MINUTES

Financial Accounting Standards Board

To:	Board Members
From:	Strange (ext. 442)
Subject:	Minutes of 06/20/06 Registration Rights Agreements Board Meeting — **Date:** July 7, 2006
cc:	Bielstein, L. Smith, Leisenring, Golden, Wilkins, Jacobs, Lott, Stevens, Fanzini, Trench, MacDonald, Rhine, Vernuccio, FASB Intranet, Gabriele, Polley, Allen, Sutay, Carney, Attmore, Bean

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: Registration Rights Agreements: Agenda Decision, Scope, Recognition and Measurement, Disclosure, Transition, Effective Date and Length of Comment Period

Basis for Discussion: Board Meeting Memorandum and Attachments dated June 6, 2006

Length of Discussion: 8:30 AM to 9:30 AM

Attendance:

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

Board members absent: None

Staff in charge of topic: Thuener

Other staff at Board table: Jacobs, Stevens, Smith, and Strange

Outside participants: None

Summary of Decisions Reached:

At the June 20, 2006 meeting, the Board decided to add a project to its agenda to determine the accounting for registration rights agreements. The Board decided to:

1. Limit the scope of the proposed FSP EITF 00-19-b, "Accounting for Registration Payment Arrangements," to registration payment arrangements
2. Separately recognize and measure, for the issuer and holder, registration payment arrangements using a model consistent with the accrual of loss contingencies under FASB Statement No. 5, *Accounting for Contingencies*, regardless of legal form
3. Require disclosures similar to those required in paragraphs 13(a)–13(c) of FASB Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees*, *Including Indirect Guarantees of Indebtedness of Others*
4. Apply the proposed FSP using a limited retrospective approach for all existing arrangements and include examples of the application of such transition in the proposed FSP
5. Direct the staff to prepare a ballot draft of the proposed FSP with a comment period of 45 days. The proposed FSP would be effective in the first fiscal year after issuance of the final FSP.

Objective of Meeting:

The objective of the meeting was for the Board to discuss whether and how to address certain issues raised in EITF Issue No. 05-4, "The Effect of a Liquidated Damages Clause on a Freestanding Financial Instrument Subject to Issue No. 00-19." The objective of the meeting was met.

Matters Discussed and Decisions Reached:

1. Ms. Thuener opened the meeting by stating that the Board has been asked to address whether a registration rights agreement is a derivative. That issue arose during Task Force deliberations of Issue 05-4. In Issue 05-4, the Task Force broadly considered whether and how a registration rights agreement affects the classification of a related financial instrument as equity or as either an asset or a liability under EITF Issue No. 00-19, "Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock."

2. The Task Force did not reach a consensus on Issue 05-4. In its discussions, the Task Force considered whether a registration rights agreement is a derivative and how that determination affected the related issues in Issue 05-4. The staff suggested that the Board consider whether a registration rights agreement is a derivative before the Task Force holds further deliberations related to Issue 05-4.

Agenda Decision

3. Because the issues are pervasive, the arrangements are common, and there is significant diversity in practice, the Board unanimously decided to add a project to its agenda. This project will address the accounting for registration rights agreements, with the ultimate goal of issuing an FSP.

Separate Recognition

4. Four Board members supported separately recognizing registration rights agreements (for the reasons set forth by the staff) and excluding those agreements from the scope of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, (EWT, GJB, KAS, LFS) while one Board member (DMY) disagreed. The accepted approach would:

a. Limit the scope of the issue to registration rights agreements only; accounting for similar agreements could not be analogized
b. Result in consistent accounting regardless of the form in which the registration rights agreement is issued and the financial instrument to which it relates
c. Reflect the economics of the arrangement because payments can be made under the registration rights agreement without affecting how the financial instrument is settled.

5. Under this approach, no further issues in relation to Issue 05-4 will need to be discussed by the Task Force. Related financial instruments would be accounted for under the provisions of other applicable GAAP (including Issue 00-19) and the registration rights agreement would not affect the accounting under those pronouncements.

6. Board members supporting separate recognition observed that the implications of derivative accounting for registration rights agreements and similar arrangements led to complex and potentially inconsistent accounting, depending on both

a. Whether the registration rights agreement is issued as a separate legal agreement or included as part of a financial instrument, and
b. Whether the registration rights agreement was issued in conjunction with a derivative in its entirety (for example, a warrant), a hybrid instrument (for example, convertible debt), or other financial instruments (for example, debt or stock).

7. Specifically, Ms. Schipper stated that requiring separate recognition of registration payment arrangements would be less costly for preparers because it allows the preparer to avoid analyzing the arrangement under complex literature. Although she noted that any scope exception to Statement 133 is inherently undesirable, she stated that the simpler analysis persuaded her to support separate recognition.

8. Ms. Seidman, indicating her support for a separate model, clarified that she does not consider registration payment arrangements derivatives under the definition contained in Statement 133. Rather, she considers them penalty provisions consistent with those described in paragraph 57(c)(1) of Statement 133.

9. Mr. Young stated that he did not support separate recognition and measurement because registration rights are typical contract terms. He believes it would be costly for preparers to separate the arrangements.

Scope

10. The Board unanimously decided the scope of the proposed FSP will be limited to registration payment arrangements. Further, because of potential implications to commercial arrangements deemed to be similar to registration payment arrangements, the proposed FSP will specifically state that the guidance should not be applied by analogy.

11. The Board observed that the term *registration rights agreements* (which described the arrangement in Issue 05-4 and has been previously used for this

topic) is a broad term relating to any agreement in which the registration of shares is discussed, whether or not a payment provision is included. The guidance in the proposed FSP will apply only to those agreements that require a contingent payment if securities are not registered pursuant to the agreement.

12. The Board decided that the form of consideration under the registration payment arrangement will not affect its classification or measurement. Therefore, a registration payment agreement, whether settled with cash, other assets, or securities, would be reflected separate from the related securities and classified as a liability. Further, penalties may be fixed or variable and calculated based on a fixed amount specified or as an adjustment to the related instrument's interest rate strike price.

Measurement Attribute

13. The Board considered three possible measurement attributes for separately recognized registration payment agreements. These measurement options included fair value, FASB Statement No. 5, *Accounting for Contingencies*, (probable approach), and an accrual of the liability in the period in which payment under the registration payment agreement is triggered.

14. Four Board members ultimately supported a Statement 5 model (RBH, DMY, LFS, GJB) as a practical, cost-beneficial measurement attribute. Three Board members supported the use of a fair value measure (KAS, GMC, EWT) because it would reflect the economic value of the registration rights agreement at inception and in subsequent periods. Mssrs. Crooch and Trott signaled that they would object to the use of a Statement 5 model.

15. Mr. Batavick supported a model consistent with the accounting for loss contingencies under Statement 5. He stated that the accrual alternative delays recognition too much to be helpful to users. Mr. Batavick stated that the cost of requiring preparers to hire experts and/or develop new valuation models for a fair value measure is not justified since the initial amount and likelihood of ultimate payment or receipt is low. Additionally, Mr. Batavick questioned the reliability of a fair value measurement for registration payment agreements due to the amount

of entity specific data required (for example, administrative practices of the entity, strength of internal controls, and the likelihood of the SEC accepting a registration statement from the entity).

16. Mr. Herz stated that while he would prefer to measure registration payment agreements using a present value of expected payments discounted using the entity's borrowing rate, he believes that a Statement 5 model would be the most practicable measurement attribute. He supported a Statement 5 model over fair value due to complexities in determining the fair value of a registration payment agreement. He noted that a fair value measurement for these arrangements would likely fall within Level 3 in the fair value hierarchy and require entities to consider hypothetical transactions and assumptions.

17. Ms. Seidman believes that the primary benefit of the proposed FSP is separate recognition of the registration payment arrangement (a minor provision in the overall instrument arrangement), such that it does not affect the classification and measurement of the related instrument. She suggested that since the initial amount recognized regardless of method is small, the Board should rigorously consider the cost-benefit of fair value. A Statement 5 model will recognize an amount for the registration payment arrangement if and when it is likely to occur; preparers would not have to compute fair value at inception and over the life of the arrangement.

18. Mr. Young preferred an approach in which a liability is accrued in the period in which payment under the registration payment arrangement is triggered due to simplicity for the preparer. However, he ultimately supported a model consistent with the accrual of loss contingencies under Statement 5.

19. Ms. Schipper stated that she believes fair value is the only conceptually correct measurement attribute because a registration payment arrangement is either a financial instrument or behaves like one. However, she recognized the practical difficulty that measuring fair value could entail, observing that an enterprise may not be able to get its securities registered for many reasons including making a business decision not to register its shares and/or having its

registration statement not accepted. Therefore, much of the information needed to assess the likelihood of registration (and determine fair value) is proprietary information. Ms. Schipper further noted that if a fair value measurement attribute is used, a registration payment arrangement could fail the materiality threshold at inception and until payment becomes likely. She observed that a similar outcome could result from using a model consistent with the accrual of loss contingencies under Statement 5. The difference between the models lies in subsequent measurement; until a payment becomes probable, no amount would be recorded under the Statement 5 model for arrangement. For that reason, she ultimately supported a fair value measurement attribute.

20. Mr. Trott supported a fair value measurement attribute because it recognizes economic events between a "more than remote" and "probable" likelihood. He noted that some registration payment arrangements are material even at the inception and that he views them similar to guarantees. Additionally, Mr. Trott stated that there is not a clear understanding or consistent application of what constitutes "probable" in a Statement 5 model. Determining the fair value is not significantly more difficult than determining the likelihood of payment/receipt. Consistent with other Board members, Mr. Trott disagreed with the accrual method because waiting until the payment is triggered for recognition is clearly too late to be useful to users of financial statements.

21. Mr. Crooch supported a fair value measurement attribute. He indicated that fair value is the most appropriate conceptual answer, despite measurement difficulty and the likelihood that fair value would yield relatively small amounts in the early life of registration payment arrangements.

Disclosure

22. Five Board members (EWT, RBH, KAS, GJB, DMY) supported a package of disclosures as presented by the staff. Those disclosures are similar to those required in paragraphs 13(a)–13(c) of Interpretation 45.

23. Ms. Schipper strongly supported the disclosures presented by the staff. She noted that the qualitative disclosures should not be burdensome to preparers, especially considering that the entity would need to consider the information presented in those disclosures before it entered into the registration payment arrangement. Mr. Batavick agreed, noting that the information needed for the disclosure is readily available and would be useful to users of financial statements.

24. Ms. Seidman preferred requiring the proposed disclosures only when the likelihood of payment under the registration payment agreement meets a certain threshold (for example, reasonably possible) for cost-benefit reasons. Ms. Seidman stated that the disclosures as proposed by the staff would be information overload for these nonsubstantive contractual provisions.

25. Mr. Trott responded that requiring entities to disclose the information regardless of likelihood would be less burdensome than requiring disclosure when a certain threshold is met. Otherwise an entity would need to evaluate when a registration payment arrangement moved from a remote likelihood to an other-than-remote likelihood.

Transition

26. The Board unanimously approved a transition approach in which the guidance under the proposed FSP would be recognized as a cumulative effect adjustment to beginning retained earnings (or other appropriate components of equity or net assets in the statement of financial position) in the period of application (a limited form of retrospective application). Ms. Thuener stated that while application of the guidance in the proposed FSP is a change in accounting principle (rather than a change in estimate), the staff determined that a full retrospective transition approach was impracticable because it would require

management judgment related to estimates that would have been made in prior periods. For all instruments issued after the issuance of the final FSP, the guidance in the final FSP would apply immediately.

27. The staff (Mr. Stevens) explained that the effect of transition would depend upon how the registration payment agreement and the related instrument or instruments were recorded at the inception of the arrangement and the likelihood of payment or receipt under the registration payment agreement at adoption of the proposed FSP. For example, if payment is not probable upon adoption, warrants initially classified as equity and issued with a registration payment agreement would have no transition adjustment. In contrast, a warrant initially classified as liability because of the registration payment agreement (that is, the warrant otherwise would have been classified as equity) would reclassify the inception (day one) fair value of the warrants to additional paid-in-capital with the remaining difference between the reclassified amount and the carrying value of the warrant reflected as an adjustment to beginning retained earnings. Mr. Stevens noted that if the arrangement had lapsed prior to adoption of the proposed FSP there would be no accounting adjustments.

28. The Board agreed with the transition as described by Mr. Stevens. The Board also requested that examples of transition be included in the proposed FSP illustrating the various situations to which an entity might apply the provisions and to prevent any ambiguity regarding where the transition adjustment would be recorded (for example, amounts to retained earnings versus additional paid-in capital).

29. Ms. Seidman noted that the advantage of this method of transition is that if the registration payment arrangement has lapsed, an entity is required to do nothing for transition. (She clarified that in accordance with Issue 00-19, an entity would have reclassified the related instrument to equity when the arrangement has lapsed.)

30. Mr. Young observed that it was not uncommon for a registration payment arrangement to cause an entity to record a liability under Issue 00-19.

Accordingly, this proposed FSP may represent significant changes to equity balances.

Timing and Effective Date

31. The Board approved the staff's request to proceed to the preballot of the proposed FSP Exposure Draft with a 45-day comment period and an effective date in the first fiscal year beginning after the issuance of the final FSP. The Board selected a 45-day comment period because many constituents are anxious to see this issue resolved

Follow-up Items: None.

General Announcements: None.