IASB/FASB Meeting March, 11 2010
FASB Education Session March 10, 2010

IASB agenda reference	**2A**
FASB memo reference	**90**

Project	**Financial instruments with characteristics of equity**
Topic	**Statement of Stockholders Equity**

Introduction

The attached paper was issued for the December meeting but not discussed due to lack of time. No changes have been made.

This paper has been prepared by the technical staff of the FASB and the IASCF for discussion at a public meeting of the FASB or the IASB.

The views expressed in this paper are those of the staff preparing the paper. They do not purport to represent the views of any individual members of the FASB or the IASB.

Comments made in relation to the application of IFRSs or U.S. GAAP do not purport to be acceptable or unacceptable application of IFRSs or U.S. GAAP.

The tentative decisions made by the FASB or the IASB at public meetings are reported in FASB *Action Alert* or in IASB *Update*. Official pronouncements of the FASB or the IASB are published only after each board has completed its full due process, including appropriate public consultation and formal voting procedures.

IASB/FASB Meeting
December 2009

IASB agenda reference	**5D**
FASB memo reference	**76**

Contact(s)	**Jill Switter**	jmswitter@fasb.org	+1 203 956 5341
	Ron Lott	rwlott@fasb.org	+1 203 956 5371

Project	**Financial instruments with characteristics of equity**
Topic	**Statement of Stockholders Equity**

Introduction

1. This paper suggests possible additions to the statement of stockholders' equity related to dilution of shareholders' interests caused by derivatives classified as equity. It was prepared in response to a Board member who supported Approach 4.1 on the condition that this information be provided.

Example Illustrating the Issue

2. The following example illustrates the issue:

   > An entity issues a written call option for 100,000 shares of common stock for a premium of CU350,000. The option, which expires at the end of the period, has an exercise price of CU40 per share. The option has a fair value of CU450,000 on the expiration date and is exercised at that time.

3. Table 1 illustrates the accounting.

Table 1—Accounting for a Physically Settled Written Option

	Approach 4.1	**Approach 4**
Record issuance of option	DR Cash CU350,000 CR Equity CU350,000	DR Cash CU350,000 CR Liability CU350,000
Remeasure option at fair value	N/A	DR Expense CU100,000 CR Liability CU100,000
Record exercise of option (12/31/X1)	DRCash CU4,000,000 DR Equity CU350,000 CR Stock CU4,350,000	DR Cash CU4,000,000 DR Liability CU450,000 CR Stock CU4,450,000

4. The CU 4,350,000 recorded in equity under Approach 4.1 does not represent the current market price of the shares issued to the option holder. In contrast, the amount recorded under Approach 4 represents the current market price at which the shares could have been issued if the option had not existed. In effect, the CU100,000 expense under Approach 4 represents dilution of the existing shareholders' interests. That information is not reported under Approach 4.1.

5. We have identified two alternatives to address this issue under Approach 4.1:

   (a) **Alternative 1**—Require that the difference between the fair value of the shares on the exercise date and the book value of the equity instrument (option) at that date be displayed as a transfer between the two instruments in the statement of changes in equity.

   (b) **Alternative 2**—Require that the newly issued shares be measured at the fair value on the exercise date. The difference between the fair value of the newly issued common share and the exercise price plus the book value of the option could be reported in either of the following ways, neither of which would affect comprehensive income:

      (i) As a direct reduction of retained earnings

      (ii) As a debit to a separate equity account.

Alternative 1—Revise the Statement of Changes in Equity

6. Alternative 1 would not modify the entries in Table 1. It would display the CU100,000 difference between the book value of the option and the fair value of the shares issued as a transfer between the option and the shares. Using the example in Table 1, the statement of stockholders' equity would be displayed as it is in Table 2:

Table 2—Statement of Changes in Equity Ignoring any other Changes in Equity (Alternative 1)

	Common Stock	*Option*	*Retained Earnings*	*Accumulated Other Comprehensive Income*	*Total Shareholders Equity*
Balance at beginning of period	**10,000,000**				**10,000,000**
Issuance of option		350,000			350,000
Exercise of option	4,450,000	(450,000)			4,000,000
Transfer of Wealth	(100,000)	100,000			0
Balance at end of period	**14,350,000**	**0**			**14,350,000**

Alternative 2—Adjust Common Shares to Fair Value

7. The second alternative is to require that newly issued common shares be measured at their fair value at the issuance date. The difference between the book value of the option and the fair value of the newly issued common shares could be reported in one of two ways:

   (a) As a direct reduction of retained earnings (Alternative 2(a)); or

   (b) As an adjustment to a separate equity account (Alternative 2(b)).

Alternative 2(a)—Direct Reduction of Retained Earnings and 2(b) as an Adjustment to a Separate Equity Account

8. If the Boards decide to make an adjustment to retained earnings, the exercise date journal entry in Table 1 for Approach 4.1 would be revised as follows:

DR Cash	CU 4,000,000	
DR Equity	CU 350,000	
DR Retained Earnings (2a) or Other Equity (2b)		CU 100,000
CR Common Stock		CU 4,450,000

9. The CU 4,450,000 credit to common stock represents the fair value of the stock issued. The debit of CU100,000 to retained earnings or other equity represents the difference between the fair value of instruments issued and the book value of the option plus the cash received. The CU100,000 would not be included in an earnings-per-share (EPS) calculation if it is recorded directly in retained earnings

or in other equity.[1] The statement of shareholders' equity would be presented as it is in Table 3:

Table 3—Statement of Changes in Equity Ignoring Any Other Changes in Equity

	Common Stock	*Option*	*Retained Earnings (2(a)) or Separate Equity Account (2(b))*	*Total Shareholders Equity*
Balance at beginning of period	**10,000,000**			**10,000,000**
Issuance of option		350,000		350,000
Exercise of option	4,350,000	(350,000)		4,000,000
Adjustment to record at fair value	100,000		(100,000)	0
Balance at end of period	**14,450,000**	**0**	**(100,000)**	**14,350,000**

10. The following entry would be added to the Approach 4.1 column in Table 1:

DR Retained Earnings (2a) or Other Equity (2b) CU100,000
CR Stock CU100,000

Staff Analysis

11. All of the alternatives presented would provide users with additional information under Approach 4.1. Either version of Alternative 2 reports the shares issued at fair value, which we believe more accurately reflects the economics of the transaction. However, we think Alternative 1 is more consistent with the underlying principles of Approach 4.1. Under Alternative 1, the exercise, conversion, or settlement of an equity instrument represents a transfer of wealth from one group of owners to another rather than a transaction in which the entity received additional equity.

12. Some may view the alternatives presented in this paper as a way to "bridge the gap" between that approach and Approach 4, as well as attract additional support. Each of the alternatives provides the same information as Approach 4 about the fair value of the common shares issued, but in different ways.

[1] The CU100,000 would have been recorded in the income statement and included in EPS over the life of the option under Approach 4.

13. Neither alternative would result in reporting the dilutive effects of the option at reporting dates between the issuance and exercise dates as would Approach 4. (The example in this paper has been deliberately oversimplified and does not show any reporting dates between issuance and exercise; however, many if not most options would remain outstanding for more than one period, and no adjustments in the statement of shareholders' equity would appear at those dates.) Nor is the dilutive effect ever reported in comprehensive income. Additional information about the changes in the option's fair value throughout its life would need to be provided in footnotes to completely reconcile the two approaches. That would increase the burden on the issuer and cause one to wonder whether such disclosure would be an adequate substitute for measurement at fair value.

Convertible Debt

14. At the December meeting, we will ask the Boards how they want to classify convertible debt. (The issue is addressed in Agenda Paper 5A/Memo 73). One possible outcome of that discussion is that the Boards may want to consider separating the instrument into a liability and equity component. The liability component would be measured at amortized cost and the equity component would not be remeasured. That outcome would raise additional issues for the Boards to address, such as:

    (a) What does the adjustment to stockholders' equity represent?

    (b) What if the convertible debt is out-of-the money and settled with cash? We are not sure how to record the difference between the cash paid upon settlement and the book value of the instrument. None of the alternatives described in this paper will address that issue.

15. The first issue is illustrated in the following example:

	If convertible debt is separated under Approach 4.1	**If convertible debt is reported as a single liability and measured at fair value**
At inception (1/1/X1)	DR Cash CU953,000 CR Liability CU862,000 CR Equity CU91,000	DR Cash CU953,000 CR Liability CU953,000
At end of Year 1 (12/31/X1)	DR Expense CU138,000 CR Liability CU138,000	DR Expense CU147,000 CR Liability CU147,000

Upon exercise (1/1/X2)	DR Liability CU1,000,000 DR Equity CU91,000 CR Stock CU1,091,000	DR Liability CU1,100,000 CR Stock CU1,100,000

16. The book value of the instrument will never equal the market price of the shares issued on the conversion date, except by coincidence. In the above example, the book value of the convertible bond at settlement is CU 1,091,000 and the fair value of the shares issued is CU 1,100,000. The reporting entity issued shares worth more than the book value of the bond. Under Alternatives 2(a) and 2(b), the last journal entry would be revised as follows:

DR Liability CU1,000,000
DR Equity CU91,000
DR Retained Earnings
(or Other Equity) CU9,000
CR Common Stock CU1,100,000

17. The CU9,000 debit to retained earnings (or other equity) in this example does not represent the change in the bond's fair value as the CU 100,000 in Tables 2 and 3 does for the option. Interest has been accreted on the liability component of the bond and has already been reported in comprehensive income. The CU9,000 can be viewed as a loss that should be included in earnings and in the EPS calculation.

Additional Supplemental Schedules

18. One Board member suggested that a public entity should be required to present a statement of capitalization at fair value. The additional statement would show the beginning balance plus issuances less repurchases or expirations plus (or minus) changes in fair value for financing liabilities. (A copy of this statement is provided in Appendix A.) That Board member also suggested that the statement of capitalization should be supplemented by a separate schedule that discloses all of the entity's outstanding equity derivatives, exercise prices, and settlement terms.

19. We will provide a more through analysis of the suggested supplemental schedules at a later date.

Questions for the Boards

Q1. Should the difference between the book value of the option and the fair value of the newly issued common share as:

Alternative 1—a transfer of wealth

Alternative 2(a)—a direct adjustment of retained earnings

Alternative 2(b)—an adjustment to a separate equity account

Alternative 3—the difference should not be reported at all.

Q2. If the Boards choose Alternative 3, how should the issue of the difference not being reported be resolved?

Appendix A

	Fair Value Beginning of the Year	Issuances	Repurchases/ Expirations	Changes in Fair Value	Fair Value End of Year
Non-Redeemable Capital					
Common Stock					
Preferred Stock					
Written Call Options					
Subtotal					
Contingently Redeemable Capital					
Preferred Stock					
Convertible Debt					
Subtotal					
Redeemable Capital					
Preferred Stock					
Long Term Debt					
Subtotal					
Total Capitalization (at fair value)					