are made.
2. Ms. Richards noted that at two education sessions held in June 2006, the Board discussed two alternatives for describing the narrow view of equity approach. She explained that Alternative Approach 1 focuses on the rights and obligations embedded in financial instruments and not on the expected outcomes. That approach classifies shares as equity and componentizes any share/nonequity hybrid (for example, stock puttable at a fixed price would be separated into a derivative liability and a share). Ms. Richards further explained that Alternative Approach 2 (the ownership approach) classifies all indirect ownership instruments—those indexed to and settled with shares—as liabilities or assets (for example, stock puttable at a fixed price would be a liability in its entirety measured at fair value). Other aspects of the ownership-settlement approach are retained under the ownership approach; however, some aspects would not be as heavily relied upon, for example, linkage. Ms. Richards highlighted that the ownership approach simplifies the ownership-settlement approach and is based on a theory that any instrument that could potentially dilute existing shareholders, such as equity derivatives, should be a liability or an asset. Ms. Richards noted that, at the education sessions, the Board directed the staff to further develop the ownership approach because it is less complex than Alternative Approach 1 and results in classification as expected under a narrow view of equity.
3. Ms. Richards noted that the first issue under the ownership approach is related to the financial statement location for recognizing gains and losses arising from remeasuring equity derivative instruments. She explained that this issue arises under the ownership approach as many instruments are subsequently remeasured at fair value, including all instruments with varying payoffs at settlement and instruments indexed to share prices.

4. Ms. Richards stated that the staff identified four methods for recognizing gains and losses that occur from remeasuring equity derivative instruments at fair value (equity derivative instruments include both freestanding and embedded equity derivatives, for example, convertible debt is considered an equity derivative instrument for this purpose). Those four methods are:

- a. Recognize the gains and losses through net income (net income method)
- b. Recognize the gains and losses through OCI (OCI method)
- c. Recognize the gains and losses through both OCI and net income by recording a financing component through net income and an unpredictable component through OCI (OCI-interest method)
- d. Recognize the gains and losses permanently through an equity account (equity account method).

5. Ms. Richards stated that the staff recommends the net income method because that method is consistent with (a) the theory behind the ownership approach as well as the current conceptual framework, and (b) the objective of simplicity in explaining and applying the approach.

6. Ms. Richards noted that both OCI methods are complex in (a) describing the class of instruments that would be eligible for OCI treatment, (b) determining EPS calculations, and (c) applying the bifurcation and hedging provisions of Statement 133. Additionally, accounting arbitrage possibilities would arise under those methods. Ms. Richards also noted that the equity account method has similar complexities and that the method would not be consistent with how other changes in liabilities and assets are recognized.

7. Ms. Richards asked the Board members if they agreed with the staff recommendation and requested that the Board members provide a basis for their decision. All Board members agreed with the staff recommendation for the reasons described in the above paragraphs five and six.

8. Ms. Seidman stated that she likely will not support the ownership approach as the appropriate method for classifying liabilities and equity. However, in the context of developing the ownership approach for comparison with other approaches, she agreed that the net income method was appropriate as reasoned by the staff.

9. Mr. Linsmeier noted that, under the ownership approach, owners are defined as investors in the direct ownership or perpetual financial instruments of the reporting entity. He stated that any nonowner distributions of or claims to the reporting entity's net resources are not resources available to the owners. Therefore, those distributions or claims, including changes in the fair value of equity derivative instruments, should be deducted from net income in accordance with the net income method.

## **PART II: DISPLAY**

10. Ms. Carnrick stated that the second issue for the Board's consideration is whether to require separate display on both the income statement and balance sheet for instruments that are classified as liabilities and assets and measured at fair value. Ms. Carnrick suggested that the Board may want to consider separately displaying instruments that are measured at fair value and their related gains and losses to provide users of the financial statements with useful information. She stated that the staff has identified four display alternatives (described next).

11. Ms. Carnrick explained that the first alternative requires separate display on the balance sheet and income statement for all instruments measured at fair value. She noted that under the ownership approach all instruments with varying payoffs are measured at fair value.

12. The second alternative, Ms. Carnrick explained, requires separate display on the balance sheet and income statement for all equity derivative instruments measured at fair value. She noted that this alternative is more complex than the first, because the issuer would have to determine if an instrument meets the definition of an equity derivative instrument, and the Board would have to determine what should be included in that category. Examples of instruments that may be separately displayed include options and forwards to issue or repurchase shares and convertible debt for fixed shares.

13. Ms. Carnrick continued with the third alternative, explaining that the Board may also choose to separately display on the balance sheet and income statement only certain equity derivatives that are measured at fair value. For example, the display requirements could be limited to positively correlated equity derivatives such as a stock option. Ms. Carnrick stated that the staff believes that this alternative adds a significant amount of complexity to the

approach, and is uncertain whether the information would be useful since many equity derivatives and other financings are related.

14. Ms. Carnrick stated that the staff recommends the fourth and final alternative, which is not to address any separate display issues on the income statement or within the asset and liabilities section of the balance sheet at this Preliminary Views stage of the project. She noted that the Board currently has other projects on its agenda that are addressing similar issues. The staff believes the Board should progress in those projects first and address any necessary display requirements in the Exposure Draft stage of the project.

15. Ms. Carnrick clarified that the ownership approach would retain from the ownership-settlement approach the requirements for separate display of equity instruments that may be settled with cash or other assets.

16. She asked the Board members if they agreed with the staff recommendation and requested that the Board members provide a basis for their decision.

17. All Board members agreed with the staff recommendation. The Board noted that display is an important factor in describing the ownership approach. However, they do not believe that display issues should be addressed at this stage of the project. Therefore, the proposed forthcoming Preliminary Views should mention that there are display issues under the ownership approach and that the Board will address those issues in the Exposure Draft based on input from constituents and related agenda projects.

Follow-up Items:

None

General Announcements:

None