MINUTES

Financial Accounting Standards Board

To: Board Members

From: Financial Instruments: Liabilities and Equity Team (Arbuckle, ext. 275)

Subject: Minutes of the January 21, 2004 Liabilities and Equity Board Meeting **Date:** February 3, 2004

cc: Leisenring, Bielstein, Smith, Golden, Cassel, Lott, Project Team, Mahoney, Swift, Polley, Sutay, Gabriele, Petrone, Thompson, FASB Intranet

Topic:	Liabilities and Equity: Unconditional Simple Instruments
Basis for Discussion:	Memorandum of December 23, 2003
Length of Discussion:	9:00 a.m. to 11:30 a.m.
Attendance:	
Board members present:	Herz, Batavick, Crooch, Schieneman, Schipper, Seidman, and Trott
Board members absent:	None
Staff in charge of topic:	Bullen and Richards
Other staff at Board table:	Arbuckle, Belot, and Bielstein
Outside participants:	None

Summary of Decisions Reached:

The Board continued its consideration of an approach for distinguishing equity from liabilities and assets that is based on liquidity and ownership relationship criteria. The Board is comparing that approach (Approach A) to alternative approaches based on a narrower view of equity (Approach B) and on the revised IAS 32, *Financial Instruments: Disclosure and Presentation* (Approach E), which also incorporates notions of liquidity and ownership relationship. The Board made the following decisions regarding the application of the proposed approaches to simple instruments including: mandatorily redeemable shares, shares that the issuer is economically compelled to redeem, and obligations requiring an entity to issue its shares.

The Board decided that mandatorily redeemable shares are analyzed as simple instruments that meet the definition of a liability (Statement 150 Approach), and acknowledged that certain issues will be addressed during the measurement and scope sections of the project. However, the Board also decided not to eliminate the possible alternative of analyzing mandatorily redeemable shares as complex instruments (Replicable Instruments Approach) for purposes of a developing a consistent model.

The Board decided the following matters concerning mandatorily redeemable financial instruments:

- Requirements for redemption that are far in the future, or are required by law, meet the definition of *mandatorily redeemable*. However, relevant facts and circumstances need to be analyzed to determine whether such an instrument is mandatorily redeemable.

- If the issuer of the shares has the unilateral right to extend the contract forever, no obligation exists. If the holder of the shares has the unilateral right to extend the contract, or if both parties must agree to extend the contract, the obligation to redeem is conditional and should be accounted for similarly to puttable shares, which will be discussed at a future meeting. However, the Board noted that the accounting might depend on whether the extension option is substantive.

- The liquidity or termination exception in Statement 150, footnote 13, which exempts shares requiring redemption upon liquidation or termination from liability classification in the entity's standalone financial statements, should not be changed. The Board rejected eliminating that exception or extending it to the consolidating entity(ies). The Statement 150 implementation issues that result from this requirement will be addressed at later meetings.

- Past practice should be considered as an indicator of evaluating non-substantive and substantive features. However, the Board directed the staff to obtain more information relating to whether past practice can cause either an equity instrument to be reclassified as a liability or a liability to be reclassified as an equity instrument and to discuss this issue again at the next Board meeting.

The Board decided that economic compulsion should not be considered in determining whether an obligation exists. However, the Board directed the staff to examine how the issue of economic compulsion relates to the issue of considering past practice in this and other Board projects and pronouncements and to discuss this issue at the next Board meeting.

The Board decided that simple instruments embodying obligations to issue a variable number of shares are classified as liabilities if an ownership relationship is not established and that simple instruments embodying obligations to issue a fixed number of shares are classified as equity. Obligations that are dual-indexed—based partly on the price of the entity's equity shares and partly on something else—and prepaid forward sales contracts to issue a fixed number of shares will be analyzed with complex instruments at a future board meeting.

<u>Matters Discussed and Decisions Reached</u>:

Mr. Bullen briefly described the surviving approaches for distinguishing equity from liabilities and assets. He stated that the Board will continue to consider an approach that is based on liquidity and ownership relationship criteria (Approach A) as compared to alternative approaches based on a narrower view of equity (Approach B) and on the revised IAS 32 (Approach E). Mr. Bullen noted that the meeting would focus on the application of the proposed approaches to further simple instruments including:

1. Mandatorily redeemable shares
2. Shares that the issuer is economically compelled to redeem
3. Obligations requiring an entity to issue its shares.

Ms. Richards introduced the first issue, stating that mandatorily redeemable shares can be viewed as simple instruments or complex instruments. She presented the staff's three approaches as to how mandatorily redeemable shares can be analyzed as follows:

1. Mandatorily redeemable shares are simple instruments that meet the definition of a liability (Statement 150 Approach).
2. Mandatorily redeemable shares are complex instruments composed of a share and a forward contract that are candidates for separation (Replicable Instruments Approach).
3. Mandatorily redeemable shares are simple instruments that can be equity if they establish an ownership relationship between the issuer and the counterparty, even though they require a transfer of assets (Pure Ownership Relationship Approach)

Ms. Richards stated that the staff recommended the Replicable Instruments Approach because it has the goal of achieving consistent accounting for instruments with similar payoffs and other economic effects. She also stated that bifurcation is not mandatory under this approach but that the goal of such an approach is to account for replicable instruments similarly whether the instruments are issued separately or combined.

Mr. Trott expressed his support for the first approach to confirm the Statement 150 classification treatment that mandatorily redeemable instruments are simple instruments classified as liabilities because of their unconditionality of redemption, but noted his concern that measurement issues emphasized by the second approach would need to be addressed to achieve consistency. Ms. Schipper articulated that she did not agree with the second or third approaches because, under those approaches, the potential for equity classification would be a departure from the liquidity notion. Ms. Schipper supported the Statement 150 Approach and agreed with Mr. Trott that measurement, labeling, and scope issues would need to be addressed. Mr. Herz agreed with Ms. Schipper's opinion.

Several Board members [GSS, GMC, GJB, LFS] supported the Statement 150 Approach but requested that the Replicable Instruments Approach not be eliminated as a possible alternative approach for analyzing mandatorily redeemable shares to achieve consistency in future decisions related to similar complex instruments and certain measurement issues.

The Board decided that under the proposed approaches for distinguishing equity from liabilities and assets (A, B, and E), mandatorily redeemable shares would be analyzed as simple instruments that meet the definition of a liability and acknowledged that certain issues need to be addressed at future Board discussions relating to measurement issues and the scope of the proposed Statement. Additionally, the Board decided not to eliminate the possible alternative of analyzing mandatorily redeemable shares as complex instruments, if such an approach was later deemed to result in more consistent accounting for instruments with similar characteristics.

Ms. Richards stated that there are four definitional subissues relating to mandatorily redeemable shares that will be discussed at this meeting and another that will be discussed at the next meeting relating to date uncertainty. Ms. Belot introduced the first subissue of whether requirements for redemption far in the future, or only because required by law, are liabilities. Ms. Belot presented three approaches:

1. Far in the future redemptions and required by law redemptions should be distinguished from those that are not (Bright-Line Approach).
2. Far in the future redemptions and required by law redemptions should not be distinguished from those that are not (Definitional Approach).
3. Far in the future redemptions should be distinguished from those that are not, but required by law redemptions should not be distinguished, or vice versa (Mixture Approach).

Ms. Belot said that the staff recommended the Definitional Approach that states termination dates are substantive by definition whether they are far in the future or required by law, the staff would not recommend trying to establish a bright line or other distinguishing criteria.

Ms. Schipper noted her belief that Statement 150 would admonish preparers to analyze a far in the future or required by law redemption to determine if it had terms that were substantive or nonsubstantive. If the terms were nonsubstantive, it would be disregarded. Ms. Schipper clarified her belief that the staff recommendation would not be the same as the Statement 150 view. The definitional approach states that far in the future or required by law redemptions are not analyzed for substantiveness, but by definition are substantive, and she agreed with the staff recommendation (Definitional Approach).

Mr. Trott agreed that far in the future redemptions should not be distinguished from those that are not, but would consider whether required by law redemptions were substantive or nonsubstantive (Mixture Approach). He expressed concern that the required by law redemption may have an option to extend or other features that would need to be analyzed to determine whether such an instrument is mandatorily redeemable. Ms. Seidman supported the staff's recommendation but was reluctant to answer that issue in isolation. Several Board members [GMC, GJB, RHH] agreed with Ms. Seidman's opinion and noted measurement as a follow-up issue for far in the future redemptions.

Mr. Schieneman expressed his concern that far in the future redemptions would be classified as liabilities as they have no immediate impact on cash flow. He voiced his support for the Bright-Line Approach, but noted that determination of what constitutes far in the future would be difficult.

The Board decided that requirements for redemption that are far in the future, or are required by law, are substantive by definition (Definitional Approach) and meet the definition of *mandatorily redeemable* in isolation; however, it noted that all relevant facts and circumstances would need to be analyzed to determine whether such an instrument is in fact mandatorily redeemable.

Mr. Bullen introduced the second subissue relating to mandatorily redeemable shares of whether options to extend the redemption date affect the classification of shares as mandatorily redeemable. The two approaches to that issue are:

1. Options to extend should not affect the classification of mandatorily redeemable shares as liabilities.
2. It depends on who has the options and other circumstances:
    a. If the issuer of the shares has the unilateral right to extend forever, the issuer maintains discretion to avoid the future sacrifice and, therefore, no obligation exists.
    b. If the holder of the shares has the unilateral right to extend forever, the shares are conditionally redeemable and should be accounted for however the Board decides for that type of redemption (similar to puttable shares).
    c. If both parties must agree to extend the contract, even if indefinitely, the potential extension should not be accounted for until agreement is reached—the shares are considered mandatorily redeemable shares until that agreement to extend is reached.

Mr. Bullen stated that the staff recommended the second approach to determine whether an obligation exists and, if so, the conditionality of that obligation.

Ms. Seidman agreed that if the issuer has the unilateral ability to extend the contract forever then no obligation exists. She also agreed that if the holder has the right to extend forever, the obligation is conditional. Ms. Seidman questioned circumstances in which both parties must agree to extend the contract and can do so forever and did not believe that the shares represent unconditional obligations until that agreement to extend is reached. She expressed her opinion that the redemption is conditioned on non-extension and, therefore, represents a conditional redemption.

The Board decided that if the issuer of the shares has the unilateral right to extend the contract forever, no obligation exists. If the holder of the shares has the unilateral right to extend the contract, or if both parties must agree to extend the contract, the obligation to redeem is conditional and should be accounted for similarly to puttable shares, which will be discussed at a future meeting. However, the Board noted that the accounting might depend on whether the extension option is substantive.

Ms. Belot introduced the third subissue of whether shares are mandatorily redeemable financial instruments classified as liabilities if they require redemption upon liquidation or termination of the entity. She noted that Statement 150 currently provides an exception from liability classification for mandatorily redeemable shares that are required to be redeemed only upon termination or liquidation of the reporting entity. However, that exception does not extend to the consolidating entity. Ms. Belot introduced three approaches regarding that issue:

1. Continue the liquidity or termination exception only in the reports of the issuing entity, requiring that mandatorily redeemable noncontrolling interests be reported as liabilities (Statement 150 Approach).
2. Disallow the liquidation or termination exception and, accordingly, mandatorily redeemable shares are classified as liabilities even if redemption is required to occur only upon liquidation or termination of the reporting entity (No Exception Approach).
3. Extend the exception to include not only the issuing entity but also the consolidated entity(ies) of which it is a part (Extended Exception Approach).

Ms. Belot stated that overall the staff recommends the Statement 150 Approach because the staff continues to see a difference between shares that are to be redeemed only upon liquidation of an entity and shares that are to be redeemed prior to liquidation of that entity and noted that one staff member recommends the Extended Exception Approach because she believes the same exception difference exists if liquidation proceeds are distributed by the parent of the subsidiary that is liquidated. The majority of Board members [RHH, KAS, EWT, GMC, GJB] agreed with the staff's recommendation to confirm the Statement 150 Approach. Two Board members [GSS, LFS] favored the Extended Exception Approach.

Ms. Richards introduced the fourth subissue relating to mandatorily redeemable shares of whether past practices of redeeming could establish an unconditional obligation. She stated that the staff recommends considering past practices of redemption in evaluating non-substantive features to determine whether an obligation exists and noted the consistency with the requirements of Statement 150.

The Board decided that past practice should be considered as an indicator when evaluating non-substantive and substantive features. However, the Board directed the staff to prepare additional analysis of the effects of past practice on the classification of an instrument as either a liability or as equity and to present that analysis at its next meeting.

Ms. Richards then introduced the second main issue of whether shares that the issuer is economically compelled to redeem would establish an obligation. The FASB Exposure Draft, *Accounting for Financial Instruments with Characteristics of Liabilities, Equity*, or *Both,* proposed that economic compulsion does not establish an obligation because the issuer has discretion. However, several constituents commented that economic compulsion could leave the issuer with little or no discretion and, thus, could establish an obligation. That issue also was brought up in the deliberations leading to Statement 150 and was put off until the second phase of the project. Ms. Richards noted that there are two approaches regarding economic compulsion; the first is that it should not be considered because the issuer retains discretion. The second is that it should be considered because the instrument's terms could establish a constructive obligation. The overall staff recommendation is that economic compulsion should not be considered in determining if an obligation exists because the issuer has no obligation to redeem—only a strong incentive. One staff member believes that economic compulsion should be considered because of the possible future desire to create such instruments but notes the difficulties of the approach.

Ms. Schipper stated that the Board should not try to define economic compulsion as it is used to describe a variety of arrangements. She noted that the existence of disadvantageous terms that could become onerous to the issuer does not in and of itself make the instrument a liability. The Board decided that economic compulsion should not be considered in determining whether an obligation exists. However, the Board directed the staff to conduct additional analysis into the relationship between economic compulsion and the consideration of past practice.

Mr. Bullen introduced the third issue of the application of the proposed approaches to unconditional obligations requiring an entity to issue its shares. He stated the two approaches relating to that issue:

1. Unconditional obligations to issue a variable number of shares with a monetary value are based solely or predominantly on a fixed amount, variations in something other than the share price, or variations inversely related to the share price are liabilities. Unconditional obligations to issue a fixed number of shares, and obligations to issue a variable number of shares that put the counterparty into an ownership relationship, are equity.
2. Same as in Approach A, but obligations that are dual-indexed (based partly on the price of an entity's equity shares and partly−even predominantly−on a fixed amount, variations in something other than the share price, or variations inversely related to the share price) are to be analyzed for possible bifurcation into liability and equity components in the next stage of this project.

Mr. Bullen expressed that the staff recommends the second approach, under which all dual-indexed unconditional obligations to issue shares are considered for bifurcation. The staff also noted that the issue of mandatorily redeemable shares redeemed at fair value that must or may be settled with a variable number of shares of another class would be analyzed at the next meeting.

The Board decided that simple instruments embodying obligations to issue a variable number of shares would be classified as liabilities if an ownership relationship is not established, and that simple instruments embodying obligations to issue a fixed number of shares would be classified as equity. Obligations that are dual-indexed—based partly on the price of the entity's equity shares and partly on something else—and prepaid forward sales contracts to issue a fixed number of shares would be analyzed with complex instruments at a future board meeting.

Follow-Up Items:

1. Analyze whether there is or should be a hierarchy of characteristics used to determine liability and equity classification.
2. Prepare additional analysis of the effects of past practice on the classification of an instrument as either a liability or as equity.
3. Conduct additional analysis into the relationship between economic compulsion and the consideration of past practice

General Announcements:

None.