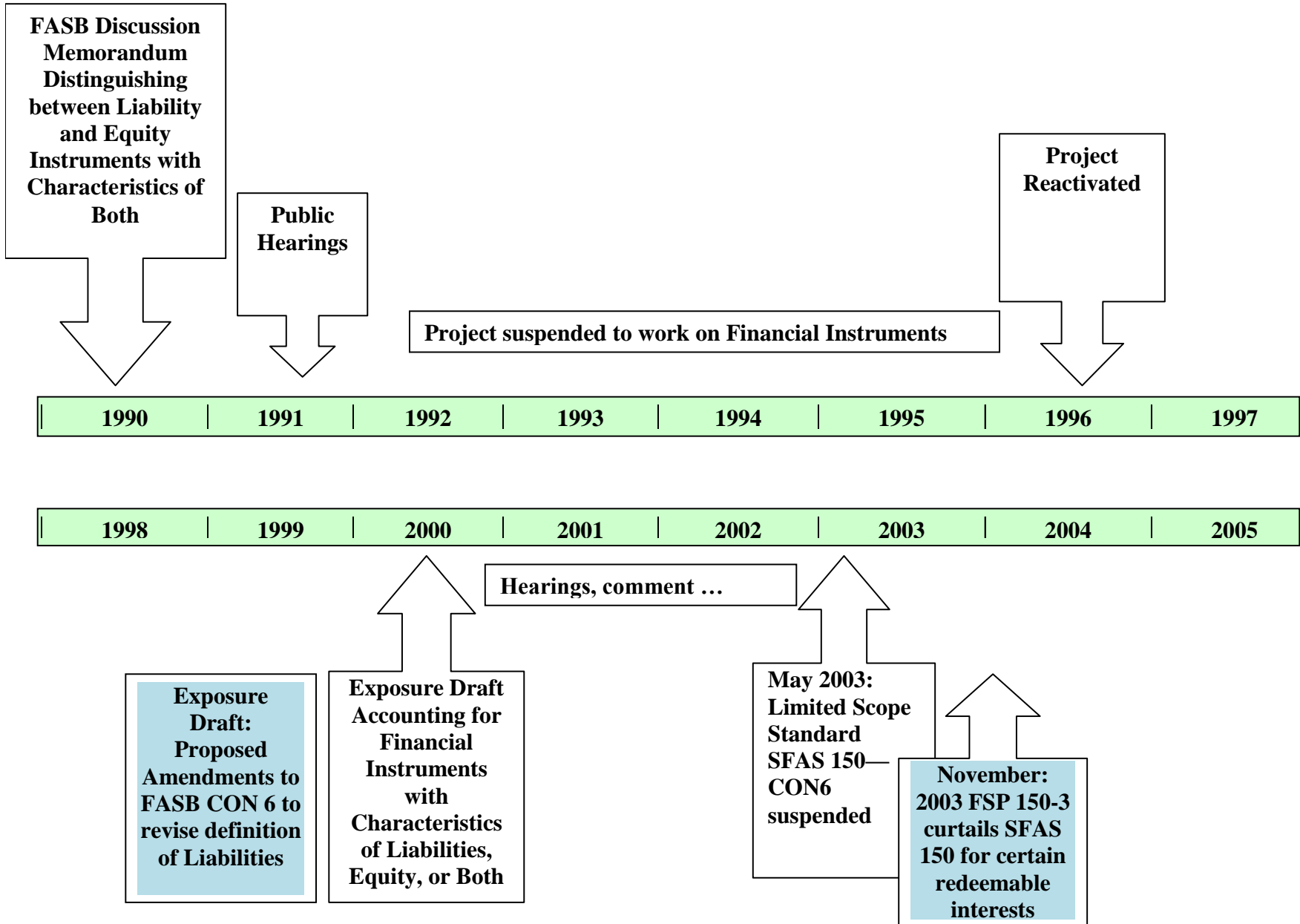


# Financial Instruments with characteristics of equity

Financial Instruments, Due Process,  
and Standard-Setting

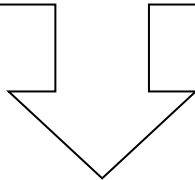
# History of Project



# Seventeen years later...

FASB Preliminary  
Views “Financial  
Instruments with  
Characteristics of  
Equity”

Joint Project with  
IASB



2007

2008

2009

2010

NO. 1550-100 | NOVEMBER 2007

## Financial Accounting Series

PRELIMINARY VIEWS

Financial Instruments with  
Characteristics of Equity

This Preliminary Views is issued by the Financial Accounting Standards Board for public comment as a step preceding the development of an Exposure Draft of a proposed Statement of Financial Accounting Standards.

Written comments should be addressed to:

Technical Director  
File Reference No. 1550-100

Comments are requested by May 30, 2008



Financial Accounting Standards Board  
of the Financial Accounting Foundation

# So what's so difficult about this?

Resources = Claims on Resources

Assets = Liabilities + Equities

Sometimes the simplest questions are the most difficult: Is there a meaningful distinction between liabilities and equities, or are all claims just claims?

# Sprague, 1908. "The Philosophy of Accounts"

## CHAPTER VIII

125. Thus the right-hand side of the balance sheet is entirely composed of claims against or rights over the left-hand side. "Is it not then true," it will be asked, "that the right-hand side is entirely composed of liabilities?" The answer to this is that the rights of others, or the liabilities, differ materially from the rights of the proprietor, in the following respects:

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in our favor is the proprietorship.

"Is it not then true" it will be asked, "that the right-hand side is entirely composed of liabilities?" The answer to this is that the liabilities differ from the rights of the proprietor:

1. The rights of the proprietor involve dominion over the assets and the power to use them as he pleases, while the creditor cannot interfere except in extraordinary circumstances.
2. The right of the creditor is limited to a definite sum which does not shrink when the assets shrink.
3. Losses, expenses and shrinkage fall upon the proprietor alone and profits, revenue, and increases in value benefit him alone, not his creditors

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## Paton, 1962. "Accounting Theory"

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What is "corporate proprietorship"? What we have is a marvelous diffusion of all aspects of ownership—control, income, risk—among a host of investors. Each security issue carries certain privileges and obligations with reference to all of the elements of ownership. To sum up, if all existing corporate stocks and bonds were to be arranged in a series according to degree of risk attaching to each, it would be impossible to draw any hard and fast line of division which follow security types and corresponds to the proprietor-creditor grouping of the sole-proprietorship. And if control or any other aspect of ownership were followed in making the arrangement there would again be no clear-cut line of cleavage.

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# Why does it matter?

Many financial statement users believe that a distinction between debt and equity is useful for evaluating solvency and for measuring performance.

Balance sheet classification affects income if income is defined as the residual left after deducting from revenue all operating expenses and cost of debt capital.

# FASB's Objectives: Internal Consistency and Simplification

Is there a decision rule that will cleanly and consistently separate debt from equity?

- Settlement Obligation approach
- Subordination approach
- Dilution approach
- Perpetual life approach
- Basic Ownership—one class of common stock is IT
- Others?

**SUNNYDELL COMPUTER CORP**

		Reason for Classifying as Debt or Equity						
		Debt or Equity?	Settlement Obligation	Subordination	Dilution	Perpetual Life	Basic Ownership	Other (explain)
1.	Class A Common							
2.	Class B Common							
3.	Class C Common							
4.	Cumulative Part. Preferred							
5.	Redeemable Preferred-MRPS							
6.	Convertible Preferred							
7.	Convertible Debt							
8.	Callable Debt Settled in Shares							
9.	Warrants (Calls)							
10.	Puts on Common							

# Comment Letters

## **Does Not Support the Basic Ownership Approach**

- KPMG
- BDO Seidman
- American Accounting Association
- AICPA/AcSEC
- Institute of Management Accountants

## **Supports the Basic Ownership Approach (potentially modified)**

- Deloitte
- PWC
- EY
- Grant Thornton

# Selected Comments

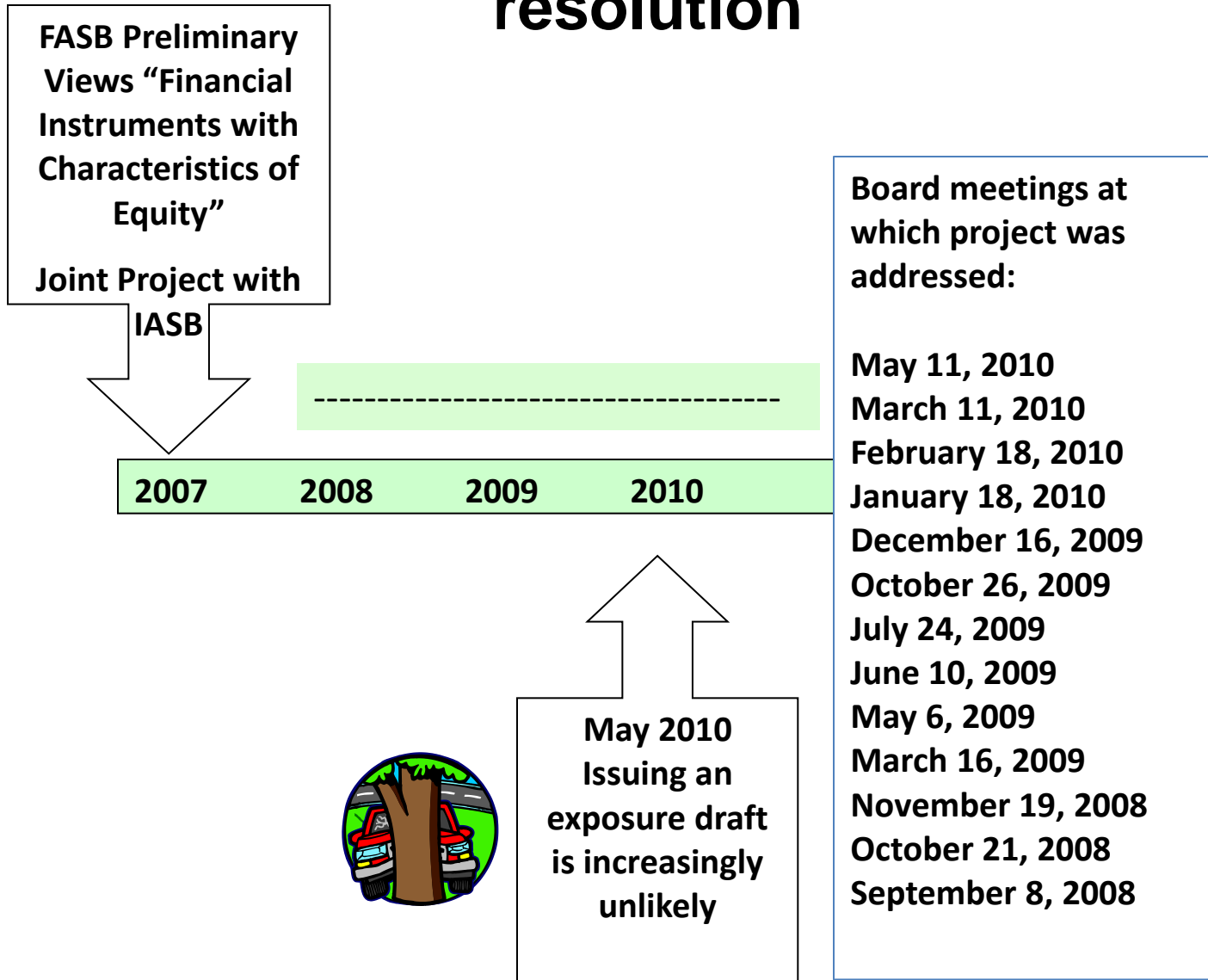
KPMG—“We do not believe that 'simplicity' should be an objective of financial reporting if the information provided... does not provide the users of financial statements with the information needed.”

BDO—“We are particularly concerned...that the Board intends to develop the concepts *after* the equity classification criteria are developed. We believe this is an incongruous approach.”

EY—“We recommend completion of the relevant components of the Conceptual Framework project in this area first, rather than creating standard and reverse-engineering the framework.”

Deloitte—“ We believe that the most important objective in distinguishing between liability and equity instruments is to provide a clear principle of which changes in value of issued instruments should and should not affect the determination of income in a performance statement.”

# Epilogue: a flurry of activity but no resolution



# Professors' Roles

Positive accounting research has advanced our profession. However, normative accounting research is becoming a lost art.

Normatively positioned critical reasoning and analysis is absolutely necessary if Standard Setters are to improve upon our existing conceptual frameworks.

Development of (and respect for) a common conceptual framework provides the best chance for developing for internally consistent, converged standards.