



## LIABILITIES AND EQUITY

Financial Accounting Standards Advisory Council  
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### Introduction

The Board has been studying for some years how to distinguish financial instruments that increase equity from liabilities (and financial instruments that reduce equity from assets.) After issuing Exposure Drafts of a proposed Statement to resolve those issues and a proposed revision to FASB Concepts Statement No. 6, *Elements of Financial Statements*, and considering responses from constituents, the Board encountered certain difficulties. The Board decided to issue FASB Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*, in 2003 as an interim measure to resolve certain issues pertaining to *freestanding* financial instruments. The Board is now working to revise Concepts Statement 6 and resolve the remaining liability and equity issues in a new Statement.

### Concepts

Some of the issues in this project raise questions about the conceptual definitions of liabilities:

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. [Paragraph 35; footnote references omitted, *emphasis* added to the two aspects of the definition discussed later in this paper.]

and of equity:

Equity is the *residual* interest in the assets of an entity that remains after deducting its liabilities.

Note: These materials are provided to facilitate understanding of the issues to be addressed at the June 22, 2004 FASAC meeting. These materials are presented for discussion purposes only; they are not intended to reflect the views of the FASB or its staff. Official positions of the FASB are determined only after extensive due process and deliberations.

In a business enterprise, *equity is the ownership interest*.  
 [Paragraphs 49 and 60; footnote reference omitted, *emphasis*  
 added.]

In Statement 150, the Board applied those definitions to require liability treatment for mandatorily redeemable shares and forward purchase contracts and written put options on the issuer's equity shares. Statement 150 also requires that certain obligations to issue a variable number of shares, the value of which (a) equals a fixed monetary amount known at inception, (b) varies based on changes in something other than the fair value of the issuer's equity shares, or (c) varies inversely with the fair value of the issuer's equity shares, should be accounted for as liabilities. The latter requirement conflicts with the definition of liabilities because that definition is restricted to obligations to *transfer assets or provide services*. That definition excludes all obligations to issue shares because an entity's own shares are not assets to that entity.

The Board is planning to amend Concepts Statement 6 to resolve that conflict. The Board has considered introducing into the definition of liabilities the concept of *ownership relationship*. Although the Board has not debated how that concept might be introduced, one possibility is to alter the definition as follows:

. . . liabilities are present obligations of a particular entity to transfer assets, *issue equity instruments that do not convey an ownership relationship*, or provide services to other entities . . . .

and to provide the following explanation of ownership relationship:

an obligation to issue equity instruments is a probable future sacrifice—and therefore can be a liability—if it does not convey an ownership relationship. Such an obligation conveys an ownership relationship if and to the extent that, through that obligation, the other party benefits from increases and suffers from decreases in the fair value of the issuer's equity instruments.

The result would be a definition of liability that continues to include instruments that require a transfer of assets and also adds instruments that do not convey an ownership relationship even though they do not require a transfer of assets. That change to the definition of liabilities would have several consequences. For example, shares of privately held entities that must be redeemed for cash equal

to fair value upon the shareholder's retirement or death would be classified as liabilities (because they will require a transfer of assets), even though they convey an ownership relationship. As a second example, a warrant (call option written) on the entity's own shares is viewed as conveying an ownership relationship; that instrument would be classified as a liability if it must be net-cash-settled but as equity if it can be settled in shares. Finally, some have criticized the introduction of lack of ownership relationship into the liability definition as a backhanded way of explicitly defining equity and therefore leaving liabilities as the residual, changing the fundamental accounting equation from  $A - L = E$  to  $A - E = L$ .

The Board has also considered defining liabilities in terms of a lack of ownership relationship, rather than simply adding this characteristic to the existing definition. Under this approach, an obligation to transfer assets would not, in and of itself, be part of the definition of a liability. Rather, the definition of a liability would encompass obligations to transfer assets that do not constitute an ownership relationship. That might be accomplished by saying:

. . . present obligations of a particular entity to transfer assets, *issue equity instruments*, or provide services to other entities *that do not convey an ownership relationship to those entities* . . .

That change would make lack of ownership relationship a *necessary* condition for an obligation to be a liability. Therefore, ownership relationship instruments that require a transfer of assets, for example, shares that must be redeemed for fair value and net-cash-settled warrants, would be classified as equity, not liabilities.

The Board has also discussed defining equity strictly in terms of ownership relationship. This could be accomplished by removing the requirement for a *present obligation* to transfer assets, issue instruments, or provide services if a contract results in a probable future sacrifice of assets and fails to convey an ownership relationship. For example, the probability-weighted present value of the cash an entity might pay out if it exercised a purchased call option to buy

back its own shares would be classified as a liability under this definition, even though the entity has no present obligation to transfer assets. The reasons why that surprising possibility might be worth considering are discussed in the next section of this paper. If that change were made, an analogous surprising change might have to be made to the definition of assets.

### **Compound Instruments Issues**

The other major set of issues in the liabilities and equity project concerns the treatment of compound instruments that have both debt and equity characteristics. The most familiar of these are convertible bonds, but there are many others, including bonds with detachable warrants, puttable stock, prepaid put options written,<sup>1</sup> and variable share forward contracts.<sup>2</sup> Their common characteristic is that if the issuer's shares go in one direction, the outcome for the holder is an equity-like return; if the shares go in the other direction, the outcome is a debt-like return. For example, if the issuer's shares increase in value, the holder of a convertible debenture will convert and receive an equity-like return and, conversely, if the issuer's share price declines, the holder will receive a debt-like return.

Under current GAAP, some of those compound instruments are accounted for entirely as liabilities, some are accounted for as "temporary equity" reported in the "mezzanine" between liabilities and equity, some are accounted for entirely as equity, and some containing embedded derivatives are bifurcated, divided between liabilities and equity. For some of the instruments, the potential equity impact is reflected in diluted earnings per share (EPS), but for others, it is not.

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<sup>1</sup> A prepaid put option is an option written by the issuer of the shares that allows the counterparty to put those shares back to the issuer at a fixed strike price. However, the strike price less the option premium is paid by the issuer at inception of the contract. At the settlement date, if the stock price is at or below the strike price, the option will be exercised and the issuer will receive shares. If the stock price is above the strike price, the option will not be exercised and the issuer will receive cash equal to the strike price.

<sup>2</sup> A variable share forward contract is a contract to issue a variable number of shares to a counterparty at a fixed total price; the number of shares varies depending on the stock price at settlement. Typically, in a specified mid-range of stated stock prices the issuer will deliver sufficient shares so that the total fair value equals the contract price. If the stock price ends up below that mid-range, the issuer will deliver 1 share; above that mid-range, the issuer will deliver .8 shares.

Many investors, creditors, accountants, and regulators have long agreed that those disparities in accounting are undesirable. But they do not agree about how to correct the disparities.

The FASB proposed in its 2000 Exposure Draft to require compound instruments to be separated into their liability and equity components, generally using a relative-fair-value method to allocate the components. That proposal was much like the requirements of IAS 32 for convertible bonds, which have been effective internationally for almost 10 years. Nonetheless, it generated considerable controversy among FASB constituents, both about the mechanics of the proposed method and about the perceived consequences of that change in financial reporting.

The Board has been considering several alternatives for separating compound instruments into components:

- A **fundamental components approach**, which would identify basic simple financial instruments (for example, shares, cash payment requirements, options written and held, and forward contracts) and decompose compound instruments into their various basic instrument components.
- The **IAS 32 approach**, reflecting recent IASB revisions that call for a “with-and-without” method to take the place of the relative-fair-value method to allocate compound instruments such as convertible debt into components.
- A **pure equity approach** that would restrict equity classification to a small group of instruments (perhaps only common shares and partnership interests) and require that all other instruments be entirely classified as liabilities.
- An **expected outcomes approach** that would initially allocate the proceeds of convertible bonds and other compound securities in proportion to the probability-weighted expected values of liability and

equity outcomes, an approach grounded in the expected cash flows method discussed in FASB Concepts Statement No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements*, and in modern option-pricing and contingent claims theory.

Each of those approaches has perceived drawbacks that may outweigh its advantages. Identifying fundamental components is difficult, and there appear to be several different ways of analyzing many compound instruments into fundamental components with considerably different accounting consequences. The IAS 32 approach reports a large debt component and a small equity component even for instruments with nearly equal chances of being converted or having to be repaid in cash, resulting in a major change in reported financial position and EPS upon a conversion that might have been highly likely for years. The pure equity approach requires distinguishing among instruments that closely resemble “ordinary” common shares but have some (perhaps small) difference that arguably makes them entirely liabilities, for example, tracking stock, nonvoting shares, shares puttable at a very high price, perpetual preferred shares, and warrants to buy common shares for one penny. The pure equity approach would continue to report unrealistic interest expense for, and require extensive procedures to reflect in EPS the potential dilution from, those liabilities. The expected outcomes approach might result in a meaningful initial allocation, but that initial allocation would soon become obsolete as share prices rose to make conversion highly likely or fell to make conversion most unlikely.

Some constituents pointed out that all of these approaches, like current GAAP, result in sharply dissimilar accounting for certain instruments that, while differing in form, have almost identical economic results. Those constituents noted that financial markets are well aware of those differences and respond by offering instruments tailored to produce similar economic results and “better” accounting for the issuer than other instruments. They suggested that the Board consider an accounting approach, derived from the approaches used by sophisticated market

participants to price complex securities, that has come to be called the Reassessed Expected Outcomes (REO) approach.

The REO approach begins in the same way as the expected outcomes approach previously described, with an initial assessment of expected outcomes, using option-pricing tools such as the Black-Scholes-Merton equations or binomial lattice procedures, suitably adapted to the particular type of instrument. An instrument's initial proceeds would be allocated to liabilities (or assets) and equity based on the probability-weighted present values of the possible debt repayment or equity issuance outcomes. For a typical zero-coupon 2 percent 5-year convertible bond issued for \$920, the initial calculations might allocate \$430 to liability and \$490 to equity. For EPS, the "delta" or equivalent number of shares would be added to the denominator to reflect the dilution; for a typical convertible, the initial delta might be around half of the shares into which the bond might be converted. Subsequently, the initial allocation of the proceeds would be reassessed reflecting changes in share prices, time remaining, and possibly changes in other important factors and appropriate reclassifications made from liability to equity or the reverse. Each reassessment would reallocate the proceeds (in this example, \$920) between debt and equity, reflecting changes in the probability of settling as debt versus the probability of settling as equity.

The constituents who proposed the REO approach illustrated how it would work for economically near-equivalent convertible bonds, puttable shares, and written calls issued separately from debt, all of which involve an issuer receiving money from an investor and end up with the issuer either keeping the money and leaving the investor with shares if share price goes up sufficiently or repaying the money with interest if the share price drops or does not go up sufficiently. Additionally, they noted that the REO approach is not affected by the form of settlement for financial instruments, focusing only on whether the payoff to the counterparty is similar to, the opposite of, or unrelated to an ownership interest. They demonstrated that the REO approach would result in comparable balance

sheets and EPS results and realistic interest expense for all those instruments. They also demonstrated that as share prices changed over the term of the instrument, the accounting and EPS reported before the conversion, redemption, exercise, or repayment event would gradually converge toward the accounting and EPS that would be reported after that event. No other method the Board has considered has those effects of comparable reporting for equity-linked instruments of different form but similar economic effects. Furthermore, the REO approach would resolve the linkage, classification, initial allocation, subsequent measurement, and EPS issues in a single procedure and set of calculations. Board members initially were intrigued by the possibilities of the REO approach.

However, the results promised by the REO approach would be fully comparable only if the approach is also applied to other types of equity-linked instruments. Further, the fact that the REO approach disregards form of settlement and does not require an obligating event as a part of the definition of liabilities or control as a part of the definition of assets creates accounting results that some find disturbing. For example, some instruments allow the entity to acquire its own shares by paying cash; an example is a purchased call option on the entity's own shares. The REO approach would result in an increase in equity for the probability-weighted value of the shares that would be acquired (if the option is in the money to the entity) and a liability for the probability-weighted present value of the amount that would be paid to acquire the shares. However, the entity has no present obligation to transfer assets because the entity has discretion to avoid the future sacrifice by not exercising its option. As another example, some instruments will result in either (a) the investor paying money to the issuer later, in exchange for shares, if share prices go up sufficiently or (b) no exchange occurring if share prices do not increase sufficiently; examples include warrants or written call options. For those instruments, the REO approach would result in an increase in equity for the probability-weighted value of the shares that would be issued and an asset for the probability-weighted present value of the amount that would be received if the option ends up "in-the-money." An option written for

a premium of, say, \$130 might result in an increase in reported equity of \$480 and an asset of \$350. While those results would mirror the two terms of the Black-Scholes-Merton equations for pricing put options and call options, they are very different from present accounting and not in keeping with the present definitions of assets and liabilities. As discussed previously, application of the REO approach would require dramatic changes in asset and liability definitions. With regard to liabilities, the result would be that instruments that convey an ownership relationship but require a transfer of assets, for example, shares that must be redeemed for fair value and net-cash-settled warrants, would be classified as equity, not liabilities.

After considering the REO approach, the Board tentatively decided not to apply the approach broadly (and, therefore, to not amend the definitions of assets and liabilities to conform). Upon further consideration, the Board decided to retain more traditional methods for classifying and accounting for simple equity-linked instruments and consider the REO approach, along with the fundamental components, IAS 32, and pure equity approaches for accounting for compound instruments. That decision will still require changes to conceptual definitions, potential separation of compound instruments into liability and equity components, and possible linkage of apparently separate instruments.

**Questions for Council members:**

1. Are the changes the Board is considering in the definitions of liabilities and perhaps assets steps in the right direction? If so, how drastic should those changes be?
2. How important is comparable financial reporting for instruments with different form but very similar economic effects?
3. How important is retaining the following elements of the definitions of assets and liabilities:
  - a. Control, in the definition of assets

- b. Required transfer or use of assets, in the definition of liabilities.
4. Should the Board work toward separating convertible bonds, puttable shares, and other compound equity-linked instruments into liability and equity components? Alternatively, is the pure equity approach a better way of accounting for those instruments? If compound instruments are not separated into liability and equity, what improvements in the accounting and reporting for those instruments are needed?
  5. If the Board decides to separate compound instruments into components, which approach sounds most promising and why?