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FASB Proposes to Narrow Definition of Equity

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Preferred Stock and Equity Derivatives Would Be Excluded

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Overview

On November 30, 2007, the FASB issued for public comment a [Preliminary Views](#) document on how to distinguish liabilities from equity. If adopted, these Preliminary Views could radically change how contracts are classified either as liabilities or assets or as equity. According to the FASB, a new standard is necessary because current accounting literature addressing this issue is inconsistent, subject to structuring, and difficult to understand and apply.

The FASB hopes its **basic ownership approach** will improve and simplify the current accounting by narrowing the definition of equity. Under this approach, only the most subordinated class of common stock will qualify as equity. Other contracts currently classified as equity (such as preferred stock and certain option and forward contracts on an entity's own equity) would instead be classified as liabilities (or, in some cases, assets).

In addition to the basic ownership approach, the Preliminary Views document discusses two alternative views, referred to as **the ownership-settlement approach** and the **reassessed expected outcomes (REO) approach**. The ownership-settlement approach is similar to the current concept of equity, except that it calls for separation of the equity and nonequity components of hybrid contracts (such as convertible debt). The REO approach, however, represents a totally different way of identifying, separating, and measuring equity and nonequity components of hybrid and derivative contracts. While the FASB preliminarily rejected these two approaches, it still invites constituents to comment on whether they are preferable to the basic ownership approach.

This *Heads Up* discusses the FASB's Preliminary Views, their application to some common contracts, and how they compare with current accounting requirements. Interested parties should provide comments to the FASB by May 30, 2008.

The Preliminary Views could radically change how contracts are classified either as liabilities or assets or as equity.

Basic Ownership Approach

The FASB's preferred approach is the basic ownership approach. This approach only allows equity classification for **basic ownership interests** (i.e., instruments that (1) are the most subordinated interest in an entity and (2) entitle the holder to a share of an entity's net assets after satisfaction of all higher-priority claims).¹ The approach's underlying principle is that only the lowest-level residual interests in an entity qualify for equity classification. All other instruments would be classified as liabilities or assets.

The FASB believes the benefits of a narrow definition of equity include:

- Simplicity (reduced complexity) in applying the accounting literature.
- Clearer distinction between the interests of different classes of stakeholders.
- Fewer opportunities to structure instruments and arrangements to achieve a desired accounting treatment.

Under the basic ownership approach, an entity would classify preferred stock and other **perpetual instruments** (other than those that qualify as basic ownership interests)² as liabilities. This would represent a major change from current GAAP, which typically require equity classification of such contracts. The FASB believes an entity should classify these types of contracts as liabilities, because they represent claims against the entity's assets that reduce the residual amount available for distribution to basic ownership interests. In other words, they have a higher priority in liquidation than basic ownership instruments. Thus, if an entity issues two classes of common stock but one class has a higher priority in liquidation, the entity would only classify the class of common stock with the lowest priority as equity.

Under the basic ownership approach, **indirect ownership interests**,³ such as options or forwards on an entity's own equity, would be classified as liabilities or assets.⁴ This represents a change from current GAAP, which require equity classification of certain derivative contracts on an entity's own equity.

Example

Assume that an entity writes a call option on its own common stock. Assuming rational economic behavior, the holder will only exercise its option when the strike price is below the common stock's current fair value. Because an "in the money" option entitles the holder to a full share of stock even though it paid less than the value of a full share, the option reduces the proportionate share of the entity's assets available to each existing basic ownership interest. Thus, such instruments are not the most residual claims of an entity's assets.

The FASB believes the benefits of a narrow definition of equity include simplicity in applying the accounting literature.

¹ Appendix A of this *Heads Up* discusses the FASB's proposed definitions of three terms: (1) basic ownership interest, (2) perpetual instruments, and (3) indirect ownership interests.

² See footnote 1.

³ See footnote 1.

⁴ The FASB has not yet considered whether share-based payment awards should be within the scope of any future standard. Under the basic ownership approach, share-based payment awards would be classified as liabilities.

⁵ In accordance with FASB Statement No. 150, *Accounting for Certain Financial Instruments With Characteristics of Both Liabilities and Equity*.

Notably, certain mandatorily redeemable financial instruments could qualify for equity treatment under the basic ownership approach. Under current GAAP, mandatorily redeemable financial instruments are classified as liabilities.⁵ Under the basic ownership approach, however, contracts that represent the most residual interest in an entity and that are redeemable at their current fair value qualify as equity. The FASB believes that such instruments are basic ownership interests because their fair value relates to the holder's proportionate share of the entity's fair value. An entity would report basic ownership interests with redemption requirements under a separate heading within equity and measure them at current redemption value.

Alternative Approaches

In its discussions leading up to the Preliminary Views document, the FASB considered several alternatives to the basic ownership approach.⁶ As noted above, the two primary alternatives identified in the Preliminary Views document are the ownership-settlement approach and the REO approach.

The Ownership-Settlement Approach

The ownership-settlement approach classifies instruments on the basis of the nature of their return and their settlement requirements (or lack thereof). Unlike the basic ownership approach, the ownership-settlement approach classifies as equity not only basic ownership instruments, but also other perpetual instruments (such as preferred stock) and certain indirect ownership instruments (such as a written call option that is settled through the issuance of basic ownership interests).

Under the ownership-settlement approach, an entity would analyze convertible debt and other hybrid contracts to determine whether they should be separated into equity and nonequity components. This creates more complexities than does the basic ownership approach.

Example

Assume that an entity issues a convertible debt instrument that grants the holder a right to convert the debt into common stock. Further assume that the common stock to be delivered upon conversion qualifies as a basic ownership interest. In that case, the ownership-settlement approach would require the entity to separate the convertible debt instrument into liability and equity components.

The FASB rejected the ownership-settlement approach because of its complexity. The ownership-settlement approach requires an entity to separate more instruments and apply complex measurement requirements to the separated components. Furthermore, the focus on method of settlement in this approach gives an entity more opportunities, compared with the basic ownership approach, to structure instruments to obtain a desired accounting outcome.

The two primary alternatives to the basic ownership approach that are identified in the Preliminary Views document are the ownership-settlement approach and the reassessed expected outcomes approach.

⁶ Other approaches that the FASB decided not to pursue include (1) a "claims" approach, which makes no distinction between liabilities and equity; (2) a "mezzanine" approach, which has a mezzanine section between liabilities and equity; and (3) a "loss absorption" approach, which defines equity on the basis of whether a contract would absorb incurred losses.

The FASB rejected the REO approach because of the complexity of its reassessment and measurement requirements.

Reassessed Expected Outcomes Approach

Like the basic ownership approach, the REO approach classifies (1) basic ownership interests as equity and (2) perpetual instruments as liabilities. Unlike the basic ownership approach, however, the REO approach separates hybrid contracts (such as convertible debt) and derivatives on the entity's own equity (such as options and forwards) into equity and nonequity components on the basis of their probability-weighted outcomes.

More specifically, the REO approach requires an entity to record instruments and components of instruments as equity or contra-equity if changes in the fair value of those instruments or components shift with changes in the fair value of a basic ownership instrument.

Example

Assume that an entity writes a call option on its common stock that allows the counterparty to pay a fixed price in cash in exchange for a fixed number of basic ownership interests. The REO approach requires the entity to separate that written call option into an asset component (the cash exercise price to be received) and an equity component (the shares to be issued). Similarly, an entity that writes a put option on its common stock that gives the counterparty a right to deliver a fixed number of the entity's basic ownership interests in return for a fixed amount of cash would separate that written put option into a liability component (the cash exercise price to be paid) and a contra-equity component (the shares to be received).

The REO approach requires continual reassessment of each component of a separated derivative or hybrid contract. An entity uses fair value measurement techniques to measure the components, with gains and losses from remeasurement reported in income for both the equity and nonequity components.

The FASB rejected the REO approach because of the complexity of its reassessment and measurement requirements.

Other Considerations for Each Approach

In addition to classification, the Preliminary Views document discusses several other considerations for each approach, including the following:

- *Scope* — To what instruments should an entity apply these principles?
- *Measurement* — How should an entity measure instruments and components?
- *Separation* — How should an entity evaluate whether separation of instruments is appropriate?
- *Linkage* — How should an entity determine whether separate instruments should be combined and accounted for together?
- *Unstated settlement alternatives* — How should an entity consider settlement of instruments that require issuance of an equity instrument but, practically, can be settled in cash?
- *Substance* — Which terms should an entity ignore as nonsubstantive?
- *Settlement, conversion, expiration, and modification* — How should an entity account for these events?
- *Reassessment* — How often should an entity evaluate the accounting treatment?

The following paragraphs discuss some of the more significant considerations in applying the basic ownership approach (these considerations become more complex when applied to the alternative approaches):

- *Measurement.* Basic ownership interests with redemption requirements (such as common stock puttable at fair value) would be measured at the current redemption value, with changes reported in a separate equity account. No other basic ownership interests would be remeasured unless this is required under other GAAP. The FASB has not decided whether or how to remeasure perpetual instruments classified as liabilities (such as preferred stock). Some alternatives include not remeasuring (but reporting dividends as an expense either when declared or at regular intervals), remeasuring at fair value with changes reported in income, or remeasuring by determining an expected retirement date and an expected dividend stream and discounting those payments.

For other instruments and components classified as liabilities or assets that have varying or uncertain settlement amounts, such as options and forward contracts on an entity's own equity, the basic ownership approach requires remeasurement at fair value as of each measurement date, with changes in fair value reported in income, unless other GAAP prevail. This approach would not require an entity to measure at fair value those instruments classified as assets or liabilities that have fixed maturity dates and fixed settlement amounts or settlement amounts that change only because of variable interest rates. Rather, an entity would measure these instruments on the basis of other GAAP.

For other instruments and components that have varying or uncertain settlement amounts, the basic ownership approach requires remeasurement at fair value.

- *Separation.* Under the basic ownership approach, an entity would only separate basic ownership instruments involving contractual payment requirements when the basic ownership instrument remains outstanding after the contractual requirement is satisfied. In such cases, the entity would report the instrument as if it were two separate freestanding financial instruments. For example, a common share may incorporate a provision that entitles the holder to a specified penalty payment if the issuer does not register the common share within a specified period (i.e., a registration rights penalty). From the issuer's perspective, the registration rights provision represents a liability and the underlying share represents a basic ownership instrument. The issuer would initially record the registration rights liability component at its fair value and the remaining basic ownership instrument at an amount equal to the difference between the transaction price and the fair value of the liability component.
- *Linkage.* The objective of the linkage guidance is to deter an entity from issuing separate instruments to obtain a more desirable accounting treatment. The FASB believes that separate instruments should be linked if they are part of the same arrangement and would be accounted for differently if issued separately. Instruments are considered part of the same arrangement if they are contractually linked or were entered into at or around the same time with the same or a related counterparty and if the economic outcome is similar to the economic outcome that would have been reached if they had been issued as a single instrument.
- *Reassessment.* An entity would reassess the classification of every instrument as of each reporting date and make necessary reclassifications if appropriate.

Appendix A

Three Key Terms

Three terms are key to understanding the FASB's Preliminary Views document: (1) basic ownership interest, (2) perpetual instrument, and (3) indirect ownership interest:

- *Basic ownership interest.* The holder of a basic ownership interest (1) has no priority over any other claims in liquidation and (2) is entitled to a percentage share of the entity's net assets that remain after all higher-priority claims have been satisfied. Examples of basic ownership interests include the most subordinated class of common stock (including common stock redeemable at fair value, if in the most subordinated class) and general partnership interests.

Under existing GAAP, basic ownership interests are typically classified as equity, except for (1) mandatorily redeemable financial instruments, which are classified as liabilities,⁷ and (2) common stock that the holder can put back to the issuer, which SEC registrants must classify in mezzanine equity outside of permanent equity.⁸

- *Perpetual instrument.* A perpetual instrument entitles the holder to a portion of the net assets in liquidation, but has no settlement requirements as long as the entity is a going concern. Examples include common stock and preferred stock with no redemption requirements (or that is redeemable solely at the option of the issuer).

Under existing GAAP, an entity typically classifies such perpetual instruments as equity.

- *Indirect ownership interest.* An indirect ownership interest is a nonperpetual contract whose fair value changes in the same direction as the fair value of a basic ownership interest and does not include any contingent exercise provisions that are based on a market price or index other than the entity's basic ownership interests or operations. Examples include certain derivative contracts on an entity's own equity, such as certain written call options, purchased put options, and forward sale contracts on an entity's own equity.

Under existing GAAP, an entity classifies indirect ownership interests as equity if they meet certain conditions and otherwise as assets or liabilities.⁹

The table below compares the three approaches described in the Preliminary Views document with the existing accounting for the three types of interests described above as well as convertible debt:

	Basic Ownership Interests	Other Perpetual Instruments ¹⁰	Indirect Ownership Interests	Debt Convertible Into Basic Ownership Interest
Basic ownership approach	Equity	Liabilities	Assets/liabilities	Liabilities
Ownership-settlement approach	Equity	Equity	Often equity ¹¹	Separated into liability and equity components
REO approach	Equity	Liabilities	Separated into equity and asset/liability components	Separated into liability and equity components
Existing GAAP	Generally equity ¹²	Equity	Often equity ¹³	Liabilities

⁷ In accordance with Statement 150.

⁸ In accordance with EITF Topic No. D-98, "Classification and Measurement of Redeemable Securities."

⁹ In accordance with EITF Issue No. 00-19, "Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock."

¹⁰ Other perpetual instruments, as discussed in the Preliminary Views document, do not require settlement as long as the entity is a going concern.

¹¹ Instruments are classified as equity when share-settled or when settlement requires delivery of a similar indirect ownership instrument that will eventually result in share settlement.

¹² A basic ownership interest that is mandatorily redeemable is classified as a liability under Statement 150. For an SEC registrant, a basic ownership interest that is redeemable at the option of the holder is classified as temporary equity under Topic D-98.

¹³ Equity derivatives that the issuer may be forced to cash-settle are classified as liabilities or assets under Issue 00-19.

Appendix B

Examples of Changes to the Accounting for Some Common Instruments If the FASB Adopts the Basic Ownership Approach

Instruments in this table are generally classified as noted. These instruments could contain features that would change the noted accounting treatment.

Type of Instrument	Current GAAP	Basic Ownership Approach
Perpetual preferred share	Equity	Liability — subsequent measurement to be determined
Common share mandatorily redeemable or puttable at fair value or at a formulaic amount designed to approximate fair value	If mandatorily redeemable, liability; if puttable, equity (temporary equity for public companies)	Equity (basic ownership instrument) — subsequently measured at current redemption value
Preferred share mandatorily redeemable or puttable, regardless of the way the amount is determined and the form of settlement (cash or shares)	If mandatorily redeemable, liability; if puttable, equity (temporary equity for public companies)	Liability — subsequently measured at accreted transaction price if redeemed or put at a fixed amount; subsequently measured at fair value, with changes in value reported in income, if redeemed or put at a variable amount
Written call option, warrant, share-settled stock appreciation right, and employee stock option settled with shares	Equity	Liability — subsequently measured at fair value, with changes in value reported in income
Written call option with a substantive registration rights penalty	Equity and a contingent liability (recognized and measured under FASB Statement No. 5, <i>Accounting for Contingencies</i>)	Liability — subsequently measured at fair value, with changes in value reported in income
Share puttable at a fixed price	Equity (temporary equity for public companies)	Liability — subsequently measured at fair value, with changes in value reported in income
Preferred share convertible into a fixed number of basic ownership instruments	Equity	Liability — subsequently measured at fair value, with changes in value reported in income (this instrument would be measured at fair value because it has a settlement requirement)
Variable-share forward sales contract issued in conjunction (separately) with common share that is puttable at a fixed price	Equity	Liability — subsequently measured at fair value, with changes in value reported in income

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