MINUTES

Financial Accounting Standards Board

To: Board Members

From: Liabilities and Equity Team

Subject: Minutes of April 2, 2003 Board Meeting **Date:** April 4, 2003

cc: Bielstein, Leisenring, Smith, Petrone, Swift, Polley, Project Team, Thompson, FASB Intranet (e-mail), Sutay, Gabriele

Topics:	Effect of Limited-Scope Statement on Embedded Derivatives
Basis for Discussion:	Staff memorandum dated March 24, 2003
Length of Discussion:	9:00 a.m. to 10:45 a.m.

Attendance:

Board members present:	Herz, Crooch, Foster, Schieneman, Schipper, Trott, and Wulff
Board members absent:	None
Staff in charge of topic:	Bullen
Other staff at Board table:	Bielstein, Martin, Nesta, B. Richards, and R. Richards
Outside participants:	None

Summary for ACTION ALERT:

The Board discussed how the classification requirements in the limited-scope Statement should be applied to instruments with embedded derivatives and the interaction between that Statement and related SEC guidance. The Board discussed the following four approaches for defining the scope of the final Statement:

- Apply the classification requirements to all embedded derivatives, requiring bifurcation.
- Apply the classification requirements only to freestanding instruments, with no new requirements to bifurcate embedded derivatives.

- Apply the classification requirements to freestanding instruments and to certain instruments with embedded derivatives, requiring, for example, bifurcation of derivatives embedded in minimal or unrelated hosts.
- Do not issue the limited-scope Statement (that is, recombine the project).

The Board decided to apply the classification requirements only to freestanding instruments, with no new requirements to bifurcate embedded derivatives. Additionally, the Board decided to prevent the provisions of the limited-scope Statement from being circumvented by the insertion of nonsubstantive or minimal features into financial instruments; the Board decided that any such features are to be disregarded in applying the classification provisions of the final Statement. [Five Board members agreed; EWT and JMF disagreed]

The Board also left unchanged the effective date of the limited-scope Statement. The final Statement will be effective immediately for all new contracts and for interim periods beginning after June 15, 2003, for existing contracts. For mandatorily redeemable shares of a nonpublic entity, the Statement will be effective for periods beginning after December 15, 2003. [All Board members agreed]

Matters Discussed and Decisions Reached:

Most of the Board's discussion focused on variations of approaches 2 and 2(a). The Board favored approach 2, with no new requirements for bifurcation. Additionally, to prevent circumvention of the objectives of the limited-scope Statement, the Board decided that nonsubstantive or minimal features in financial instruments are to be disregarded in applying the provisions of the proposed Statement. The Board chose that approach for the following reasons:

- It would not require bifurcation of embedded derivatives, thereby avoiding potentially confusing interaction with existing SEC guidance, potentially short-lived classification guidance for compound instruments that will be further deliberated in Phase 2, and possible operational difficulties.
- It is consistent with the Board's original intent for the limited-scope Statement.

Board members cited the following shortcomings of a modified approach 2:

- A modified approach 2 with anti-abuse language addressing only nonsubstantive or minimal features does not address situations where an instrument within the scope of the Statement is embedded in a substantive but unrelated host.
- The language intended to prevent abuse may result in unintended consequences.

The Board discussed two variations of approach 2, including the following:

1. Apply the classification requirements only to freestanding instruments and not to embedded derivatives, disregarding any nonsubstantive or minimal features included in financial instruments that would otherwise be within the scope of the Statement.
2. Apply the classification requirement only to freestanding instruments and not to embedded features. For instruments within the scope of the Statement, (a) disregard any nonsubstantive or minimal features that would avoid liability classification and (b) report an instrument that consists of (i) one or more embedded features that if freestanding would be within the scope of this Statement and (ii) a substantive, but unrelated, equity host as a liability, to be marked to market in its entirety.

The Board decided to adopt the first variation of approach 2 for the following reasons:

- The Board was concerned that it would not be representationally faithful to record an instrument within the scope of the Statement embedded in a substantive but unrelated equity host as a liability, marked to market, since a significant portion of that instrument would be equity, and the result would be marking an entity's own equity shares to market through earnings.
- Reporting such an instrument in its entirety at fair value would change the previously agreed upon measurement attribute for embedded physically settled forward purchase contracts.
- The Board did not want to preempt deliberations in Phase 2 of the liabilities and equity project.
- The term "equity host" is not well defined in practice.
- The first variation of approach 2 seems likely to result in fewer unintended consequences.

In deciding not to extend the effective date of the limited-scope Statement for existing contracts beyond its previous decision for interim periods beginning after June 15, 2003, the Board reasoned that, even if the Statement is not issued until late in May 2003 as projected, constituents would still have ample time to implement its provisions since its requirements affect only a relatively small number of instruments even at large, complex entities.

Follow-up Items:
None

General Announcements:
None