Financial Accounting Valuation Insights

Statement of Financial Accounting Standards No. 150: *Accounting for Certain Instruments with Characteristics of Both Liabilities and Equity*

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Introduction

In May 2003, the Financial Accounting Standards Board (FASB or the Board) issued Statement of Financial Accounting Standards (SFAS) No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*.

This Statement is (1) effective for financial instruments entered into or modified after May 31, 2003, and (2) otherwise effective at the beginning of the first interim period beginning after June 15, 2003. An exception to these effective dates applies to financial instruments (1) issued by private entities and (2) subject to mandatory redemption. For such entities, the effective date will be for fiscal periods beginning after December 15, 2004.

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The FASB describes SFAS No. 150 as a "limited-scope Statement," subject to future deliberation and likely issuance of a supplementary or replacement statement. For the time being, SFAS No. 150 requires a financial statement issuer to classify three types of instruments as liabilities, including the following:

1. A financial instrument issued in the form of shares that is subject to mandatory redemption and that embodies an unconditional obligation requiring the issuer to redeem it by transferring its assets:
   a. at a specified or determinable date (or dates) or
   b. upon an event that is certain to occur.
2. A financial instrument, other than an outstanding share:
   a. that at inception embodies an obligation to repurchase the issuer's equity shares, or is indexed to such an obligation,
   b. and that requires or may require the issuer to settle the obligation by transferring assets.
3. A financial instrument that embodies an unconditional obligation, or a financial instrument (other than an outstanding share) that embodies a conditional obligation that the issuer must or may settle by issuing a variable number of its equity shares if, at inception, the monetary value of the obligation is based solely or predominantly on:
   a. a fixed monetary amount known at inception,
   b. variations in something other than the fair value of the issuer's equity shares, or
   c. variations inversely related to changes in the fair value of the issuer's equity shares.

Statement Development

At the time of this writing, SFAS No. 150 (1) was the most recent statement issued by the FASB and (2) was developed primarily to respond to specific criticisms. These criticisms asserted that there did not exist a standard method of classifying and measuring certain financial instruments that have characteristics of both liabilities and equity. Many issuers reported these instruments in the equity section of the balance sheet, some in the liabilities section, and some in a mezzanine area—between the liabilities and equity sections.

SFAS No. 150 was developed (1) to eliminate financial statement inconsistencies and (2) to further promote convergence toward accounting standards implemented by international accounting oversight agencies.

In August 1990, the Board issued a Discussion Memorandum, *Distinguishing between Liability and Equity Instruments and Accounting for Instruments with Characteristics of Both*. The 1990 Discussion Memorandum, combined with another Discussion Memorandum issued in 1991, *Recognition and Measurement of Financial Instruments*, was a comprehensive effort undertaken by the Board to better clarifying the distinctions between liabilities and equity, as defined in FASB Concepts Statement No. 6, *Elements of Financial Statements*.

Hearings and meetings were conducted to discuss what changes, if any, should be made to Concepts Statement No. 6. FASB decided that no changes should be instituted. The project became dormant and remained that way until 1996.

A few years later, the Board resumed its research on accounting for financial instruments with characteristics of liabilities and/or equity. Subsequently, the FASB issued the following two Exposure Drafts on October 27, 2000:

1. *Accounting for Financial Instruments with Characteristics of Liabilities, Equity, or Both*, and
2. *Proposed Amendment to FASB Concepts Statement No. 6 to Revise the Definition of Liabilities*.

During the last couple of years, the Board confirmed its stance on the classification of the three freestanding financial instruments listed at the beginning of this article. The result was the issuance of SFAS No. 150.

In a future pronouncement, the FASB plans to address additional financial instruments with combined liability and equity characteristics, including:

1. convertible bonds,
2. puttable stock, and
3. other instruments not covered by SFAS No. 150.

Impact on Financial Statements

SFAS No. 150 requires entities to report financial instruments that can be converted to a specific monetary value as a liability on the balance sheet. These instruments were often previously reported in the equity section of the balance sheet. Now, these instruments should be recorded as liabilities with a corresponding decrease in equity. The Statement also outlines what financial statement disclosures must be made regarding these financial instruments.

Instruments Subject to Mandatory Redemption

An example of the first type of financial instrument covered by SFAS No. 150—instruments subject to mandatory redemption—would be shares that must be repurchased by an issuer as part of a buy-sell agreement following the termination of an employee-owner through retirement or death. If the agreement requires the shares to be repurchased at book value, then the balance sheet will show:

1. a liability equal to the book value of the shares that will eventually be repurchased and
2. a corresponding decrease in the equity section of the balance sheet.

However, if the agreement requires the shares to be repurchased at fair market value and fair market value exceeds book value, it is possible (depending on the size of the block of stock to be repurchased) that the equity amount could equal zero or show a deficit.

Obligations of an Entity to Repurchase its Shares

The second type of financial instrument covered by SFAS No. 150—obligations of an issuer to repurchase its shares—would require a liability to be recorded, if for example, an entity entered into a forward contract to repurchase a specified number of its own shares at a future date for a specified forward contract price.

This instrument embodies an unconditional obligation to transfer assets (in this case, the amount of the forward contract price) at some point in the future. Therefore, the entity would recognize a liability and reduce equity by an amount equal to the present value of the forward contract price.

Obligations to Issue a Variable Number of Shares

The third type of financial instrument covered by SFAS No. 150—obligations to issue a variable number of shares—would also require recognition of a liability. For example, an entity may agree to receive some monetary value (cash or equivalently valued assets) in exchange for a commitment to remit a sufficient number of the issuer's shares necessary to total a certain dollar value.

> *". . . the instrument should be measured in one of two ways."*

In this example, it is not known how many of the issuer's shares will have to be transferred, but the total dollar value is known. Therefore, a liability should be recorded as well as a decrease in equity.

Financial Statement Impact of SFAS No. 150

The financial statement impact of SFAS No. 150 goes beyond (1) the potentially significant change to the balance sheet and (2) subsequent influence on the income statement. Earnings per share calculations are also affected.

Entities that have (1) outstanding common stock subject to mandatory redemption or (2) entered into forward contracts requiring future repurchase of a fixed number of common shares should exclude those shares from the denominator when calculating basic and diluted earnings per share.

In addition, contractual dividends and participation rights in undistributed earnings attributable to shares that will be redeemed or repurchased are deducted from income.

Impact on Entities

In implementing SFAS No. 150, a financial instrument should be measured and recorded as a liability at fair value. Fair value, as defined in Appendix D of the Statement, is the amount at which an asset (liability) could be bought (incurred) or sold (settled) in a current transaction between willing parties, that is, other than in a forced or liquidation sale.

Subsequently, the instrument should be measured in one of two ways. If both (1) the amount to be paid and (2) the settlement date are known with certainty, the instrument should be measured as the present value of the amount to be paid at settlement, with interest cost accrued based on an implicit rate.

If either (1) the amount to be paid or (2) the settlement date is unknown (perhaps due to contingent factors), the instrument should be measured as the amount of cash that would be paid if the contract was settled on the reporting date. In this second scenario, any change in amount from the previous reporting period is reported as interest cost.

SFAS No. 150 applies to all entities with financial instruments characterized by one of the three descriptions above with several notable exceptions. The Statement does not apply to obligations under stock-based compensation agreements. This is true if those obligations continue to be accounted for under:

"Although an entity's income statement may or may not differ much under SFAS No. 150, the balance sheet could conceivably be turned upside-down."

1. Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees*,
2. AICPA Statement of Position 93-6, *Employer's Accounting for Employee Stock Ownership Plans*, or
3. SFAS No. 123, *Accounting for Stock-Based Compensation*.

However, the FASB has hinted that these exceptions will be reviewed in the near future to determine if SFAS No. 150 or similar authoritative pronouncements should be extended to more comprehensively cover equity-based compensation plans.

Although an entity's income statement may or may not differ much under SFAS No. 150, the balance sheet could conceivably be turned upside-down. This is true:

"If most of an entity's equity is owned by employees and will ultimately have to be repurchased, the result may be a net worth deficit."

1. if large portions of what was previously treated as equity must now be reclassified as debt or
2. if the entity had very little equity to begin with.

The second situation is often the case with pass-through entities that distribute large amounts of cash or other assets.

If most of an entity's equity is owned by employees and will ultimately have to be repurchased, the result may be a net worth deficit. Such a situation poses an interesting dilemma for bankers, lenders, creditors, investors, insurers, and a host of other parties interested in the financial position of an entity at a given point in time.

What will these people think of an entity that appears to be cash flow positive, but has negative book value? The FASB may answer this question in its future deliberations on issues concerning the differences between liabilities and equity.

Summary and Conclusion

SFAS No. 150 represents a significant change in the way most entities account for financial instruments with characteristics of both liabilities and equity. The benefits, as noted by the Board, will include:

1. more complete balance sheet data available to investors and creditors and
2. more relevant and reliable financial information.

These benefits will occur at presumably minimal cost to the reporting entity.

The Board based its opinion about anticipated costs on the fact that implementation of SFAS No. 150 prohibits restatement.

Ultimately, the entities affected by SFAS No. 150 will judge the costs associated with implementation and subsequent compliance. Explicit costs will stem from:

1. gaining an understanding of the Statement,
2. classifying what instruments should be moved from the equity to the liabilities section of the balance sheet,
3. measuring the fair value of those instruments, and then
4. revaluing them each year until the obligation is fulfilled.

Implicit costs, if any, (1) will stem from confusion about the Statement and its intended purposes, and (2) will result in lost business and financing opportunities.

All costs can be minimized with an in-depth understanding of SFAS No. 150 through research and consultation. An additional explanation of SFAS No. 150, which is expected to be put forth by the FASB in the near future, may also help to minimize costs.

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