MINUTES

Financial Accounting Standards Board

To:	Board Members
From:	Financial Instruments: Liabilities and Equity Team (Arbuckle, ext. 275; Belot, ext. 363)
Subject:	Minutes of the February 18, 2004 Liabilities and Equity Board Meeting
Date:	March 24, 2004
cc:	Leisenring, Bielstein, Smith, Golden, Cassel, Project Team, Mahoney, Swift, Polley, Sutay, Gabriele, Petrone, Thompson, FASB Intranet

Topic:	Liabilities and Equity: Conceptual Language, Hierarchy, and Remaining Simple Instrument Issues
Basis for Discussion:	Memorandum of February 6, 2004
Length of Discussion:	10:45 a.m. to 12:10 a.m.
Attendance:	
Board members present:	Herz, Batavick, Crooch, Schieneman, Schipper, Seidman (by phone), and Trott
Board members absent:	None
Staff in charge of topic:	Belot, Bullen (by phone), and Richards
Other staff at Board table:	Arbuckle, T. Johnson
Outside participants:	None

Summary of Decisions Reached:

The Board discussed how to express the distinction between equity and liabilities and assets in conceptual, definitional terms and whether a hierarchy of criteria is needed. The Board also discussed the following remaining issues involving arguably simple instruments that were introduced at previous meetings, but that have not been resolved yet:

a. Determining whether an obligation exists
b. Mandatorily redeemable share issues
c. Certain unconditional rights to receive a variable number of shares
d. "Shares" that include or are tied to unconditional rights to receive assets.

The Board decided that:

1. The definitions of liabilities and assets in FASB Concepts Statement No. 6, *Elements of Financial Instruments*, will be amended to include obligations to issue and rights to issue or redeem equity instruments if those obligations or rights do not convey an ownership relationship. The Board will consider further changes to those definitions at a future meeting after the liabilities and equity project team explores those possible changes and the resulting implications for that and other projects.

2. A decision flow diagram will be included in the proposed Statement to illustrate the hierarchy of criteria for an issuer's classification of instruments with characteristics of equity and of liabilities or assets.

3. For purposes of this project, an obligation is a liability if enforceable at law, including enforceability construed under the doctrine of promissory estoppel. However, non-substantive features should be disregarded in making assessments about enforceability and the existence of an obligation.

4. An obligation is unconditional if the obligating event is certain to occur even if the timing is uncertain.

5. Shares required to be redeemed at fair value, possibly by issuance of a variable number of the parent entity's shares at the issuer's discretion, are analyzed as simple instruments embodying an unconditional obligation that are classified as equity if they convey an ownership interest to the counterparty and if the discretion to settle in shares is substantive. The Board will consider at a future meeting whether that principle applies to other instruments under which the issuer has the discretion to settle by issuing shares instead of transferring assets.

6. Certain rights to receive a variable number of shares, such as a right to receive a variable number of shares based on a fixed monetary amount known at inception, are simple instruments to be classified as assets.

7. Unconditional rights to receive assets that are included in or are tied to “shares” under a contract that is unexecuted entirely should be netted against those shares in equity (for example, stock subscriptions receivable for shares that have not been issued). Whether unconditional rights to receive assets that are included in or are tied to “shares” for which the contract has been executed partially (for example, a note received in exchange for shares that have been issued) should be recognized as an asset or netted against those shares in equity is to be considered at a future meeting addressing the unit of accounting.

The Board has concluded its discussions relating to the classification of simple instruments (with the exception of the follow-up issues identified in the above decisions). The Board will move forward to discuss complex instruments and the unit of accounting at its next meeting.

Matters Discussed and Decisions Reached:

Mr. Bullen introduced the staff’s draft revisions to Concepts Statement 6, specifically the definitions of liabilities and assets. He noted that the revisions require certain obligations to issue shares to be classified as liabilities and certain rights to receive shares to be classified as assets. Mr. Bullen asked Board members if they agreed with the proposed changes. He suggested that if the Board prefers making further revisions to the definitions, beyond the proposed revisions relating to shares issuances or receipts, those changes should be considered at a future meeting. He also asked the Board to consider a decision flow diagram that the staff created to help distinguish simple equity instruments from liabilities or assets.

Ms. Schipper agreed with the staff’s revisions to the definitions but recommended that the staff add a restrictive clause regarding ownership in the proposed definition of liabilities. She noted that the staff draft currently contains a footnote explaining that not all obligations to issue equity instruments result in liability classification, and the staff’s revision of paragraph 35 of Concepts Statement 6 does not reflect that restriction. All Board members agreed with the staff’s revisions and with Ms. Schipper’s recommendation.

Additionally, Mr. Trott believes that significant improvements to the definitions in Concepts Statement 6, beyond that of the staff’s revisions for share issuances or receipts can be made to achieve consistent application. He recommended that the staff consider revisions to the definitions and present them to the Board at a later date. Mr. Trott also stated that the decision diagram is helpful in determining the classification of simple financial instruments. He observed that the diagram begins with a liquidity question and addresses the ownership relationship second. Mr. Trott believes that the decision flow diagram illustrates a hierarchy regarding liquidity and ownership and could help constituents understand the guidance.

Ms. Seidman questioned whether the decision flow diagram addresses the accounting of financial instruments for issuers and investors both, or only for issuers. She expressed concern that the diagram currently might cause confusion if some investors believe it applies to their investments. Ms. Richards stated that the scope of the project and the diagram pertains to the entity that issued the financial instrument or may be required or entitled under the terms of a financial instrument to issue or receive its shares. Mr. Bullen stated that the staff could include in the diagram a clarification that the accounting applies only to the issuer of the shares or financial instrument and not to the investor. Mr. Bullen also suggested that the liabilities and equity project team work with the revenue recognition team, and potentially other projects, to create a proposed revision of the definitions and present it at a later date.

All Board members agreed that the definitions of liabilities and assets in Concepts Statement 6 should be amended to include obligations to issue and rights to issue or redeem equity instruments if those obligations or rights do not convey an ownership relationship. The Board will consider further changes to those definitions at a future meeting after the liabilities and equity project team explores those possible changes and the resulting implications for that and other projects. The Board also unanimously agreed to include a decision flow diagram in the Statement to illustrate the hierarchy of criteria for an issuer's classification of instruments with characteristics of equity and of liabilities or assets.

Ms. Belot introduced the issue of how to determine whether an obligation exists. She asked the Board to determine whether liabilities are limited to legal obligations and legally constructed obligations arising from promissory estoppel, or whether liabilities should be interpreted even more broadly to include constructive obligations that are not legally enforceable. She recommended that for the purposes of this project, the Board interpret obligations such that legal enforceability, or enforceability arising from promissory estoppel, creates an obligation that is a liability. In addition, she recommended that nonsubstantive features of contracts be disregarded in making assessments about enforceability and the existence of an obligation.

Some Board members [EWT, KAS, and GJB] agreed that, at the Concepts Statement level, liabilities include constructive obligations that are not legally enforceable. However, those

Board members proposed that the Concepts Statement notions would result in more operable accounting standards if liabilities are limited to legal obligations and legally constructed obligations arising from promissory estoppel. Mr. Herz expressed concern that an approach focusing on legal obligations and legally constructed obligations arising from promissory estoppel would preclude judgment of the substance over form of contracts and arrangements. The staff noted that disregarding nonsubstantive features in the analysis and not providing detailed guidance would incorporate a degree of judgment on the part of financial statement preparers. All Board members agreed that for purposes of this project, an obligation is a liability if enforceable at law, including enforceability construed under the doctrine of promissory estoppel. However, nonsubstantive features should be disregarded in making assessments about enforceability and the existence of an obligation. The Board noted that the staff should provide clarification of the language about nonsubstantive features.

Ms. Richards introduced several issues relating to mandatorily redeemable shares. The first issue was whether an obligation to transfer assets is unconditional if the timing of redemption is uncertain but the redemption event is certain to occur. Ms. Richards presented three approaches to this issue:

1. Statement 150 Approach—Unconditional obligation and entire amount is a liability
2. Conditional Obligation Approach—Part Equity, part (possibly small) liability
3. No Obligation Approach—Entire amount is equity.

Ms. Richards stated that the staff recommended the Statement 150 Approach for classification and reexamining this issue in future measurement and display discussions.

Mr. Schieneman did not agree with the staff's recommendation, noting that the Board has seen issues caused in the current standard by this classification, and he believes that the issue could be handled with disclosure. Mr. Schieneman said he does not favor bifurcation in general, but that he might consider it for these circumstances.

Mr. Batavick reluctantly supported the staff's recommendation because he would prefer to address this issue with measurement and display discussions. Ms. Seidman agreed with Mr. Batavick and noted that if shares are redeemable at a current fair value there are measurement and other issues to be addressed. Mr. Herz agreed with Ms. Seidman, noting that measurement issues would be difficult to address. The Board decided [6 members agreed; GSS disagreed] that an obligation is unconditional if the obligating event is certain to occur even if the timing is uncertain.

Ms. Richards then introduced the issue of how to analyze shares that should be redeemed at fair value, possibly by issuing a variable number of a parent entity’s shares. She stated that the shares are a simple instrument embodying an unconditional obligation that is classified as equity, because the counterparty’s payoff moves in the same direction as the issuer’s share price and the issuer has the discretion to settle in shares. She also noted that including a provision for disregarding nonsubstantive terms, such as a nonsubstantive share-settlement provision, would alleviate the concern that obligations to transfer assets would be misclassified as equity.

Some Board members [EWT, RHH, and LFS] expressed concern that the issue of instruments containing a choice of settlement is broader that the discussions relating to the current topic. Those Board members directed the staff to address that issue on a broader basis, taking into account the issues raised and guidance now provided in EITF Issue No. 00-19, “Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company’s Own Stock.” The Board voted [4 members agreed; GMC, GSS, and GJB disagreed] to follow the staff’s recommendation of analyzing shares required to be redeemed at fair value, possibly by issuance of a variable number of the parent entity’s shares at the issuer’s discretion, as simple instruments embodying an unconditional obligation that are classified as equity if they convey an ownership interest to the counterparty and if the discretion to settle in shares is substantive. The Board members that disagreed with the decision favored an approach similar to the IASB’s approach that specifies if any settlement alternative does not result in equity, the instrument cannot be classified as equity. The Board will consider at a future meeting the general principle of issuer discretion for all financial instruments under which either party can allow settling by issuing shares or transferring assets.

Ms. Richards introduced the issue of whether certain rights to receive a variable number of shares are simple instruments classified as assets. She recommended that those instruments, such as rights to receive a variable number of shares based on a fixed monetary amount known at inception, be classified as simple asset instruments because, similar to a note payable settled with a variable number of shares based on a fixed monetary amount known at inception, an ownership relationship is not established.

All Board members agreed with the staff's recommendation to classify certain rights to receive a variable number of shares as simple asset instruments if the ownership relationship test is not met. Ms. Seidman encouraged the staff to analyze FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, to find the precise terms to sufficiently limit the scope of that decision.

Finally, Mr. Bullen asked the Board to consider how "shares" that include or are tied to unconditional rights to receive assets should be accounted for (for example, a note receivable in exchange for shares or a stock subscription receivable). He recommended that the shares be recorded as equity and an asset should be recognized until the money is received. He also noted that another staff member thinks "shares" that include or are tied to rights to receive assets are equity, but whether they are shown at "grossed up" or net amounts should be decided at a future meeting.

Some Board members expressed concern about making a decision to account for both "shares" that have been delivered and "shares" that have yet to be delivered in the same way. All Board members agreed that unconditional rights to receive assets that are included in or are tied to "shares" under a contract that is unexecuted entirely should be netted against those shares in equity (for example, stock subscriptions receivable for shares that have not been issued). All Board members decided to consider at a future meeting whether unconditional rights to receive assets that are included in or are tied to "shares" for which the contract has been executed partially (for example, a note received in exchange for shares that have been issued) should be recognized as an asset or netted against those shares in equity.

Follow-Up Items:

None.

General Announcements:

None.