

MINUTES



Financial Accounting
Standards Board

To: FASB Board Members

From: Financial Instruments with Characteristics of Equity Team
(Clark x443)

Subject: Minutes of the November 19, 2008, Board Meeting: *Financial Instruments with Characteristics of Equity* **Date:** December 2, 2008

cc: Leisenring, Bielstein, Golden, Bossio, Lott, Allen, Klimek, Chookaszian, Posta, Malcolm, Mills, Glotzer, C. Smith, Stoklosa, Proestakes, Sutay, Mechanick, Bhavé, Petrone, Prince, Clark, Gabriele, Finden (IASB), Liz Figgie (IASB), Gavin Francis (IASB), LiLi Lian (IASB), FASB Intranet

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, Interpretation, or FASB Staff Position.

Topic: Developing a Classification Model

Basis for Discussion: FASB Memo No. 63 (IASB Agenda Paper 9)

Length of Discussion: 1:21 p.m.–2:30 p.m.

Attendance:

Board members present:	FASB: Herz, Linsmeier, Seidman, Siegel, and L. Smith
Board members participating by phone:	None
Board members absent:	None
Staff in charge of topic:	Switter (FASB), Figgie (IASB, by phone)
Other staff at Board table:	FASB: Golden, Lott (by phone), C. Smith, Bhavé, Prince, and Clark

Summary of Decisions Reached:

The Board continued redeliberations of its Preliminary Views, *Financial Instruments with Characteristics of Equity*. The Board decided that all instruments that have no contractual settlement requirement (perpetual instruments) and entitle the holder to a share of the issuer's net assets in liquidation should be classified as equity.

The Board decided that, in principle, derivatives on an issuer's own equity instruments would be classified as liabilities or assets. The Board decided to discuss at a future meeting whether derivative instruments within the scope of FASB Statement No. 123 (revised 2004), *Share-Based Payment*, would be subject to that classification principle.

The Board briefly discussed several other matters without reaching decisions, including:

1. Whether puttable instruments, redeemable ownership instruments, and noncontrolling interests in subsidiaries would be classified as liabilities or as equity in the statement of financial position
2. If instruments classified as liabilities or assets were required to be measured at fair value, how the recognized gains and losses might be presented in the statement of comprehensive income.

The Board directed the staff to continue analyzing those issues for further consideration at a future meeting.

Objective of Meeting:

The objectives of the meeting were to (1) resolve three basic classification issues and (2) provide the staff with guidance on how to proceed with further analysis of future issues. The objectives were met.

Matters Discussed and Decisions Reached:

1. Ms. Switter stated that the two objectives for the meeting are (a) to resolve three basic classification issues (paragraph 1 of the meeting handout) and (b) to provide the staff with guidance on how to proceed with further analysis of future issues (paragraph 2 of the meeting handout).

ISSUES RESOLVED AT THIS MEETING

Issue 1: Classification of a Perpetual Basic Ownership Instrument

2. Ms. Switter explained the first issue, which was the classification of perpetual basic ownership instruments. She noted that a basic ownership instrument has the following characteristics:

- a. The holder has a claim to a share of the assets of the entity that would have no priority over any other claims if the issuer were to liquidate on the date the classification decision is being made.
- b. The holder is entitled to a percentage of the net assets of the entity that remain after all higher priority claims have been satisfied. The holder's share depends on its share of the total claims with the lowest priority and is bound only by the net assets available.

3. Ms. Switter acknowledged that some redeemable instruments meet the definition of a basic ownership instrument as described in the FASB Preliminary Views and IASB Discussion Paper, both titled *Financial Instruments with Characteristics of Equity*; however, she noted that the staff will address the classification of redeemable instruments at a later date.

4. **Staff Recommendation:** The staff recommended that perpetual basic ownership instruments be classified as equity because they represent ownership interests in the entity. Holders of basic ownership instruments bear the ultimate risks and are entitled to the ultimate rewards inherent in an entity and its activities.

5. **Board Vote:** All Board members agreed with the staff recommendation.

6. **Board Comments:** Mr. Linsmeier stated that the staff also would need to reexamine how a basic ownership instrument is defined. He added that comment letter respondents suggested that defining a basic ownership instrument in terms of preference in liquidation (a liquidation perspective) is not appropriate and instead, the definition should be based upon preference in dividends (a going-concern perspective).

Issue 2: Classification of a Perpetual Instrument with a Liquidation Preference

7. Ms. Switter described the second issue, which was whether perpetual instruments with a preference to dividends or in liquidation (preferred shares) should be classified as equity. Ms. Switter noted that classifying preferred shares as equity will address concerns of the majority of the respondents to the Preliminary Views and the Discussion Paper who objected to classifying preferred shares as liabilities. She further noted that classifying preferred shares as equity also will eliminate the need for the Board to decide how to measure instruments without settlement requirements.

8. Ms. Switter stated that a potential disadvantage to classifying preferred shares as equity involves increasing dividend rates or similar features that become so punitive that future settlement is a high probability, even without contractual settlement (economic compulsion). She added that several Board members have already stated that it is necessary to establish a principle requiring liability classification in those situations.

9. **Staff Recommendation:** The staff recommended that all instruments that lack a settlement requirement be classified as equity.

10. **Board Vote:** All Board members agreed with the staff recommendation.

11. **Board Comments:** Mr. Siegel questioned whether companies issue “plain-vanilla” preferred shares. Ms. Switter stated that based on staff research, very few companies issue “plain-vanilla” preferred shares and that most preferred shares have embedded features. She further stated that was one reason why the Board initially decided to classify preferred shares as liabilities.

12. Mr. Smith asked the staff how a preferred share that could be converted into a common share would be classified. Ms. Switter stated that the staff did not yet fully analyze that issue, but that it would address the issue at a later meeting.

13. Mr. Linsmeier agreed that perpetual instruments with a preference in liquidation should be classified as equity. He added that he is not interested in pursuing the perpetual approach if a lot of exceptions or added complexities, such as the bifurcation of puttable and redeemable instruments, are required.

14. Ms. Seidman stated that she believes that if the issuer has the option to redeem an instrument, then the instrument should be classified as equity.

15. Mr. Siegel asked Ms. Switter to summarize the Board's prior deliberations on economic compulsion issues. Ms. Switter stated that the Board previously considered classifying preferred shares as equity and developing a principle to address the issue of economic compulsion. However, the Board decided that the proposed economic compulsion principle raised more issues than it resolved. She added that in the future the staff will present the Board with a memorandum addressing the issue of economic compulsion.

16. Mr. Herz stated that he would be comfortable classifying a perpetual instrument with a preference in liquidation as equity or classifying it as a liability without subsequent remeasurement. Mr. Siegel added that the Investors Technical Advisory Committee's comment letter suggested that the Board classify perpetual instruments with a preference in liquidation as liabilities and require subsequent remeasurement.

17. Ms. Seidman stated that she is comfortable classifying as equity an instrument with no settlement requirement that provides the holder with a share of the entity's net assets. She added that the staff should clarify the meaning of *settlement requirement* and could start with the language in the Conceptual Framework, which suggests that there is "no discretion to avoid." Mr. Linsmeier stated that the staff would need to analyze how the proposed definition of equity will interact with the conceptual framework project.

Issue 3: Classification of a Derivative on an Issuer's Own Equity Instrument

18. Ms. Switter stated that there are two alternatives for classifying derivatives on an issuer's own equity instruments. Alternative 1 is to classify indirect ownership instruments that are settled with equity instruments as equity (or contra-equity). Ms. Switter further explained that the Preliminary Views defines an indirect ownership instrument as a derivative whose fair value changes in the same direction as the fair value of the basic ownership instrument. Alternative 2 is to classify all equity derivatives as assets or liabilities.

19. Staff Recommendation: The staff recommended that all derivatives on an issuer's own equity instruments be classified as liabilities or assets (Alternative 2). Ms. Switter noted that Alternative 2 is consistent with the basic ownership approach and perpetual approach, which are

the two approaches the Boards agreed to use as a starting point in this project. She also acknowledged that classifying all derivatives as liabilities or assets will require the Boards to consider whether employee stock options accounted for under FASB Statement No. 123 (revised 2004), *Share-Based Payment*, or IFRS 2, *Share-Based Payment*, should be within the scope of the project. She added that the staff will address the issue of employee stock options at a future meeting.

20. Board Vote: All Board members agreed with the staff recommendation.

21. Board Comments: Ms. Seidman stated that the classification of derivatives on an issuer's own equity instruments is the most difficult issue in the project. She added that the problem with Alternative 1 is that classification depends on form of settlement. For example, a share-settled-written call option would be classified as equity and a cash-settled-written call option would be classified as a liability. Both instruments have identical economic profiles (payoffs) but have different classifications based solely on the form of settlement. For that reason, she stated that she believes all derivatives on an issuer's own equity instruments must be classified as either equity or non-equity. She further stated that she would prefer to classify all derivatives on an issuer's own equity instruments as equity; however, she acknowledged that other Board members would probably not support that idea. Ms. Seidman stated that she supported the staff recommendation for simplicity purposes. She also stated that the staff recommendation would require the Board to revise the Conceptual Framework's definition of a liability.

22. Mr. Herz stated that he believes that derivatives on an issuer's own equity instruments should be classified as assets or liabilities. He acknowledged that his decision will have ramifications for presentation and measurement.

23. Ms. Seidman emphasized the importance of separately displaying those derivatives that are cash settled versus those instruments that are not on the balance sheet. Mr. Smith agreed with Ms. Seidman's comment and added that he is concerned that the income statement will be affected by changes in an entity's own stock price. He stated that he also is concerned about the classification of a perpetual preferred share that is convertible into common stock.

24. Ms. Seidman clarified that she agreed with the staff recommendation because it is too complex to create a model that would classify indirect ownership instruments settled with equity instruments as equity (or contra-equity). She added that she believes warrants represent equity

instruments, but for the sake of reducing complexity, she supports the staff recommendation. Mr. Smith suggested that some of Ms. Seidman's concerns can be addressed by enhanced presentation and disclosure requirements. Ms. Seidman agreed.

25. Mr. Herz stated that if the staff's recommendation was not accepted, then the Board would be moving toward an ownership-settlement approach. The other Board members agreed.

ISSUES THAT NEED FURTHER CONSIDERATION

26. Ms. Switter stated that to expedite future deliberations, the staff would like guidance from the Board on the issues described in paragraph 2 of the meeting handout.

Issue 4: Separation of Hybrid Instruments

27. Ms. Switter stated that the Preliminary Views requires an instrument to be separated into equity and non-equity components if it requires payment and, after payment is made, an equity instrument remains outstanding. She added that some Board members also have suggested that other instruments, such as some or all puttable instruments and a bond that grants an option to the holder to convert it into a fixed number of equity instruments, should be separated. Ms. Switter asked the Board if other instruments in addition to those already identified should be considered for separation.

28. **Board Comments:** Mr. Linsmeier stated that he is willing to consider a principle that would result in separating puttable shares. However, he would not separate a bond that grants an option to the holder to convert it into fixed numbers of equity instruments. Mr. Herz agreed with Mr. Linsmeier. Mr. Herz further stated that if an instrument has only one outcome, it should not be separated. Mr. Linsmeier added that he would prefer to limit the number of instruments that require separation.

29. Mr. Siegel stated that he saw no need for the staff to consider additional instruments outside of those the staff identified.

Issue 5: Classification of Redeemable Ownership Instruments

30. Ms. Switter stated that the staff identified three alternatives for the classification of redeemable (either mandatorily or at the option of the holder) ownership interests. Those alternatives include:

- a. Classifying all redeemable ownership instruments as equity
- b. Classifying all redeemable ownership instruments as assets or liabilities
- c. Classifying some specific types of redeemable ownership instruments as equity.

31. She added that classifying some specific types of redeemable ownership instruments as equity is consistent with the requirements in the Preliminary Views and IAS 32, *Financial Instruments: Presentation*. Ms. Switter asked the Board which redeemable instruments, if any, should be classified as equity.

32. **Board Comments:** Mr. Linsmeier stated that classifying some specific types of redeemable ownership instruments as equity will be an exception to the underlying principle of the perpetual approach. He added that making exceptions to the principle will push the Board back to the basic ownership approach. He stated that he no longer agrees with the Board's previous decision to allow an entity to have two classes of basic ownership instruments—both perpetual and redeemable.

33. Mr. Smith asked the staff if the discussion of redeemable ownership instruments was meant to address cooperatives. Ms. Switter stated that the discussion was meant to address the concerns of private companies, member organizations, and other similar businesses. She added that some staff members believe it may be appropriate to develop different classification principles for different types of business entities. Ms. Switter noted that the staff is considering that idea and plans to discuss it with the Board in the future.

34. Mr. Linsmeier suggested that those entities that report under full International Financial Reporting Standards (IFRS) could use the perpetual approach and those entities that report under IFRS for private companies could use the basic ownership approach. He added that including both the perpetual approach principles and basic ownership approach principles in one final Statement could add significantly to the complexity of the guidance.

35. Mr. Golden suggested that the Board adopt the perpetual approach and make a clearly-labeled exception for private companies, cooperatives, and membership organizations. He added that the Board should then explain the reason for the exception; that is, these entities need the redemption feature embodied in their instruments to ensure the liquidity of the instruments and to

restrict ownership of the instruments. Ms. Seidman agreed with Mr. Golden's comments and added that the redemption feature is the only practical way for the entities to transfer ownership.

Issue 6: Classification of Subsidiary Instruments in Consolidation

36. Ms. Switter stated that the staff identified two alternatives for determining how instruments issued by a subsidiary should be classified in the consolidated financial statements. Those alternatives are:

- a. Alternative 1: Carry over classifications from subsidiary financial statements into consolidated financial statements, unless the nature of the instrument changes in consolidation because of arrangements between the instrument holder and another member of the consolidated group.
- b. Alternative 2: Always reconsider classifications of instruments issued by a subsidiary in the consolidated financial statements regardless of how the instruments are classified by the subsidiary.

37. Ms. Switter asked the Board whether the staff had identified all the appropriate classification alternatives. She also asked the Board to share its views on the alternatives.

38. **Board Comments:** Ms. Seidman stated that if the Board uses the principle underlying the perpetual approach, then the issue resolves itself. That is, as long as the nature of the equity instrument remains the same in consolidation as it is at the subsidiary level, then it is still equity. Mr. Linsmeier added that that even if the underlying principle of the basic ownership approach is used, he would choose Alternative 1.

39. Mr. Smith stated that the decision to classify perpetual instruments as equity obviates the need to address the issue of classification of the subsidiary's instruments in consolidation. Ms. Seidman added that the staff would need to analyze the interaction of FASB Statement No. 160, *Noncontrolling Interests in Consolidated Financial Statements*.

Issue 7: Income Statement Presentation

40. Ms. Switter explained that the Preliminary Views did not address income statement presentation issues associated with measuring financial instruments at fair value; however, users have stated that they would like additional disaggregated information about the changes in fair value of financial instruments. She added that for financial instruments classified as liabilities,

almost all users that the FASB and the IASB have received input from would like interest expense for non-derivative instruments and changes in the value of derivatives related to an entity's share price separately displayed. Some users also suggested that the change in fair value of a financial instrument related to an entity's own credit risk be separately displayed. Ms. Switter asked the Board if separate presentation should be required of (a) interest expense for all non-derivative instruments classified as liabilities and (b) changes in the fair value of equity derivatives classified as liabilities. Mr. Lott asked the Board what other issues related to financial statement presentation, if any, should be analyzed.

41. **Board Comments:** Mr. Linsmeier stated that there needs to be consideration of whether to separately record a current period cost of capital expense (for all liabilities, not just non-derivatives) separately from all other changes. He added that he would like to ask users if they want the same disaggregation that will be presented on the balance sheet (the separate presentation of a liability that is settled in assets versus a liability that is settled in shares) for the income statement as well. He stated that some users have noted that they would like to see such a presentation. Mr. Linsmeier questioned whether users viewed all components of an entity's cost of capital the same.

42. Mr. Siegel agreed that Mr. Linsmeier's question is important. He added that users would like to see separately displayed the changes in fair value that are reflective of (a) changes in an entity's own credit risk and (b) changes in an entity's stock price. Mr. Linsmeier stated that he would be willing to consider requiring the disclosure of changes in fair value that are reflective of changes in an entity's own credit risk, but that he would not present those changes on the face of the financial statements because there is uncertainty as to how to measure the portion of the total fair value change of a financial instrument that is attributable to changes in an entity's own credit risk (for example, a warrant). Mr. Linsmeier added that some people would assert that credit risk is separate from liquidity risk but that in today's environment liquidity risk and credit risk are intertwined.

43. Mr. Golden asked Mr. Linsmeier if he would like the income statement disaggregated by instrument or by nature of the fair value change related to the instrument. Mr. Linsmeier stated that he would separate the current period cost of capital for an instrument from all other effects. He added that the balance sheet would be disaggregated by class of instrument.

44. Ms. Seidman questioned why an entity that enters into a derivative transaction would have to separate out a current period cost of capital charge, whereas an entity that finances itself in some other way would not have to do the same because it is not required by current generally accepted accounting principles. Mr. Linsmeier stated that there appears to be a desire for presentation of a current measure of cost of capital for both interest and liabilities settled in stock.

45. Ms. Switter noted that the presentation issues associated with financial instruments have implications outside of the project. Mr. Herz agreed and added that in addition to those presentation issues, other general issues should be addressed separately from this project.

46. Mr. Linsmeier stated that this project should focus on income statement presentation issues because constituents are concerned about how the Board's classification decisions will impact the income statement. That is, constituents are concerned with what changes in fair value due to changes in an entity's credit risk and other factors will flow through the income statement.

47. Ms. Seidman stated that she did not want to require disclosure of interest expense that effectively requires bifurcation to properly calculate the amount of the expense. She noted that one objective of this project is to simplify the financial instruments guidance. She added that at a minimum, the Board should require the presentation of flows, and that's what investors have expressed their desire to see. Mr. Herz added that users do not want fair value interest. Mr. Linsmeier added that flows (interest expense) should be captured in the income statement and that the Board will need to consider how to handle other changes in fair value that are not a flow. Ms. Smith stated that users would prefer to see interest expense or an equivalent notion presented on the face of the financial statements.

48. Ms. Seidman emphasized the need for the staff to consider the interaction of this project with the financial statement presentation project, especially with regard to the proposed required reconciliation.

Follow-up Items:

None.

General Announcements:

None.