

MINUTES



Financial Accounting
Standards Board

To: Board Members

From: Liabilities and Equity—Bellantoni (ext. 445)

Subject: Minutes of the October 5, 2005 Board Meeting: Liabilities and Equity—Separation Criteria and Obligation First Approach **Date:** October 14, 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

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Topic: Liabilities and Equity: Separation Criteria and Obligation First Approach

Basis for Discussion: Board memorandum No. 32

Length of Discussion: 10:00 a.m. to 10:55 a.m.

Attendance:

Board members present: FASB: Herz, Batavick, Crooch, Schipper, Seidman, Young, and Trott (by phone)
IASB: Leisenring

Board members absent: None

Staff in charge of topic: Richards

Other staff at Board table: Bellantoni, Bergstrom, Carnrick, Lott, Thuener, and Bielstein

Outside participants: None

Summary of Decisions Reached:

The Board continued its discussion of the “ownership-settlement” approach to accounting for financial instruments with characteristics of equity, liability, or both. This meeting focused on how multiple-component instruments might be separated under that approach including, (1) the separation principles used to identify components and (2) the initial and subsequent measurement of those components.

The Board agreed on the following separation principles:

1. Instruments would be separated if they embody an obligation and have both equity and non-equity components involving either:
 - a. Two or more settlement alternatives or possibilities with differing counterparty payoffs at the settlement date.
 - b. At least one settlement alternative or possibility and at least one perpetual alternative or possibility with differing counterparty payoffs at the settlement or outcome date.
 - c. One settlement requirement with a counterparty payoff at settlement that is based on more than one market factor.
2. Applying those separation principles would produce the following results:
 - a. Only instruments with both equity and non-equity components would be separated. Instruments with more than one equity component would be classified as equity, and those with more than one non-equity component would be classified as liabilities or assets.
 - b. Instruments that do not embody an obligation would not be separated, for example, callable stock that is otherwise perpetual would be classified as equity in its entirety.
 - c. Instruments having interim settlements consisting of instruments that would be separated (for example, warrants on puttable stock) would not be separated until the interim

settlement occurs. Prior to any interim settlement, those instruments would be liabilities or assets in their entirety.

- d. Upon separation, there would be only two ultimate components—equity and non-equity; components would not be further subdivided (unless required by FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*).
- e. The fair value option for an instrument in its entirety would not be available in lieu of separation. However, the fair value option could be applied to the non-equity component. (This requirement is pending the Board's finalization of the fair value option and hybrid instruments projects.)

For instruments that would be separated under the above principles, the Board agreed:

- 1. To first identify and measure the obligation embodied in the debt component at its fair value and then allocate the remaining proceeds to equity.
- 2. That the following measurement requirements would apply under the obligation first approach:
 - a. Embedded issuance costs (if any) would be expensed before separation occurs.
 - b. The debt component that has been identified would be separated and measured at its fair value. If the debt component contains a stated settlement date and amount, present value techniques would be used to determine the component's fair value. At future meetings, the Board will further discuss how to apply present value techniques to a debt component that contains various put and call features (for example, puttable, callable convertible debt).
 - c. If the debt component's settlement date or amount is unknown, the debt component would be subjected to Statement 133 to determine whether the component is or has an embedded derivative that is measured at fair value or is accounted for under FASB Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others* (see requirements

2(g) and (h) of this summary). If so, the debt component (or a part of the debt component for embedded derivatives) would be accounted for under those provisions. If the component is not within the scope of Statement 133 or Interpretation 45, it would be measured at the amount that would be paid if settlement occurred at the reporting date in an orderly liquidation.

- d. If an instrument's debt outcome occurs (for example, the debt is put or called early) or the terms of an instrument are modified, requirement 2(b) or (c) would be reapplied. That is, the extinguishment proceeds (ignoring any issuance costs) would be reallocated by remeasuring the debt component at the discount rate in effect at that date for the remaining most distant stated maturity period. A gain or loss would be recognized through income for the difference between the old and new carrying amounts. Any remaining portion of the proceeds would be allocated to equity.
- e. If an instrument's equity outcome occurs (for example, conversion), no gain or loss would be recognized. For example, if puttable, callable convertible debt were converted into a fixed number of shares, then the carrying amount of the liability would become equity with no gain or loss recognized through income.
- f. However, if the conversion terms are modified resulting in the equity outcome (for example, changing the terms of an instrument to induce conversion), extinguishment accounting (requirement 2(d)) would be applied to compute any gain or loss before the carrying amount is recorded in equity.
- g. A debt component that is a guarantee or a derivative in its entirety would be accounted for under Interpretation 45 or Statement 133.
- h. Debt components that are separated but that are not derivatives in their entirety also would be first analyzed under Statement 133 to determine if there are any embedded derivatives that must be bifurcated before applying the measurement requirements in 2(b) or (c).

- i. All instruments are reevaluated at each reporting date to determine if they continue to meet the separation criteria. If not (for example, if a put option expires such that puttable stock becomes a perpetual instrument), the instruments would be accounted for as single-component instruments as of the date the change occurred. No gains or losses would be recognized through income for such reclassifications unless a debt extinguishment or modification occurs.

The Board directed the staff to continue development of the ownership-settlement approach for later comparison to other possible approaches to accounting for instruments in the scope of this project.

Objective of Meeting:

The objective of the meeting was to decide on the (a) identification of components using separation principles and (b) initial and subsequent measurement of those components under the obligation first approach. The objectives of the meeting were met.

Matters Discussed and Decisions Reached:

1. At this meeting, Ms. Richards proposed to the Board a possible accounting approach for multiple-component instruments. The objectives of that approach are to identify components based on the classification principles developed at previous meetings (the ownership-settlement approach) and to separate and measure the obligation embodied in the liability component at its fair value (the obligation first approach). She explained that, at future meetings, the overall accounting approach will be compared to other possible accounting approaches for financial instruments with liability and equity characteristics.
2. Ms. Richards first described the proposed principles for identifying and separating equity and non-equity components as follows:
 - a. Instruments would be separated if they embody an obligation and have both equity and non-equity components involving either:
 - (1) Two or more settlement alternatives or possibilities with differing counterparty payoffs at the settlement date.

- (2) At least one settlement alternative or possibility and at least one perpetual alternative or possibility with differing counterparty payoffs at the settlement or outcome date.
 - (3) One settlement requirement with a counterparty payoff at settlement that is based on more than one market factor.
3. Ms. Richards further explained that the separation principles were further developed and revised from the Board's previous decisions at its June 29, 2005, meeting to be consistent with the obligation first approach. She noted that applying the separation principles would produce the following results:
 - a. Only instruments with both equity and non-equity components would be separated. Instruments with more than one equity component would be classified as equity, and those with more than one non-equity component would be classified as liabilities or assets.
 - b. Instruments that do not embody an obligation would not be separated, for example, callable stock that is otherwise perpetual would be classified as equity in its entirety.
 - c. Instruments having interim settlements consisting of instruments that would be separated (for example, warrants on puttable stock) would not be separated until the interim settlement occurs. Prior to any interim settlement, those instruments would be liabilities or assets in their entirety.
 - d. Upon separation, there would be only two ultimate components—equity and non-equity; components would not be further subdivided (unless required by Statement 133).
 - e. The fair value option for an instrument in its entirety would not be available in lieu of separation. However, the fair value option could be applied to the non-equity component. (This requirement is pending the Board's finalization of the fair value option and hybrid instruments projects.)
4. The Board unanimously agreed with the separation principles as revised. Ms. Seidman noted that the principles are consistent with both the ownership-settlement and obligation first approaches.
5. Next, Ms. Richards described application of the obligation first approach for components that are required to be separated. Ms. Richards further noted that this approach first measures the obligation embodied in the debt component at its fair value and then allocates the remaining

proceeds to equity. She outlined the staff's proposed initial and subsequent measurement requirements as follows:

- a. Embedded issuance costs (if any) would be expensed before separation occurs.
- b. Second, the debt component that has been identified would be separated and measured at its fair value. That amount would be determined by identifying the debt outcome that would require the largest sacrifice that can be demanded by the holder at the most distant settlement date discounted over the period to the latest possible contractual maturity date (the most distant settlement date) using a discount rate that reflects the market interest rate for instruments with similar put or call options and similar risks of nonpayment.
- c. If the most distant settlement date or largest amount is unknown (varies), the debt component would be subjected to Statement 133 to determine whether the component is or has an embedded derivative that is measured at fair value or is accounted for under Interpretation 45 (see requirements 5(g) and (h) of the minutes). If so, the debt component (or a part of the debt component for embedded derivatives) is accounted for under those provisions. If the component would not be within the scope of Statement 133 or Interpretation 45, it would be measured at the amount that would be paid if settlement occurred at the reporting date in an orderly liquidation.
- d. If an instrument's debt outcome occurs or the terms of an instrument are modified, requirement 5(b) or (c) would be reapplied. That is, the extinguishment proceeds (ignoring any issuance costs) would be reallocated by remeasuring the debt component at the discount rate in effect at that date for the remaining most distant maturity period. A gain or loss would be recognized through income for the difference between the old and new carrying amounts. Any remaining portion of the proceeds would be allocated to equity.
- e. If an instrument's equity outcome occurs (for example, conversion), no gain or loss would be recognized. For example, if puttable, callable convertible debt is converted into a fixed number of shares, then the carrying amount of the liability becomes equity with no gain or loss recognized through income.
- f. However, if the conversion terms are modified resulting in the equity outcome (for example, changing the terms of an instrument to induce conversion), extinguishment accounting (requirement 5(d)) would be applied to compute any gain or loss before the carrying amount is recorded in equity.
- g. A debt component that is a guarantee or a derivative in its entirety would be accounted for under Interpretation 45 or Statement 133.

8. Mr. Trott, Mr. Batavick, and Mr. Young supported the staff's proposed measurement requirements under the obligation first approach, including paragraph 5(b) as stated because they believe that it would be easier to implement than the alternative. Mr. Trott believes that many instruments on the market have puts and calls attached and determining the appropriate puttable, callable rate would be easier than determining an estimated maturity date. Mr. Trott believes that the alternative method is more complex and will require more accounting adjustments for subsequent events, which would not be representationally faithful in his view. Mr. Young suggested adding a test to determine if the stated maturity date would be substantive.
9. Ms. Schipper stated her belief that the method described in requirement 5(b) would not be simpler to explain and implement than the alternative method. She noted a concern of using a debt rate that aligns with the stated maturity date even though the debt is not expected to last until the stated maturity date. Ms. Schipper believes that, even though both methods incorporate puts and calls into the measurement, the two methods would appear to result in differing measurement amounts. She believes that the alternative method would result in the most representationally faithful liability reporting. She also noted that, under the alternative method for requirement 5(b), requirement 5(c) may be simplified. For example, if an estimated maturity date is used, the issue of determining the fair value for debt components with uncertain settlement dates may be simplified. The staff agreed and noted that requirement 5(c) will be reconsidered depending on the Board's future decision for requirement 5(b).
10. Ms. Seidman believes that the alternative is preferable for determining the fair value of a debt component for which certain cash flows are expected to occur; however, she noted that under the alternative method the expected cash flows would be affected by the entity's stock price (because the stock price would affect the determination of the put or call being exercised). Ms. Seidman believes that the alternative is not necessarily simpler than requirement 5(b), but that it would better reflect the initial fair value of the hypothetical debt component.

11. Mr. Herz believes requirement 5(b) as stated would be simpler to implement; however, he is uncertain whether the puttable, callable debt rate would provide a representationally faithful liability amount. He also noted that he is uncertain whether the two methods would result in differing amounts; and requested the staff provide additional information.
12. Mr. Leisenring noted that requirement 5(b) measures the fair value of a hypothetical instrument because it requires the entity to use the stated maturity date and a rate corresponding to the stated maturity time period; however, in practice the bonds trade at values that reflect the likelihood of being extinguished earlier than the stated maturity date due to puts and calls. Mr. Leisenring further noted that the perceived simplification of using an estimated maturity date in the alternative would be offset by subsequent reassessments due to changes in estimates. He explained that, requirement 5(b), the extinguishment of the instrument acts as a trigger for the reassessments. Under the alternative, many different factors could cause an entity to change its estimated maturity date, and as a result, the entity would have to make reassessments each reporting period until the instrument is extinguished.
13. Although agreeing with the proposed measurement requirements of the obligation first approach, all Board members unanimously agreed that they needed additional information before deciding how to fair value the debt component using present value techniques. Therefore, the Board directed the staff to further research both methods and present the results at a future Board meeting.

Follow-up Items:

14. The staff will further research the application of present value techniques for the debt component as directed by the Board. This issue will be discussed at a future meeting.

General Announcements:

None.