



## LIABILITIES AND EQUITY

Financial Accounting Standards Advisory Council

December 2004

### Introduction

The Board has been considering approaches for distinguishing liabilities from equity for single component instruments before it tackles classification and measurement issues for complex instruments. The Board has tentatively chosen an approach that combines two principles: (1) the relationship between the issuer and the counterparty that is established by an instrument (ownership relationship) and (2) the issuer's settlement obligation. The following is a description of that approach.

### Ownership/Settlement Approach in Distinguishing Liabilities from Equity for Single-Component Instruments

The Board has decided that a single-component instrument is classified as a liability or equity as follows (words in *italics* are defined as described below):

1. An instrument that does not embody a *settlement obligation* is equity (unless it is an asset). An example is a share (common or preferred) that is not subject to redemption requirements.
2. An instrument that establishes a *direct ownership relationship* between the issuer and the holder is equity, even if it embodies a settlement obligation. An example is a common share that is mandatorily redeemable at its proportionate share of an entity's fair value.
3. An instrument that establishes an *indirect ownership relationship* that would be settled or ultimately settled by issuing an instrument that establishes a direct ownership relationship is equity (such as a physically settled written call option). Otherwise, the instrument is a liability (such as a net cash-settled written call option).

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4. An instrument that embodies a settlement obligation and does not establish either a direct ownership relationship or an indirect ownership relationship is a liability. An example is a written put option.

The Board also agreed on the following definitions in applying the approach:

1. A *settlement obligation* is a present obligation of an entity settled prior to liquidation to:
  - a. Transfer or provide use of assets
  - b. Use assets to provide services
  - c. Stand ready to use assets to provide services or transfer or provide use of assets
  - d. Issue shares or other instruments (fixed or variable number).
2. A *direct ownership relationship* is established by an instrument of an entity or consolidated subsidiary (reference instrument) that:
  - a. Is (or together with other instruments is) the most subordinated interest(s) issued by the entity or consolidated subsidiary, and
  - b. Shares pro rata in the earnings and losses of the entity with other instruments meeting characteristic 2(a).
3. An *indirect ownership relationship* is established by an instrument of an entity in which the counterparty's payoff at settlement is based on and varies in the same direction as the fair value of the reference instrument and does not contain a contingency provision that is based on an external market or index.

### **Tables, Flowcharts, and Examples**

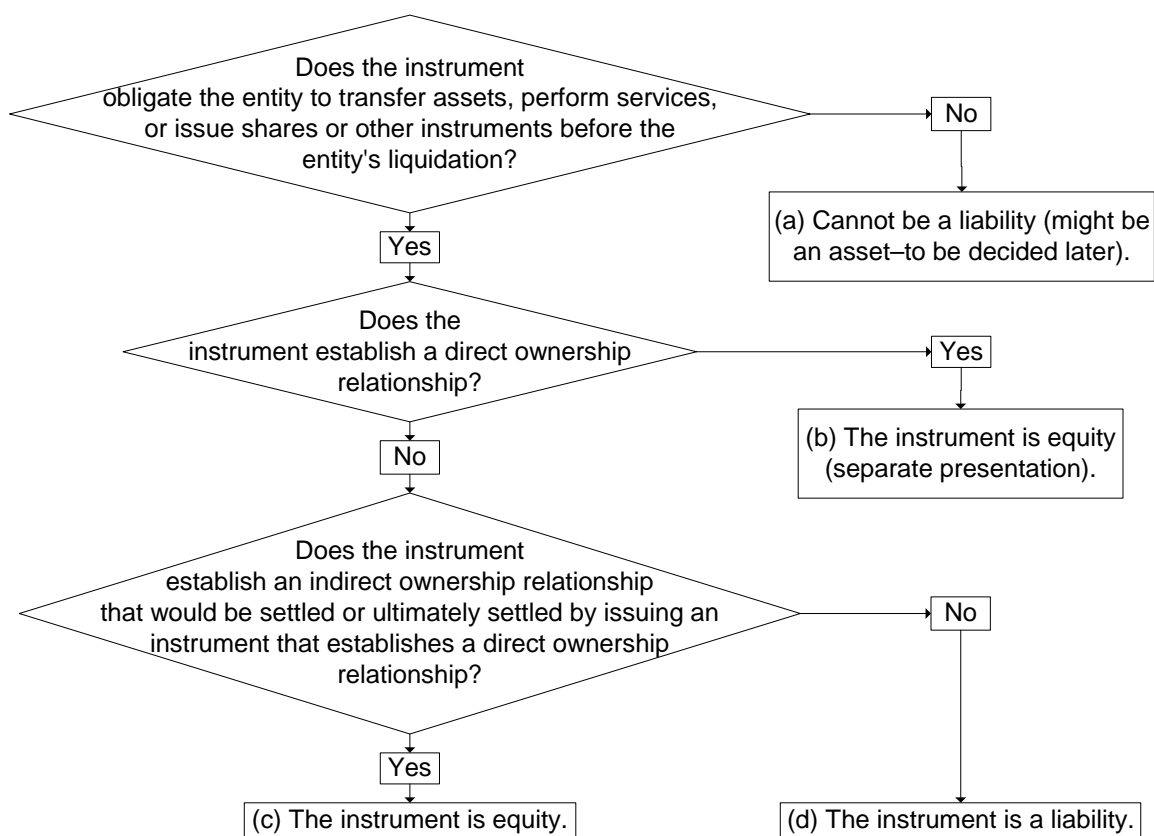
The table, flowchart, and examples found on the following pages further illustrate the Ownership/Settlement Approach. Following those illustrations are some issues the Board will consider next and questions for Council members.

## Ownership/Settlement Table

Ownership Criterion Met?	Settlement Criterion Met?		
	Yes—Ultimate Settlement Does Not Establish Direct Ownership	Yes—Ultimate Settlement Establishes Direct Ownership	No
No	Liability (d)	Liability (d)	Equity (a)
Yes—Indirectly (indexation to reference instrument)	Liability (d)	Equity (c)	Equity (a)
Yes—Directly (reference instrument)	Equity (b)	Equity (b)	Equity (a)

\*Lettered annotations indicate the classification in the flowchart.

## Ownership/Settlement Flowchart



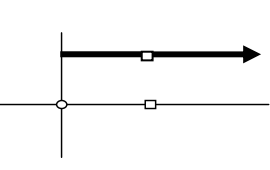
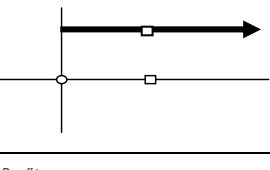
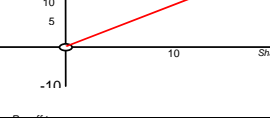
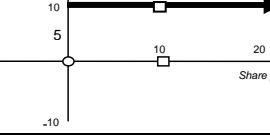
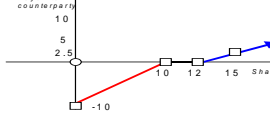
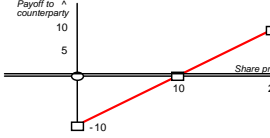
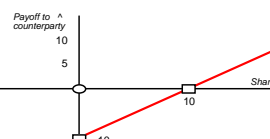
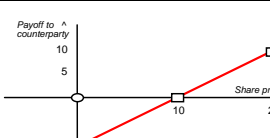
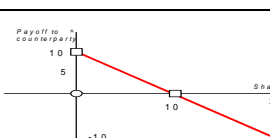
\*Lettered annotations indicate the classification in the table.

## Examples Illustrating Classification of Single-Component Instruments under the Ownership/Settlement Approach

<b>Instrument</b>	<b>Counterparty Payoff Profile</b>	<b>Ownership/Settlement Approach</b>	<b>Current GAAP<sup>1</sup></b>
1. Proprietorship interest		Equity	Equity
2. Common share		Equity	Equity
3. Mandatorily redeemable share at a fixed price settled with assets		Liability	Liability
4. Most subordinated interest that is mandatorily redeemable at fair value settled with assets		Equity—separate	Liability*
5. Most subordinated interest that is mandatorily redeemable at book value or a formula highly correlated to fair value settled with assets		Equity—separate	Liability*
6. Mandatorily redeemable share at fair value (not most subordinated interest) or indexed debt settled with assets		Liability	Liability*
7. Mandatorily redeemable noncontrolling interests at a fixed price settled with assets		Liability	Liability
8. Mandatorily redeemable noncontrolling interests at fair value (of the subsidiary shares, most subordinate) settled with assets		Equity—separate	Liability*

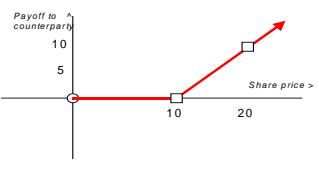
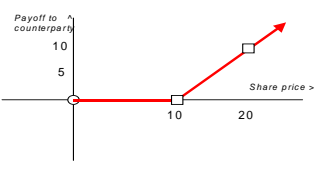
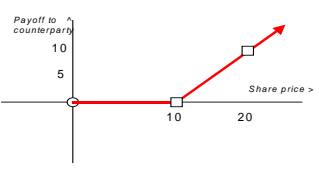
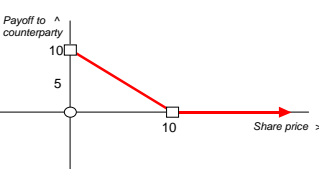
<sup>1</sup> Current GAAP includes the requirements of FASB Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*, before the deferral under FSP FAS 150-3, “Effective Date, Disclosures, and Transition for Mandatorily Redeemable Financial Instruments of Certain Nonpublic Entities and Certain Mandatorily Redeemable Noncontrolling Interests under FASB Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*.” Instruments denoted by a \* indicate those that might have been subject to an indefinite deferral.

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<b>Instrument</b>	<b>Counterparty Payoff Profile</b>	<b>Ownership/ Settlement Approach</b>	<b>Current GAAP<sup>1</sup></b>
9. Perpetual preferred stock		Equity	Equity
10. Note payable cash or share settled (variable number of shares)		Liability	Liability
11. Mandatorily converting instrument into a fixed number of shares <sup>2</sup>		Equity	Liability (debt host with an embedded equity derivative)?
12. Mandatorily converting instrument into a variable number of shares		Liability	Liability
13. Variable share forward sale contract <sup>3</sup>		Equity	Generally Equity
14. Physically settled forward sale contract for a fixed amount		Equity	Equity
15. Net cash-settled forward sale contract (fixed sale price)		Liability	Liability
16. Net share-settled forward sale contract (fixed sale price)		Equity	Equity
17. Physically or net-settled forward purchase contract (at a fixed price)		Liability	Liability

<sup>2</sup> This assumes that an instrument that mandatorily converts into a fixed number of shares (same as a prepaid forward sale) is not a compound instrument. The staff understands that there are mixed views about how this is accounted for under current GAAP.

<sup>3</sup> This assumes that a variable share forward sale contract is not considered a compound instrument.

<b>Instrument</b>	<b>Counterparty Payoff Profile</b>	<b>Ownership/ Settlement Approach</b>	<b>Current GAAP<sup>1</sup></b>
18. Treasury stock purchase	Not applicable	Equity	Equity
19. Physically settled written call option (stock option)		Equity	Equity
20. Net cash-settled written call option (cash SAR)		Liability	Liability
21. Net share-settled written call option (stock SAR)		Equity	Equity
22. Written put option (physically or net settled)		Liability	Liability

### Some Issues the Board Will Consider Next

1. How the approach should apply in distinguishing assets from equity.
2. What form of settlement should be assumed if there are multiple settlement alternatives.
3. Refining what is meant by the phrases *most subordinated* and *sharing pro rata in the earnings and losses of an entity* in determining a direct ownership relationship.
4. Measurement and presentation for single component instruments.

### Questions for Council Members

1. Do you have any questions or concerns about the Ownership/Settlement Approach?
2. In addition to the issues that the Board will consider next, what other issues do you believe that the Board should consider?