Issue Highlights

FASB Addresses Issues Related to the Classification of Compound Financial Instruments That Have Characteristics of Liabilities and Equity

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In October 2000, the FASB issued an Exposure Draft, *Accounting for Financial Instruments with Characteristics of Liabilities, Equity, or Both,* which, as the title suggests, would establish standards for accounting for such financial instruments. In general, the Exposure Draft focuses on requirements to be used in determining the classification of financial instrument components as liabilities or equity. The requirements are based on a revised definition of liabilities that would result in a liability classification for certain obligations to issue equity shares that do not establish an ownership relationship. Without the revised definition of liabilities, all financial instrument components embodying obligations that could potentially be settled by the issuance of equity shares would be classified as equity. However, the Board concluded that obligations should not be classified as equity unless they establish an ownership relationship.

The notion of ownership relationship in the Exposure Draft is based on the distinguishing characteristic of equity in paragraph 51 of FASB Concepts Statement No. 6, *Elements of Financial Statements*, that owners invest in a business with the expectation of benefiting by obtaining a return on their investment if the enterprise is profitable but bear the risk that the enterprise may be unprofitable.

The Exposure Draft would also provide guidance on (1) accounting for costs incurred to issue a financial instrument that has liability or equity characteristics, (2) accounting for repayments and conversions of convertible debt, and (3) certain issues related to accounting for the noncontrolling interest in a consolidated subsidiary.

Need for Project

With the increasing complexity of financial instruments, the current classification in the statement of financial position of instruments that contain both liability and equity characteristics sometimes results in a lack of representational faithfulness. For example, the equity component of convertible debt is presented as a liability. This project would provide a clearer approach for distinguishing between the liability and equity components of financial instruments. In addition, other standard setters have addressed the issue of accounting for financial instruments with characteristics of liabilities and equity. The Board believes that the proposals in the Exposure Draft would enhance convergence with the accounting standards used in other nations.

Relationship to Concepts Statement

In determining the appropriate classification for components of financial instruments, the Board first considered the definition of liabilities in FASB Concepts Statement No. 6, *Elements of Financial Statements.*

Liabilities are probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events.

Obligations that require (or permit at the issuer's discretion) settlement by issuance of the issuer's equity shares do not meet the above definition of liabilities because the shares are not assets to the entity. But some of those instruments, such as those in which the value rather than the number of the shares to be issued is fixed do not establish an "ownership relationship" between the issuer and the holder. Thus, this project also proposes an amendment to the definition of liabilities in an FASB Exposure Draft, *Proposed Amendment to FASB Concepts Statement No. 6 to Revise the Definition of Liabilities.* That proposal would change the definition of liabilities such that certain obligations to issue equity shares that do not establish an ownership relationship would be considered liabilities.

Fundamental Principles Underlying the Proposed Statement

The following fundamental principles underlie the requirements of the Exposure Draft.

1. A financial instrument component that does not impose an obligation on the issuer should not be classified as a liability.
2. A financial instrument component that imposes an obligation on the issuer should be classified based on the nature of the relationship it establishes between the holder and the issuer.
3. An equity instrument that is issued by a less-than-wholly-owned subsidiary to an entity outside the consolidated group (noncontrolling equity interest in the subsidiary) should be reported in the consolidated financial statements as a separate component of equity.

The Exposure Draft would require that the issuer of a financial instrument that contains one or more components that, if freestanding, would be classified as equity and one or more components that, if freestanding, would be classified as liabilities identify and report those components separately. The fundamental basis for determining whether a financial instrument

component should be classified as a liability or as equity is the nature of the relationship that the component establishes between the issuer and the holder. The following three aspects distinguish liability components from equity components:

a. The existence (or lack) of a present obligation to one or more other entities
b. Whether a reporting entity must settle the obligation by a transfer of assets or has the discretion to settle by an issuance of equity shares
c. If settlement of the obligation involves the issuance of the issuer's own equity shares, the risks and benefits associated with the value of the holder's investment in the issuer.

One of the requirements for liability classification under the approach in the Exposure Draft is that a component embody a present obligation. That requirement is consistent with the original definition of liabilities in Concepts Statement 6 and, therefore, does not represent a change. The primary proposed change relates to obligations that do not require a transfer of the entity's assets. Concepts Statement 6 requires that if a component is to be classified as a liability, the present obligation must entail settlement by "probable future transfer or use of assets." The approach in the Exposure Draft places less emphasis on form of settlement and looks to the definition and description of equity in Concepts Statement 6 to assist in determining classification.

Obligations that settle with equity were classified as equity under the original definition in Concepts Statement 6. However, the Board concluded that those obligations should not be classified as equity unless they expose the holder to risks and benefits that are similar to those to which an owner is exposed. The notion of monetary value was developed to assist in determining whether the risks of changes in fair value of the issuer's equity shares to which the holder is exposed are similar to those to which a holder of outstanding equity shares is exposed. Monetary value is the amount of value that the issuer would have to convey to the holder at maturity under the contractual terms of the obligation presuming the fair value of the issuer's equity shares does not change. If changes in the monetary value of an obligation are caused by, equal to, and in the same direction as changes in the fair value of the issuer's equity shares throughout the period the obligation is outstanding, the holder of the component is exposed to risks and benefits that are similar to those to which a holder of that number of outstanding equity shares (an owner) is exposed. If that is the case, the component establishes an ownership relationship and the component should be classified as equity.

For example, consider a holder of an obligation that requires settlement by issuance of 1,000 equity shares. If the current fair value of the shares is $20, the monetary value of the obligation is $20,000. If the change in fair value of the shares increases to $21, the monetary value increases to $21,000. The holder of the financial instrument is exposed to similar risks of changes in fair value as is the holder of the equity shares, and thus, an ownership relationship is established and the instrument would be classified as equity.

The Exposure Draft requires that the noncontrolling interest in a consolidated subsidiary be reported in the consolidated financial statements as equity. That requirement would be a change from current practice in which noncontrolling interests are reported as a separate item between the liabilities section and the equity section of the consolidated balance sheet. The Board noted that displaying the noncontrolling interest as a liability has no conceptual support because it does not meet the definition of a liability under Concepts Statement 6. None of the entities involved have an obligation, and the noncontrolling interest thus lacks a fundamental characteristic of a liability. The Board rejected maintaining the current practice of reporting the noncontrolling interests as a separate item between the liabilities section and the equity section because it saw no compelling reasons to create a new element of financial statements to report the interests of noncontrolling stockholders in subsidiaries.

Consistent with the decision that noncontrolling interests are equity of the consolidated group, the Board also concluded that sales of subsidiary shares are sales of the consolidated entity's equity and should not result in gain or loss recognition as long as the subsidiary remains consolidated. If a sale of shares results in the subsidiary's no longer being consolidated, the transaction is no longer a transaction in the entity's own equity and the sale could result in gain or loss recognition.

Application to Specific Instruments

The following outlines application of the basic principles of the Exposure Draft to specific instruments.

Common Stock

Because the shares convey an ownership interest to the holder and do not embody an obligation on the part of the issuer, common stock is classified as equity.

Preferred Stock That Is Mandatorily Redeemable

That instrument embodies an obligation to transfer assets to the holder to redeem the shares at a specified price and time. The instrument is, therefore, classified as a liability.

Preferred Stock That Is Mandatorily Convertible into a Fixed Number of Common Shares

That instrument embodies an obligation that must be settled by issuance of a fixed number of common shares, so the holder is exposed to the risks of changes in the fair value of the issuer's equity shares. The instrument is therefore classified as equity.

Preferred Stock That Is Mandatorily Convertible into Common Shares Worth a Fixed Dollar Amount

That instrument embodies an obligation that must be settled by issuance of common shares equal to a fixed dollar amount. The monetary value of that obligation is fixed, so the holders of the preferred shares are not exposed to the risks of changes in the fair value of the issuer's equity and will receive shares worth a fixed amount at the date of conversion regardless of changes in

the fair value of the common shares. Therefore, the instrument is classified as a liability. Classifying the instrument as a liability under this Exposure Draft represents a change from its current classification as equity.

Convertible Debt

The basic convertible debt instrument contains (a) an obligation to repay principal, (b) an obligation to make periodic interest payments, and (c) an obligation to issue a fixed number of equity shares if the conversion is exercised. The first two obligations require settlement by a transfer of assets and do not meet the criteria for equity classification, so are classified as a liability. The third obligation requires settlement by issuance of a fixed number of equity shares and is classified as equity. The amounts allocated to the liability component and the equity component are based on their relative fair values at issuance.

Callable Convertible Debt

Under the approach in the Exposure Draft, the call option in callable convertible debt is not treated as a separate component. The instrument would consist of (a) a callable obligation to repay principal, (b) an obligation to make periodic interest payments, and (c) a callable conversion option exercisable by the holder. The amount allocated to the conversion option is recorded as equity and the amount allocated to the callable debt is recorded as a liability.

The comment deadline for the Exposure Draft is April 30, 2001. Field visits will be conducted with participants who agreed to apply the general guidance in the Exposure Draft to complex financial instruments containing characteristics of liabilities and equity. Redeliberations of the issues contained in the Exposure Draft are scheduled to begin after July 1, 2001.