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If it Quacks Like a Duck: Financial Instruments with Characteristics of Equity–Still Equity for FASB?

In thinking about a financial instrument, issuers, financial intermediaries and their advisers have been accustomed to considering the characteristics of the financial instrument. Does the financial instrument have "equity-like" characteristics? Does the financial instrument behave more like debt? Sometimes evaluating the equity-like traits and the debt-like traits of a financial instrument requires thinking about the same traits from different perspectives—most often from at least four (though sometimes more) perspectives. From a legal, or form, perspective, is the instrument structured as an equity security or as a debt security? From a tax perspective, is it debt? From a ratings agency perspective, does the instrument receive "equity credit" in recognition of its equity-like features? And, finally, from an accounting perspective, how will the financial instrument be treated on the issuer's balance sheet? Financial innovation resulted in the development of more complex products, including instruments like convertible securities and hybrid securities, that have characteristics of debt and equity. These new products required closer analysis and often were difficult to classify for accounting purposes. Nonetheless, there is still an intuitive aspect to answering all of these questions—stock was equity and debt was debt.

In response to the increasing complexity of financial products, the Financial Accounting Standards Board, or the FASB, has been focused on a project intended to clarify the distinctions between debt and equity. The FASB issued, and solicited, comments on a proposed approach (the "Preliminary Views") for distinguishing between equity and liabilities. The revisions, if adopted as proposed, will impact the characterization of financial instruments as wide ranging as preferred stock, convertible debt, hybrid securities and most equity derivatives. Although the FASB's approach is principles-based, rather than rules-based, it is less intuitive. Many instruments which currently are classified as equity either will be classified as debt or will be separated into debt and equity components and treated as two separate instruments for reporting purposes. Any issuer with anything other than common stock in the equity section of its balance sheet will need to evaluate its equity for possible changes to the characterization.

In the course of this project, the FASB has been considering many alternatives in order to remedy what it believes to be unnecessary difficulty in characterizing liabilities and equity. In addition, the FASB believes that under the existing regime, it is possible for an issuer to choose how it characterizes a financial instrument for reporting purposes by altering the financial instrument's legal form, without necessarily modifying the substance of the instrument. The FASB seeks to implement an accounting standard that focuses on the substance of a financial instrument, and reduces the significance of form.

Although additional work remains to be done by the FASB before any standards are implemented, issuers that are considering raising capital through the issuance of financial products that may have equity-like and debt-like features may want to consider alternative outcomes for these instruments.

Basic Ownership Approach

The Preliminary Views scope is vast, and covers the following financial instruments: (1) basic ownership instruments, (2) other instruments that are ownership interests in legal form, and (3) any other contract that is settled with basic ownership instruments or whose fair value is determined by prices of basic ownership instruments.

The Preliminary Views propose the "basic ownership approach" to classify equity instruments. Under the basic ownership approach, only "basic ownership instruments" are classified as equity. A financial instrument is considered a "basic ownership instrument" if it is (1) the most subordinated interest in an entity and (2) entitles the holder to a share of the entity's net assets after all higher priority claims have been satisfied. Under the basic ownership approach, only the most residual claim (one with no priority over any other claim and with no upper or lower limit on its share amount) will be classified as equity. Applying the basic ownership approach to certain hybrid instruments, would result in a different characterization of these instruments for accounting purposes. In using this approach, the FASB draws a distinction between "legal form ownership interests," which are proprietary interests in an entity, and basic ownership interests. Legal form will not determine classification. So, for example, while a share of preferred stock is a legal form ownership interest, it is not a basic ownership interest because preferred stock typically conveys to the holder a priority over the issuer's common stockholders in a liquidation. Unlike prior methods for classification, application of the basic ownership approach results in classifying preferred stock as a liability. Under the basic ownership approach, instruments that combine a contractual payment requirement and a basic ownership instrument that will remain outstanding following satisfaction of the contractual payment requirement must be separated into their component pieces for classification purposes. Only the basic ownership component of such an instrument would be characterized as equity. For example, a basic ownership instrument with registration rights penalties would be separated into two elements. The registration rights penalties are classified as a liability (unless these are immaterial). An entity will not be able to avoid such separation by electing fair value treatment of the entire financial instrument. Financial instruments will be linked and treated as a single instrument if they are part of the same arrangement and reporting the components of the financial instruments separately would result in a different accounting outcome. This provision is intended to foreclose the possibility that an issuer or a product structurer might be able to choose between varying accounting treatments for a financial instrument merely by varying the form.

Using the basic ownership approach produces results that are unusual. As discussed above, preferred stock would be considered a liability. In addition, a forward contract and an option also would be considered liabilities– even if the forward contract or option involves delivery of a basic ownership instrument (such as common stock). This approach classifies all derivatives on basic ownership instruments as liabilities or assets– regardless of the form of settlement, which is at variance with current accounting practices. Further, a redeemable instrument (mandatorily redeemable or redeemable at the holder's option) will only be characterized as a beneficial ownership instrument if, on the classification date, the redeemable instrument is redeemable at par and by its terms prohibits redemption if such redemption would impair the claims of any higher priority interest (other than a basic ownership interest).

The basic ownership approach requires that an issuer reassess the classification of instruments at each reporting date and reclassify as needed. Instruments will be measured initially at the transaction price unless alternative measurement is specified in other Generally Accepted Accounting Principles, or GAAP. Unless required by other GAAP rules, the only basic ownership instruments and components requiring remeasurement are those with redemption requirements– which need to be remeasured at each reporting date and reported at their then current redemption value. The FASB has not yet determined whether other perpetual instruments not classified as equity will be required to be remeasured and, if required, the appropriate remeasurement method.

Comments on the FASB Preliminary View

There have been a significant number of comments to the FASB's Preliminary View. Many industry participants have been critical of the basic ownership approach because changes in the fair value of instruments that entitle the holder to receive an entity's net assets (such as, for example, preferred stock and stock purchase warrants) are reflected in income– however these measurements are not indicative of an entity's financial performance. Most commentators have urged the FASB to reject the basic ownership approach and, instead, to adopt the "ownership-settlement approach." The ownership-settlement approach more closely mirrors the approach taken by international accounting standards, requires less dramatic reclassifications to existing financial instruments, more accurately reflects the economic substance of financial instruments, and still improves and simplifies existing GAAP reporting practices.

Other commentators advocate a modified basic ownership approach. The most significant modification would substantially expand the category of instruments that would be classified as equity, but does not rely on the outcome of the instrument for such classifications. Under the modified approach, instruments with priority in a liquidation, such as preferred stock, would continue to be classified as equity.

Still other commentators encourage the FASB and the International Accounting Standards Board, or IASB, collectively to develop a method.

Alternatives– the Ownership-Settlement and the Reassessed Expected Outcomes Approaches

The Preliminary Views discuss, and reject, the "ownership settlement approach" and the "reassessed expected outcomes" approach as alternatives to the basic ownership approach. Under the ownership-settlement approach, instruments are classified based on the nature of their return and their settlement requirements (or lack thereof). The key distinction between the basic ownership approach and the ownership-settlement approach is that, in addition to basic ownership interests, perpetual instruments (such as preferred stock) and indirect ownership instruments settled by issuing related basic ownership instruments (such as derivatives or hybrid securities) are classified as equity. The FASB rejected this approach because the FASB believes this approach results in additional complexity (arising, says the FASB, from the more expansive required separation of the components of financial instruments). The FASB also noted that the ownership-settlement approach affords issuers the opportunity to structure a transaction in order to achieve a desired reporting treatment.

The reassessed expected outcomes approach is derived from techniques currently in use for convertible debt securities. The underlying principle is that financial instruments and components with fair value changes in the same or opposite direction as the fair value of a basic ownership instrument are considered equity or contra-equity. This approach uses an instrument's probability-weighted outcomes to separate and classify instruments. Classification is determined by the nature of the counterparty's return, similar to the ownership-settlement approach. Under the reassessed expected outcomes approach, basic ownership instruments, including redeemable instruments, are classified as equity. Equity derivatives and hybrid instruments (those with an embedded derivative) would have equity components. However, perpetual instruments would be classified as liabilities because their outcomes are not basic ownership outcomes– that is, they do not share equally with basic ownership instruments in a liquidation, and they do not convert into basic ownership instruments. The FASB rejected this approach principally because it results in additional complexity (again, as a result of the required separation of financial instruments into their components). The FASB also believes that the costs associated with implementing this approach outweighed its benefits.

Conclusion

Ratings agencies have already responded to the increasing complexity of instruments which have both debt and equity characteristics. For example, hybrid securities are analyzed by ratings agencies under a basket approach wherein the securities are effectively divided into debt and equity components. The changes proposed by the FASB may in some respects bring more consistency to the treatment of financial products for accounting and ratings agency purposes. However, it is not yet clear if ratings agencies will make further changes to their methods in light of the changes proposed by the FASB. In any event, if the FASB basic ownership approach were to be adopted, the market would have to adjust to a new, stricter definition and understanding of "equity."

We will publish alerts regarding any additional FASB/IASB guidance.

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