MINUTES

To:	Board Members
From:	Liabilities and Equity—Arveseth (ext. 384)
Subject:	Minutes of the October 23, 2006 Joint Board Meeting: Liabilities and Equity—Project Update
Date:	November 2, 2006
cc:	FASB: Bielstein, Smith, Golden, MacDonald, Liabilities and Equity Team, Conceptual Framework Team, Financial Statement Presentation Team, Financial Instruments Team, Polley, Gabriele, Glotzer, Carney, Allen, Fanzini, FASB Intranet IASB: Upton, Thomas, Francis, Lian, Hague, Hughes

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Topic: Liabilities and Equity: Project Update

Basis for Discussion: Board Memorandum dated October 4, 2006

Length of Discussion: 9:00 a.m. to 10:30 a.m.

Attendance:

Board members present:	FASB: Herz, Batavick, Crooch, Linsmeier, Seidman, Trott, and Young IASB: Tweedie, Barth, Bruns, Cope, Garnett, Gelard, Jones, Leisenring, McGreggor, O'Malley, Smith, and Yamada
Board members absent:	FASB: None IASB: Engstrom
Staff in charge of topic:	Carnrick and Richards
Other staff at Board table:	Hughes, Hickey, Upton, Arveseth, Bielstein, and Lott
Outside participants:	None

Summary of Decisions Reached:

The purpose of the meeting was informational. The FASB staff updated the IASB Board on the current status of the FASB project on liabilities and equity. The staff provided an overview of the three possible approaches to account for financial instruments and other certain instruments with characteristics of liabilities, assets, and equity that have been developed in this project. The staff described the FASB plan to issue for comment a Preliminary Views in the second quarter of 2007 that will include the approach preferred by the majority of FASB members and also describe and illustrate other approaches considered by the Board. The IASB affirmed its plan to issue a due process document containing the FASB's Preliminary Views for comment by its constituents.

Objective of Meeting:

The objective of the meeting was to update the IASB members on the current status of the liabilities and equity project. The objective of the meeting was met.

Matters Discussed and Decisions Reached:

1. Ms. Richards noted that the current accounting guidance includes over 60 pieces of literature that address the various financial instruments within the scope of the liabilities and equity project. A number of reporting and implementation issues have arisen due to the inconsistency and complexity of that guidance. The objective of this project is to develop a comprehensive standard that would replace all of the current literature with a single set of requirements that provides users with the most relevant and transparent information. Another goal is to converge with the IASB.

2. Ms. Richards noted that the FASB has been in the process of developing three approaches to account for financial instruments (and certain non-financial instruments) with characteristics of liabilities, equity, or both, and assets: (a) the ownership-settlement approach, (b) the ownership approach, and the (c) the reassessed expected outcomes (REO) approach. She stated that the FASB was in the process of finalizing the REO approach. Upon completion of the REO approach, the FASB will select a preferred approach and begin drafting the Preliminary Views.

The Preliminary Views, which would include a summary of the preferred approach and the other two alternatives, is expected to be released in May 2007.

OWNERSHIP-SETTLEMENT APPROACH

3. Ms. Richards stated that the objective of the ownership-settlement approach is to identify equity instruments or components based on ownership instruments or other instruments with payoffs similar to ownership instruments that, if settled, would result in issuance or return of ownership instruments. All other instruments or components would be liabilities or assets.

4. Ms. Richards explained that two of the principles developed by the FASB in conjunction with the ownership-settlement approach apply to all three approaches: linkage and substantive features. The linkage principle requires instruments that are part of the same arrangement to be linked if the accounting for the instruments individually differs from accounting for them as a single instrument. The substantive features principle requires an instrument to be classified in the same manner as another instrument with the same or similar outcomes by identifying features that a) have more than a remote likelihood of affecting an instrument's outcome and b) have more than a minimal effect as compared to other features within an instrument. Ms. Richards pointed out that the ownership-settlement approach relies more heavily on linkage than the other two approaches.

5. Ms. Richards further explained the three types of instruments classified as equity under this approach:

a. Perpetual instruments issued by the reporting entity that embody no settlement obligation and entitle the holder to a portion of the issuer's net assets in liquidation

b. Direct ownership instruments issued by the reporting entity that represent the most subordinated claim to a proportional share of the reporting entity's net assets that is neither limited nor guaranteed

c. Indirect ownership instruments issued or held by the reporting entity with a counterparty payoff based on and settled with direct ownership instruments.

6. Ms. Richards continued by explaining the separation principle under the ownership-settlement approach. An instrument is separated into equity and nonequity components if it embodies an obligation and has both equity and nonequity outcomes with differing counterparty

payoffs at the outcome date. All other instruments that are not equity instruments or are not separated into equity and nonequity components are classified as liabilities or assets in their entirety.

7. Regarding measurement under the ownership-settlement approach, Ms. Richards explained that all instruments are initially measured at transaction price (excluding transaction costs, which are expensed). For separated instruments, the nonequity component is measured first at its hypothetical fair value (using expected timings and amounts), and the equity component is the residual transaction price. Equity instruments and components that include settlement requirements are remeasured at current settlement value; other equity instruments are not remeasured unless otherwise required. Nonequity instruments or components with varying payoffs are measured at fair value unless other accounting guidance requires a different measurement attribute (for example, investments would not be measured under this approach). Ms. Richards opened the floor to Board members for their comments and questions.

8. Ms. O'Malley asked how an instrument would be initially measured if the transaction price did not equal fair value. Ms. Richards explained that the initial measurement would equal the transaction price, adding that the approach had been developed before the publication of FASB Statement No. 157, *Fair Value Measurements*.

9. Mr. Trott noted that the ownership-settlement approach would result in accounting that is similar to the treatment under current accounting. However, he pointed out that there are two features that are unique compared to the current accounting. The first feature is the use of an expected settlement date to determine the initial measure and accretion period rather than the contractual date. That feature may have a significant impact on measurement and extinguishment accounting. The second feature is the requirement to identify substantive features based on the likelihood that those features would affect the instrument's outcome and would have a more than minimal effect on the instrument's outcome. He also pointed out that the assessment of substantive features is made at each reporting period.

10. Mr. Smith noted that a call option settled in cash would not be equity under the ownership-settlement approach. Mr. Smith asked how a call option would be classified if it was settled in

shares that are immediately puttable to the issuer at fair value. Ms. Richards explained that the form of settlement would be evaluated under the substantive features principle to determine if that feature should affect the instrument's classification. For example, if the shares were immediately puttable to the issuer, then the feature may be deemed to be a cash settlement feature in substance, which would result in a liability classification. She further explained that the evaluation of whether the shares were such that the holder would be substantively exposed to the risks and returns of ownership would require professional judgment. Mr. Smith indicated he preferred the ownership-settlement approach. However, he expressed concerns regarding (a) the subjective judgment required to apply the substantive features principle, especially as it relates to his call option example above and (b) the classification of indirect ownership instruments as equity as some of those instruments have a limit on downside losses.

11. Regarding Mr. Smith's comments, Mr. Leisenring further noted that the ownership-settlement approach requires an assessment of whether an instrument is settleable in identifying substantive features, not whether it is settled. Therefore, the reporting entity must predict the counterparty's actions upon settlement, which may not reflect the actual actions at settlement.

12. Mr. Tweedie asked why the FASB decided to use the expected settlement date for measurement and accretion. Mr. Trott explained that during the Board's deliberations of the obligation first approach for measuring the nonequity component of a multiple-component instrument, the Board considered two possible measurement methods: inclusion of contingent features in (a) the discount rate or (b) the expected (probability-weighted) settlement date. The Board decided to use the expected settlement date method as that method was more consistent with the other principles of the approach and the necessary information was more readily available to preparers. Ms. Seidman pointed out that the expected settlement date method considers the future stock price in estimating the settlement date of the instrument, a factor that concerned some of the FASB members.

13. Ms. O'Malley asked if the ownership-settlement approach results in a similar initial measurement for multiple-component instruments as REO. The staff noted that the ownership-settlement approach is similar; however it measures the nonequity component based on a 100 percent likelihood of occurrence, whereas REO uses the probability of the debt's occurrence in

measurement (reflecting the uncertainty of a debt outcome’s date and amount in its measurement).

OWNERSHIP APPROACH

14. Ms. Carnrick stated that the objective of the ownership approach (a narrower view of equity) is to identify the owners of an entity (equity instruments) and the instruments that will or may affect the net assets available to those owners. Therefore, the approach focuses on potential dilution of the owners and not on the economic outcome of a particular instrument. She explained that the key difference of the approach is that it modifies the ownership-settlement approach by classifying all indirect ownership instruments, such as options and forwards, as liabilities or assets. Thus, under this approach, equity instruments include only perpetual (for example, perpetual preferred stock) and direct ownership instruments (for example, common shares).

15. Ms. Carnrick further explained that the ownership approach places less emphasis on linkage and substantive features and separation would be limited. Moreover, no instruments are separated unless there is a possibility of a distinct nonequity payment and, after settlement, an equity share would remain outstanding (for example, stock with required dividend payments). Ms. Carnrick also explained that the measurement principles are the same as those principles under the ownership-settlement approach; however, more instruments would be measured at fair value through income, for example, convertible debt or puttable stock. She added that because more instruments would be subsequently measured at fair value, extinguishment accounting would also be less complex.

16. Mr. Crooch noted that a possible advantage of this approach is that it results in less accounting arbitrage. Ms. Richards pointed out there would also be reduced arbitrage under the ownership-settlement approach, but some issues related to accounting arbitrage have yet to be addressed by the FASB, including economic compulsion and constructive obligations. However, both the ownership approach and the ownership-settlement approach may leave open a structuring opportunity in that perpetual preferred shares are equity (this issue will be

readdressed by the Board). She noted that accounting arbitrage opportunities may be virtually eliminated under REO.

17. Mr. Yamada inquired how a liability would be recognized in conjunction with the recognition of stock compensation expense under FASB Statement No. 123 (revised 2004), *Share-Based Payment*. Mr. Leisenring noted that if the FASB decided to require indirect ownership instruments issued as share-based payments to be accounted for under the ownership approach, then the effect of that treatment would be settlement date accounting. However, other considerations would affect that treatment, such as the vesting period and the scope of the final Statement.

18. Ms. O'Malley asked about the accounting treatment under the ownership approach for perpetual preferred stock with a required dividend. Ms. Richards explained that the ownership approach would require separation of the nonequity obligation from the perpetual instrument. She further noted that this treatment would effectively result in a liability classification for the instrument as a whole as the fair value of the obligation would be the majority of the transaction price.

19. Mr. Herz stated that some constituents may object to the ownership approach as it would require a reporting entity to record indirect ownership instruments at fair value. He noted that the fair value of indirect ownership instruments would be affected by changes in the reporting entity's share price. Therefore, the ownership approach would require a reporting entity to record the effect of changes in its share price on those instruments in earnings. However, Mr. Herz also noted that, although the staff has not yet addressed earnings per share (EPS), the requirement to record indirect ownership instruments at fair value could essentially simplify the EPS denominator calculation for equity derivatives and hybrid instruments as the changes in fair value of those instruments would already be reflected in the numerator.

REASSESSED EXPECTED OUTCOMES APPROACH

20. Ms. Carnrick stated that the FASB is in the process of finalizing the REO approach and expects to complete the approach in November 2006. Ms. Richards added that some of the material that would be presented had not been fully deliberated by the FASB, for instance, the

FASB members had not yet seen the REO fair value method. Ms. Carnrick explained that REO is a probabilistic measurement approach that uses contingent claims modeling techniques to determine the probability of an equity or a nonequity payoff or both at the outcome date. She noted that REO differs from the other approaches because it focuses on expected inflows and outflows of economic resources and the type of payoff, not on the form of settlement or on control over rights and obligations. Under REO, an instrument or component is classified as equity or contra-equity if it is (a) a direct ownership instrument or (b) an instrument whose fair value is based directly or inversely on a reporting entity's direct ownership instruments.

21. Ms. Carnrick stated that the separation principle is the same under REO as the ownership-settlement approach. If both equity and nonequity payoffs at the outcome date are identified, then the instrument is separated. Moreover, options and forwards are separated into a nonequity component and an equity component and recorded gross, which is necessary in order to avoid accounting arbitrage.

22. In contrast to the obligation first measurement approach under the ownership-settlement approach, Ms. Carnrick explained that REO incorporates the probability of a nonequity payoff in the initial and subsequent measurements of a nonequity component. Ms. Carnrick further explained that subsequent measurement under REO can be depicted by using a full fair value approach for the components, which would result in a gain or loss through income for the change in the entire instrument's fair value (similar to the ownership approach). It also can be depicted by forcing the sum of the reallocated components to the initial transaction price, which would not result in a gain or loss (but would result in interest expense or income based on the current value of the nonequity component). Common shares are the only equity instruments that would not be remeasured under REO. The FASB Board will decide at a future meeting which way to depict the REO approach.

23. Mr. Leisenring noted that the recognition of assets and liabilities under the REO approach conflicts with the current definitions of those elements in the conceptual framework. Mr. Leisenring and Mr. Yamada further noted that under REO, a nonequity component (asset or liability) is recognized for instruments whose fair values are based directly or inversely on a reporting entity's direct ownership instruments. Therefore, a nonequity component is recognized

and measured based on the future probability of its occurrence, even if the reporting entity does not control a present right or obligation related to that component. Mr. Trott further noted that this approach is inherently different from the current approach in the conceptual framework project.

24. Ms. Barth asked whether staff had considered how each approach related to both the current conceptual framework and the conceptual framework project. Mr. Trott stated that the relationship between the two may become clearer as the Board deliberates the conceptual framework and liabilities and equity projects.

25. Mr. Gélard noted that REO makes recognition and measurement precedential to other accounting guidance. Ms. Seidman stated that the reason for that treatment was that REO was designed to account for financial instruments in the way market participants view them. In addition, she noted that REO would result in the fewest opportunities for accounting arbitrage as it focuses on an instrument's payoff, not the form. Mr. Gélard stated that the problem was that the approach does not fit into either the existing framework or the developments in the conceptual framework project.

26. Mr. Yamada asked whether entities would need to hire valuation professionals to implement REO. Ms. Richards responded that that would depend on the entity in question but it was likely that many would need an investment banker's advice on the model used when the product is sold to them. Most of the valuation models have been utilized for many years but the REO approach would expand the use of those models use in accounting.

27. Mr. McGregor asked the FASB Board members to give their current leanings regarding the three approaches. Mr. Trott favored the ownership-settlement approach. Mr. Crooch and Mr. Herz favored the ownership approach. No other Board members commented about their preference. Mr. Herz suggested that the staff consider incorporating the interaction of the conceptual framework with the alternative approaches as part of the Preliminary Views.

<u>Follow-up Items</u>:

28. The staff will consider incorporating the interaction of the conceptual framework with the alternative approaches as part of the Preliminary Views.

General Announcements:

None.