

MINUTES



**To:** Board Members

**From:** Liabilities and Equity—Detling (ext. 354)

**Subject:** Minutes of the November 15, 2006 Board Meeting: Liabilities and Equity—**Date:** November 21, 2006  
REO Follow-Up Issues

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

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**Topic:** Liabilities and Equity: Follow-Up Issues Related to the REO Approach

**Basis for Discussion:** Board Memorandum No. 50

**Length of Discussion:** 9:25 a.m. to 10:00 a.m.

**Attendance:**

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

Board members absent: None

Staff in charge of topic: Carnrick

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

Outside participants: None

### Summary of Decisions Reached:

The Board finalized details for describing an accounting approach for instruments with equity and liability or asset characteristics that it refers to as the reassessed expected outcomes (REO) approach. Previously, the Board developed two other possible approaches to distinguish liabilities from equity and assets—the ownership-settlement and ownership (narrower view of equity) approaches.

The REO approach separately reports components of instruments with equity and nonequity characteristics. This is accomplished through probabilistic measurement methods utilizing contingent claims modeling techniques to determine probabilities of equity or nonequity payoffs at the expected outcome date.

At its September and November 2006 education sessions, the Board discussed two possible measurement methods for describing the REO approach—the transaction price and fair value methods. The former forces the sum of the separated components to equal the transaction price plus or minus interest, and the latter results in the sum of the components equaling the fair value of the entire instrument. Under the fair value method, each component would reflect the current probability of that payoff's occurrence, including the expected timing and amount of the payoff. Any changes in the instrument's total fair value would be recognized as a gain or loss in net income. Under the transaction price method, the sum of the amounts recorded for the separated components would be forced to equal the transaction price, which results in recognition of components that are not measured at their fair values. Thus, an instrument's total change in fair value would not be recognized.

At this meeting, the Board made the following decisions related to the REO approach:

1. REO should be described using the fair value method, which requires remeasurement at fair value for separated components. The Preliminary Views also will describe REO under the transaction price method and explain why the fair value method is preferred by Board members.

2. Under both measurement methods for the REO approach, the equity section of the balance sheet should be separated into the following three categories: (a) potentially dilutive equity (which represents equity components separated and remeasured at their fair values within net income), (b) ownership instruments that are settled with assets (which are remeasured at their settlement values with changes recorded in other equity accounts), and (c) common shares (which are not remeasured).
3. Although Board members believe the display of gains and losses under the fair value method REO approach is important, this issue will not be addressed at this stage of the project. The Board will address display 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.
4. Interest expense under the transaction price method of REO would be calculated using an average balance of the nonequity component over the reporting period (note that this decision applies only for descriptive purposes—the Board rejected using the transaction price method of the REO approach).

At a future meeting, the Board will compare all three approaches to tentatively choose its preferred approach. The Board affirmed that all three approaches will be presented in the Board's upcoming Preliminary Views that it expects to publish in mid-2007. In addition, the Board decided that the Preliminary Views document would explain how the ownership-settlement and ownership approaches would change assuming all financial instruments were remeasured at fair value with changes recognized in income.

Objective of Meeting:

The objectives of the meeting were to determine, under the REO approach: (1) subsequent measurement of separated components, (2) display within the equity section, (3) certain interest expense issues, and how all three accounting approaches being considered by the Board will be described in the Preliminary Views. The objectives of the meeting were met.

### Matters Discussed and Decisions Reached:

1. Ms. Carnrick opened the meeting by stating that the primary objective was to discuss the final details of the REO approach. There are two ways of describing the REO approach—the transaction price method and the fair value method. The difference between the two methods is in the subsequent measurement of separated instruments. Under the transaction price method, equity and nonequity components are remeasured and reallocated such that the total value of the instrument always equals its transaction price. Interest expense or income is recorded for the nonequity component. Under the fair value method, each of the separated components of an instrument is remeasured at its fair value, and the sum of the components would approximate the fair value of the entire instrument. The changes in fair value of both the equity and the nonequity components are recorded in income.
2. Ms. Carnrick stated that the staff believes that REO should be described using the fair value method because it provides more relevant information than the transaction price method and is more compatible with the Board's long-term goals of measuring financial instruments at fair value. The staff believes the fair value method should be used even in the current mixed measurement attribute reporting model because of the relevance of the information provided by this method. She asked if Board members agreed that REO should be described in the Preliminary Views using the fair value method of measurement regardless of whether the Board decides to measure all financial instruments at fair value in the future.
3. Ms. Carnrick also asked the Board to confirm how the other two accounting approaches should be described in the Preliminary Views. She stated that the staff recommends that the ownership and the ownership-settlement approaches be described as previously decided by the Board. She further explained that the staff recommends that the document include a description of how those two approaches would change if the Board decides in the future that financial instruments should be measured at fair value.
4. Ms. Seidman stated that the Preliminary Views should provide descriptions and analyses of the three approaches using consistent assumptions about the state of the reporting model.

For example, one approach should not assume the current mixed measurement attribute reporting model, while another assumes an accounting model in which all financial instruments are measured at fair value. She believes this consistency will increase the understandability of the document.

5. Ms. Seidman further pointed out that the staff rejected the transaction price method of REO because it results in separated components being subsequently carried at amounts that do not reflect their fair value. She noted that, similar to the REO transaction price method, under the ownership-settlement and ownership approaches, the sum of the components does not equal the fair value of the total instrument. The staff believes that the REO approach fundamentally differs from the other approaches in the information presented. The fundamental theory behind the REO approach is to provide information about the current probability of an equity or nonequity (or both) outcome. The only way to obtain that information is to measure both components at fair value. Under REO, holders of contracts that have equity-like returns are not considered owners even though they are classified within equity. Therefore, potentially dilutive equity instruments are remeasured through income, unlike ownership instruments.

6. The ownership approach is similar to REO in that holders of contracts with equity-like returns are considered potentially dilutive to existing shareholders. However, the fundamental difference under the ownership approach is that instruments with equity-like returns are considered liabilities and assets and, therefore, are not separated from their host contracts. Therefore, the main difference between the REO and ownership approaches is in the degree of information that is presented to users. In contrast to those two approaches, the theory behind the ownership-settlement approach is to portray information about an entity's potential maximum nonequity obligation, so the focus is on providing that measurement.

7. Based on the theory underlying REO, Ms. Seidman agreed with the staff that the REO approach should be depicted using a fair value method regardless of what the Board decides for fair valuing other financial instruments. However, she believes that the Preliminary Views should describe how all approaches would differ if the Board decides in the future to fair value all financial instruments. She believes this is especially important under the ownership-settlement approach so that constituents understand how to measure the nonequity component.

8. Mr. Trott believes that REO should be described using the fair value method. He agreed with the staff that there is a fundamental difference between REO and the other approaches. REO results in a remeasurement of equity-like instruments through income to display probability-based information, while the other approaches do not remeasure any equity classified instruments because those instruments are considered ownership instruments.

9. Mr. Herz stated that, under the fair value method REO approach, remeasuring certain equity components results in recognizing gains and losses based on changing share prices. He believes that this accounting treatment suggests that those instruments are not truly equity, and in fact, the REO approach would be a narrower view of equity. He agreed with the staff that REO under the fair value method produces the same results as the ownership approach, but that the information would be presented differently. Mr. Herz, therefore, agreed that REO should be described using the fair value method.

10. Mr. Linsmeier agreed that the fair value method of REO is a very narrow view of equity. He further stated that REO is narrower in its view of equity than the ownership approach because perpetual preferred stock with a fixed return would be a liability. Staff members explained that they had attempted to develop an alternative for REO that would not result in the equity components being remeasured through earnings, but were unable to do so. Mr. Stevens explained that, under REO, remeasurement of equity must be recognized through earnings to make sense. For example, if the liability component of convertible debt would be remeasured at fair value, but the equity component would not be remeasured that way, an issuer would recognize gains if its stock price increases. This would not make economic sense because the issuer would be giving additional consideration to the holder under a conversion. Additionally and in response to Mr. Linsmeier's comment about perpetual preferred stock, the staff noted that the Board may revisit that issue at its next meeting (whether perpetual preferred stock should be equity under the ownership and ownership-settlement approaches).

11. Messrs. Batavick, Crooch, Herz, Linsmeier, and Young also agreed that the fair value method of REO is preferable to the transaction price method regardless of what the Board decides for fair valuing of other financial instruments. They agreed based on the reasons the staff described in paragraph 2. Messrs. Crooch and Linsmeier further stated that the

Preliminary Views needs to explain why the fair value method is better. They believe the Board's rationale can be best explained by comparing the relevance of the information portrayed under both the transaction price and fair value methods. The Board agreed that the Preliminary Views also needs to include a discussion of how all the approaches would work in a fair value or mixed attribute reporting model.

12. Ms. Carnrick stated that the second issue is related to display. The staff recommends that the equity section of the balance sheet be separated based on the three types of equity instruments that are recorded in REO—potentially dilutive equity, ownership instruments that are settled with assets, and common shares. The staff also recommends that ownership instruments that are settled with assets, such as stock redeemable at fair value, be measured at their current settlement values with changes recorded through equity accounts. This treatment is consistent with the ownership and ownership-settlement approaches.

13. The Board agreed that direct ownership instruments potentially settled with assets should be recorded at their settlement values for the same reason as decided under the other approaches. The Board also agreed that the equity section of the balance sheet should be separated into the three categories recommended by the staff since different measurement methods would be used in those sections.

14. Ms. Carnrick then stated that since the Board decided to describe REO using the fair value method, issues related to display of the gains and losses on the income statement arise. For example, should gains and losses that are recorded through income be disaggregated into components representing interest expense and changes in share prices? The staff recognizes that display on the income statement is important under REO but believes that presentation issues arising from measuring instruments at fair value would be better addressed in the Exposure Draft on liabilities and equity (which is expected to be issued following the Preliminary Views), by considering (a) the Board's decisions made in other projects addressing financial statement display and (b) constituent input on the Preliminary Views. This recommendation is consistent with the Board's decision on presentation in the income statement under the ownership approach.

15. The Board unanimously agreed with the staff recommendation. Mr. Herz suggested that it will be difficult for users to evaluate the approaches without explaining the impact and display of each approach on the income statement. Mr. Linsmeier agreed that the income statement effect and display of each approach is important. He stated that the Preliminary Views should state that the display and income statement effects are being explored in the financial statement presentation project and should also provide a summary of what is being considered in that project.

16. Ms. Carnrick stated that the last issue relates to the calculation of interest expense under the transaction price method. Even though the transaction price method is not preferred by the Board, this issue must be addressed to explain it in the Preliminary Views. Ms. Carnrick explained that the staff does not believe that calculating interest expense using the beginning balance accurately reflects the costs associated with carrying the nonequity amount over a period.

17. Ms. Carnrick then stated that the Board has another project on its agenda that is performing research on the presentation of interest expense and its calculation. She said that the staff believes that the liabilities and equity project should only provide a general description of what interest expense or income should represent. The staff recommends that reporting entities should be required to calculate interest expense or income that appropriately reflects the costs associated with carrying the nonequity amount during the period. She further explained that this may result in an entity using an average balance or some other method depending on the complexity of an entity's model. The method of calculation should be applied consistently over the life of the instrument. The Board unanimously agreed with the staff recommendation for the reasons described. Mr. Herz expressed a concern that using the term *appropriate* may not be the best way for the staff to describe the calculation of interest expense since differing views might exist about what is truly *appropriate*. The staff confirmed that it will address this issue in drafting.

Follow-up Items:

None.

General Announcements:

None.