

**American Accounting Association’s Financial Accounting Standards Committee  
Response to FASB Invitation to Comment on the  
Proposed Statement of Financial Accounting Standards  
Accounting for Financial Instruments with Characteristics of Liabilities, Equity, or Both**

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The Financial Accounting Standards Committee of the American Accounting Association (hereafter the Committee) is charged with responding to requests for input from standards setters on issues related to financial reporting. The Committee is pleased to respond to the FASB’s invitation to comment on the proposed statement of financial accounting Standards “Accounting for Financial Instruments with Characteristics of Liabilities, Equity, or Both” (hereafter the Proposed Standard). The comments in this letter reflect the views of the individuals on the Committee and not those of the American Accounting Association.

We employ the following definitions throughout this comment letter. We refer to a financial instrument used for financing as a financing instrument. We define a simple financing instrument as one that has a single component that is either straight debt or common equity. A compound financing instrument has multiple components, at least one of which is a liability and one of which is equity. The components of a compound financing instrument may be separable, meaning that the components can be independently valued through their lives. A bond with an attached warrant is a separable compound financing instrument. Alternatively, the components of a compound financing instrument may be inseparable, which means that the instrument has liability and equity components that can be defined separately for valuation purposes, but the instrument’s ultimate payoff will be either as a liability or as equity but not both. For such instruments, the values of the liability components are inherently related to the values of the equity components through their lives, because the probability that the instrument will ultimately pay off as a liability moves inversely with the probability that the instrument will pay off as equity. Convertible debt is an inseparable compound financing instrument. A hybrid financing instrument has characteristics of a liability and equity but does not have distinct components that are straight debt or common equity. Preferred stock is a hybrid instrument.

The Committee supports the FASB’s development of standards to classify financing instruments in a consistent and conceptually sound fashion. We emphasize the difficulty of this task, however, and find it ironic that at a time when financing instruments and firms’ capital structures are becoming increasingly complex, the Proposed Standard attempts to limit the number of categories for classifying these instruments. Like the FASB, we favor elimination of the “mezzanine” as it is currently constituted from firms’ balance sheets, because it is poorly described and inconsistently applied. However, we do not believe that all financing instruments need be forced into either liabilities or equity. The Committee supports a consistent classification methodology for financing instruments based on well-defined characteristics derived from a

carefully articulated perspective or perspectives about the distinctions between these instruments, which may result in more than two balance sheet categories of instruments.

The Committee's most significant concern with the Proposed Standard is that liabilities will include instruments that are heterogeneous on important dimensions that are not clearly distinguished in the financial statements. To address this concern, the Committee believes that the Proposed Standard should employ two perspectives in classifying financing instruments: the presence or absence of contractually specified claims on assets (a "solvency" perspective) and the presence or absence of an ownership relationship (a "valuation" perspective). We can support either of two approaches to balance sheet classification of financing instruments based on these perspectives. First, either the solvency or valuation perspective could be viewed as primary and the other perspective as secondary, and firms could be required to partition financing instruments into liabilities and equity based on the primary perspective and to create subcategories of liabilities and equity based on the secondary perspective. Second and perhaps preferably based on the results in Hopkins (1996) discussed below, firms could be required to create the same four categories of financing instruments as in the first approach but only the two categories of financing instruments for which the solvency and valuation perspectives align would be designated as liabilities or equity. The two categories for which the solvency and valuation perspectives differ would be designated as well-defined mezzanines.

The remainder of our comment letter is organized into two sections: an overview of our conceptual and practical concerns with the Proposed Standard and our comments on specific questions posed in the Proposed Standard. In the first section, we discuss the Committee's views on the classification issues raised above in greater detail. We also discuss three other significant concerns. The first concern is that the initial classification of hybrid and inseparable compound financing instruments relies too heavily on contractual provisions such as mandatory redemption rather than on economic substance. The second concern pertains to measurement issues for inseparable compound financing instruments. Most notably, we are concerned that measurement occurs only at one date and that measurement does not rely on the probability that an inseparable compound instrument will be settled as debt or equity. The third concern pertains to the articulation between the balance sheet and the income statement.

In the second section, we base our responses to specific questions posed in the Proposed Standard on the conceptual discussion in the first section of this document and, to the extent possible, on research evidence. Because of the existence of a considerable amount of on-point research, we discuss measurement issues in detail in this section.

## **Overview of Conceptual and Practical Issues**

### *Choice of classification criteria for liabilities and equity*

The Committee previously commented on this project in March 1999. In that letter, the Committee stated (in greater detail than we do here) that both solvency and valuation perspectives are important for classifying financing instruments for certain types of economic decisions, and that neither perspective dominates the other for all decisions. The solvency and

valuation perspectives yield four fundamentally distinct categories of financing instruments: liabilities from both a solvency and valuation perspective (e.g., straight debt), liabilities from a solvency perspective and equity from a valuation perspective (e.g., the obligation to transfer the fair value of a fixed number of equity shares), equity from a solvency perspective and liabilities from a valuation perspective (e.g., the obligation to transfer a variable number of equity shares with a fixed fair value), and equity from both a solvency and valuation perspective (e.g., common equity).

The Proposed Standard classifies components of financing instruments (hereafter financing components) as liabilities or equity using a two-step process that incorporates both solvency and valuation perspectives. In the first step, any financing component that requires the firm to pay cash or assets is classified as a liability and any financing component that is not an obligation (i.e., that does not require the firm to transfer anything to the holder of the component) is classified as equity. The Committee interprets the first classification step as motivated by a solvency perspective. For financing components that are obligations but do not require the firm to pay cash or assets, a second step is required to determine classification. When the change in the monetary value of a financing component is equal to the change in the fair value of a fixed number of equity shares, the component is classified as equity; otherwise it is classified as a liability. We interpret the second step as invoking a valuation perspective in a subordinate and narrow way that makes it relatively difficult for a financing component to qualify as equity.<sup>1</sup> We are concerned that, as a result of this narrowness, a financing component that does not impair solvency and whose economic substance from a valuation perspective is primarily equity may still be classified as a liability.

As a result of the primacy of the solvency perspective and the subordination and narrowness of the application of the valuation perspective, liabilities under the Proposed Standard do not clearly convey information that is relevant either for assessing solvency or for determining equity value. Liabilities under the Proposed Standard include three distinct types of financing instruments: liabilities from both solvency and valuation perspectives, liabilities from a solvency perspective and equity from a valuation perspective, and equity from a solvency perspective and liabilities from a (narrow) valuation perspective. The Proposed Standard classifies as equity only financing components that are equity from a solvency perspective and equity from a (narrow) valuation perspective. A noteworthy result is that most complex financing instruments – many of which are currently classified in the mezzanine – are classified as liabilities rather than equity, yielding a heterogeneous and undifferentiated set of liabilities. The Committee recognizes that some heterogeneity is unavoidable and is not opposed to heterogeneity per se. However, the heterogeneity induced in the Proposed Standard hampers key decisions based on the financial statements, namely the assessment of solvency and estimation of equity value.

The Committee believes that the four fundamentally distinct types of financing components described above should be clearly distinguished. It is important to note that the Committee does

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<sup>1</sup> Admittedly, other aspects of the Proposed Standard effectively broaden the valuation perspective in the second step. Specifically, the concept of monetary value allows stock options to be treated as equity even though they are not valued in exactly the same way as the underlying stock. In addition, there are potentially many types of equity shares that are not valued identically, e.g., common stock, preferred stock, minority interest, and tracking stock. An option on any of these types of equity shares would be classified as equity in the second step.

not take issue with a two-step approach as an appropriate way to classify financing components into liabilities and equity. We also do not take issue with the primacy of a solvency perspective in the Proposed Standard, although some members of the Committee would prefer a valuation perspective to be primary. Our concern is that the Proposed Standard does not clearly distinguish financing components that are liabilities or equity based on the consistent application of either the solvency or valuation perspectives, or both. While the Committee would prefer classification based on consistent application of both the solvency and valuation perspectives, as discussed previously, we would prefer a classification methodology based on consistent application of either perspective to the mixed methodology in the Proposed Standard.

As noted previously, the Committee can support the classification of the four types of financing instruments either as subdivisions of liabilities and equity or through the creation of two well-defined mezzanine-like categories in addition to liabilities and equity. We emphasize that the subdivisions or separate categories should appear on the face of the balance sheet rather than in the footnotes. The Committee believes that balance sheet presentation of the four categories of financing instruments is necessary because research evidence suggests that analysts take certain attributes for granted when instruments are classified as either liabilities or equity (Hopkins, 1996). As more fully described in our response to Issue 3(a), in an experimental analysis of analyst behavior, Hopkins (1996) that shows that analysts more carefully examined the attributes of the mandatorily redeemable preferred stock (MRPS) when it was classified in the mezzanine, but the analysts attributed certain characteristics to the MRPS when it was classified as either debt or equity. This last result suggests that it is extremely important to distinguish financing components with distinct or ambiguous characteristics on the balance sheet, and it may imply that the approach that creates two well-defined mezzanines is preferable to the approach that creates subdivisions of liabilities and equity.

Even with four categories of financing instruments, heterogeneity within each category will remain. The solvency and valuation perspectives provide continuums on which to rank financing components, not discrete definitions. In this regard, the Committee favors appropriate sequencing of claims within categories to convey as much information as is possible about where specific financing components fall along these continuums. For example, consider an obligation to pay cash equal to the fair value of a fixed number of equity shares. While this obligation is a liability under a solvency perspective, its effect on solvency is mitigated by the fact that the fair value of the equity shares decreases as the firm becomes less solvent, and it is equity under a valuation perspective. For most analytical purposes, this financing instrument would be treated as equity. We do not object to this instrument being classified in the liability category under a solvency perspective and equity under a valuation perspective, but it should be reported below financing instruments that have greater effects on solvency.

#### *Focus on contractual provisions rather than economic substance*

The Committee believes that the classification methodology in the Proposed Standard places too much weight on the contractual provisions of financing instruments rather than their economic substance. For example, the Proposed Standard relies completely on the presence or absence of a mandatory redemption feature to classify certain hybrid instruments. Mandatorily redeemable preferred stock is treated entirely as a liability regardless of the nature and economic importance

of the mandatory redemption provision. In contrast, the Committee believes that a 1-year redemption provision renders preferred stock primarily a liability, while a 100-year redemption provision does not.

Risky debt is another example of a financing instrument with characteristics of equity whose contractual provisions result in its classification as a liability. Risky debt can be viewed as a hybrid instrument that contains an implicit written put option on the firm. As the value of the firm declines, the risky debt becomes more of a residual claim and thus more like equity from a valuation perspective. At some point as its risk increases, we would change the classification of risky debt from a liability under both a solvency and valuation perspective to a liability under a solvency perspective and equity under a valuation perspective.

One implication of the Proposed Standard's reliance on contractual provisions is that the classification of hybrid financing instruments is very different from and essentially inconsistent with that of inseparable compound instruments. Consider as an example common stock that is puttable in 1 year. Under the Proposed Standard, this compound instrument is treated more like equity and less like a liability than the 100-year mandatorily redeemable preferred stock in the prior example, even though the puttable common stock reduces the solvency of the firm to a far greater extent.

In summary, the Committee believes that the Proposed Standard's focus on contractual provisions results in unnecessary and poorly described heterogeneity of financing instruments within liabilities and equity as well as unclear distinctions across these balance sheet categories. The Committee believes the reliance on contractual provisions to define classification creates the most severe problems for hybrid financing instruments but also creates significant problems for inseparable compound instruments, and that the economic substance of these instruments should determine their classification. In this regard, we believe the exact equality condition in paragraph 17c(2)(a) of the Proposed Standard should be replaced with an economic substance condition.

The Committee recognizes that it is more difficult to implement a standard based on economic substance than one based on contractual provisions.<sup>2</sup> However, we believe that such an approach is necessary, especially for hybrid and inseparable compound financing instruments, if the Proposed Standard is to be descriptive and robust to future permutations in financing instruments. Economic rights surely will be divided in many different and hard to imagine ways over time. A standard that is locked into specific contractual definitions of liabilities and equity

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<sup>2</sup> It is interesting to note that the tax code also acknowledges the difficulties associated with distinguishing liabilities from equity. One substantive factor that can affect tax classification is the incentives of the parties that hold the other side of a claim (as noted in Bittker and Eustice, 2000). In the event of financial distress, shareholders that also own debt will likely subordinate their debt claims, while third party creditors are more likely to force the firm into bankruptcy. Thus, the economic substance of debt held by parties that are also equityholders is more like equity than debt. Bittker and Eustice note that this reasoning implies that even the straightest shareholder debt can be classified as equity. Moreover, the Treasury is authorized by Congress to issue prospective regulations to classify debt and equity that are based on five criteria that allow for economic substance to provide positive or negative evidence about classification. The same regulation also permits the IRS to treat interests in corporations as "in part stock and in part indebtedness". With respect to nature of the guidance that tax regulations provide for classifying financing instruments as debt and equity, legal scholars note that the "virtues of vagueness exceed its vices" (as cited in Bittker and Eustice, 2000).

is likely to be less flexible than a standard that employs conceptual definitions that capture the economic substance of financing instruments.

### *Inseparable compound financing instruments*

This section has three subsections. In the first subsection, we discuss limitations of the components approach and relative-fair-value method in the Proposed Standard for inseparable compound financing instruments, given that these instruments pay off either as liabilities or as equity but not as both. We propose an alternative probability-based components approach and valuation method for these instruments. In the second subsection, we discuss a numerical example that illustrates the limitations of the Proposed Standard and the application of our proposed approach. In the third subsection, we discuss the issue of interactions between multiple options in inseparable compound financing instruments.

#### (i) Application of the components approach and relative-fair-value method at issuance and subsequently; an alternative probability-based components approach

Under the Proposed Standard, the liability and equity components of compound financing instruments are measured at issuance using the relative-fair-value method. The Committee supports this approach for separable compound financing instruments. The Committee does not believe this approach is appropriate for inseparable compound financing instruments, however, because the valuation models used to estimate the values of the components of inseparable financing instruments generally do not measure the value of the instrument when it pays off as equity distinct from its value when it pays off as debt. For example, in the case of convertible debt, option pricing models compute the *incremental* value of the instrument that results from having the option to receive a fixed payoff (like debt) or equity, whichever is higher. It is this option value that would be recorded as equity under the relative fair value method. In our view, this incremental value does not correspond to the accounting construct “equity” in any meaningful sense. In general, the purpose of valuation models used to compute the incremental values of the components of inseparable financing instruments is not the same as the purpose of financial statements, which is to identify the liability and equity components separately, consistent with the accounting definitions of these terms.

In this regard, the Committee believes that the measurement of the components of an inseparable compound financing instrument should incorporate, both at issuance and subsequently, the current (i.e., conditional) probabilities that the instrument pays off as a liability or as equity (hereafter, the payoff probabilities). For example, consider convertible debt that will be converted with 100% probability one year after issuance, perhaps because the conversion option starts deep in the money but the first allowed conversion date is one year after the issue date.<sup>3</sup> At issuance, the liability component of this instrument would be ascribed some (possibly substantial) value under the Proposed Standard, even though interest payments will be made only for one year.

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<sup>3</sup> There might be accounting, tax, control or other reasons why such an instrument would be issued instead of equity.

In contrast, we would classify this instrument either entirely or primarily as equity using one of two approaches. An approach that is simple but basically inconsistent with a components approach is to classify a financing instrument entirely as a liability or as equity if the probability that it pays off as such exceeds some threshold. In the example above, the convertible debt would be classified entirely as equity. An approach that is consistent with a components approach (though not the same components approach as in the Proposed Standard) is to estimate the probability that the financing instrument pays off as a liability or as equity and record as the values of the liability and equity component the probability-weighted discounted values of the future payments as a liability and as equity, respectively. In the example above, the liability component of the convertible debt would equal the discounted value of the one interest payment and the equity component would equal the discounted value of the equity share that will be received upon conversion. Note that under this approach the equity component of convertible debt is not treated as an option but rather as equity with some probability.

We provide a numerical example demonstrating this approach in subsection ii below. The example illustrates a situation where the liability component of convertible debt is overstated using the proposed components approach, and how a probability-based approach, in our opinion, leads to a more reasonable separation of liabilities and equity.

While we believe this approach best reflects the nature of inseparable compound financing instruments as paying off either as liabilities or equity but not as both, this approach is computationally complex. The value of the equity component is not simply the value of the conversion option. Firms would have to determine the probabilities of payoff as debt or equity and the expected payoff amounts. While there are ways to infer the probabilities and expected payoffs from market prices, as we will discuss below, the inferences require a number of estimates over which managers would have significant discretion.

We further emphasize that a probability-based approach, and in fact any approach, should be applied to inseparable compound financing instruments in all periods, not just at the issue date of the instrument. Subsequent to issuance, the liability and equity components of inseparable compound financing instruments are not revalued under the Proposed Standard as the payoff probabilities change. As a result, the liability and equity components will become increasingly incorrectly valued as the probability approaches 100% for either form of payoff. Moreover, the valuation errors on the components are likely to be negatively correlated, although the exact nature of this correlation will depend on the ongoing accounting for liabilities and equity. Assume, for example, that liabilities are measured at amortized cost and equity is accounted for as a residual claim, as is currently the case under U.S. GAAP. Under this assumption, if the probability that the inseparable compound financing instrument pays off as equity rises (falls) after issuance, then the equity component will be undervalued (overvalued) and the liability component will be overvalued (undervalued). Alternatively, assume that fair value accounting is adopted for liabilities but not for equity, as proposed in the FASB's December 1999 preliminary views on fair valuing financial instruments. Under this assumption, the ongoing valuation of the liability component will (we presume) reflect changes in the probability of conversion while the value of the equity component will not. Therefore, even if the FASB rejects a probability-based approach in favor of the proposed components approach, we still strongly recommend that the

FASB consider the subsequent revaluation of the components of inseparable compound financing instruments after the issue date.<sup>4</sup>

Our proposal above to incorporate the current payoff probabilities into the ongoing valuation of the liability and equity components largely eliminates the problem of correlated valuation errors for these components. The Committee recognizes that this approach implies that the equity components of financing instruments must be revalued over time to reflect changes in these probabilities, however, something that is not done under current U.S. GAAP. If the equity components of inseparable compound financing instruments are to be revalued, the FASB would need to decide whether and how to record this revaluation on the income statement.

(ii) A numerical example illustrating the importance of the payoff probabilities and our probability-based components approach

The following numerical example illustrates the limitations of the components approach in the Proposed Standard for inseparable compound financing instruments. It also illustrates our probability-based approach to estimating the value of the liability and equity components of inseparable compound financing instruments.<sup>5</sup>

The example involves a convertible bond in a binomial option pricing setting with two dates, 0 and 1, that span a single period. The firm's net operating assets (hereafter, the firm) have a value at date  $t=0$  of \$100. The value of the firm rises by a proportion  $u=50\%$  to \$150 with a probability  $q=60\%$  and falls by a proportion  $d=50\%$  to \$50 with a probability  $1-q=40\%$ . We refer to these probabilities as the "true" probabilities.<sup>6</sup> The firm's weighted-average cost of capital  $r_w$  is 10%, i.e., the firm's current value equals the expected discounted firm value at the weighted average cost of capital, i.e.,  $100 = [(.6*150) + (.4*50)]/1.1$ . The risk-free rate  $r_f$  is 5%, so that the risk-neutral probabilities used in the binomial option pricing formula are  $p=(1+r_f-d)/(u-d) = (1.05-0.5)/(1.5-0.5) = 55\%$  and  $1-p = 45\%$ . Note that the risk-neutral probabilities are not the same as the true probabilities; in general, less weight is placed on the up state(s) when the weighted average cost of capital exceeds the risk-free rate. The firm value can be expressed as the expected discounted value of the future values using the risk-neutral probabilities and risk-free rate i.e.,  $100=[(.55*150) + (.45*50)]/1.05$ .

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<sup>4</sup> While the Committee believes it is critical that the components of inseparable compound financing instruments be revalued subsequent to issuance, the Committee thinks that it might also be a good idea if revaluation were applied more broadly, for example, to the components of separable compound financing instruments and to stand-alone equity options. Specifically, this might improve comparability across financing components that would and would not be fair valued as SFAS No. 133 derivatives. For example, Credit Suisse First Boston Corporation (2001) notes that put options and warrants would be derivative instruments under SFAS No. 133 and so would be fair valued. The Committee does not propose the revaluation of straight equity, of course, as there must be some claim that is valued as a residual.

<sup>5</sup> Credit Suisse First Boston Corporation (2001) also uses convertible debt to illustrate potential concerns about balance sheet classifications under the Proposed Standard. Their example illustrates how accounting for convertible debt and puttable common stock, two economically similar financing instruments, differs under the Proposed Standard. A probability-based approach, like the one the Committee advocates, would reduce the differences between the balance sheet representations of these two similar financing instruments.

<sup>6</sup> As discussed in Hull (2000), it is not necessary to make any explicit assumptions about the probabilities of up and down movements to derive the binomial option pricing model. However, it is "natural" to think of the percentages as such probabilities and to think of the option price as the expected discounted payoff to the option.

The convertible bond has a face value of \$60 and promises to pay \$64 at date 1. At date 1, if the bond is converted, the bondholders receive half the equity of the firm, which is worth \$75 in the up state and \$25 in the down state. If the bond is not converted, the bondholders receive the minimum of \$64 or the value of the firm (i.e., in the case of default), which is \$64 in the up state and \$50 in the down state. These calculations indicate that the bond converts in the up state and receives \$75 and does not convert in the down state and receives \$50.

We first calculate the value of the (straight) bond without the conversion option and then calculate the value of the convertible bond. Without further assumptions, it is necessary to make these calculations using the risk-neutral probabilities and risk-free rate, since the costs of capital for the straight and convertible debt have not been stated. At date 0, the value of the straight bond is  $[(.55*64)+(.45*50)]/1.05=\$54.95$ . The value of the convertible bond is  $[(.55*75)+(.45*50)]/1.05=\$60.71$ , implying the value of the conversion option is \$5.76. An internal rate of return calculation using the \$60.71 value of convertible debt calculated above and the true probabilities implies that the risk-adjusted cost of convertible debt capital is 7.06%.

Under the approach in the Proposed Standard, the convertible debt would be classified as \$54.95 of liabilities and only \$5.76 of equity reflecting the calculations above. This relatively large allocation of value to the liability component occurs despite the fact that the debt effectively always pays off as equity in this stylized example; in the up state the bondholders convert the debt to equity and in the down state the bondholders receive the firm.

In contrast, our probability-based components approach would estimate the value of the equity component as the probability-weighted discounted value of its payoff as equity and the value of the liability component as the probability-weighted discounted value of its payoff as a liability. As discussed below, there are various ways one could make these estimates that involve conceptual and practical tradeoffs. An intuitively appealing way would be to use the true probabilities and the risk-adjusted cost of convertible debt capital, so that the value of the equity component is  $(.6*75)/1.0706=42.03$  and the value of the debt component is  $(.4*50)/1.0706=18.68$ . Note that the total value of the convertible debt is again \$60.71, but a far greater amount is allocated to the equity component than under the relative fair value approach in the Proposed Standard.

A limitation of the probability-based components approach above is that, in practice, firms do not know the true probabilities or expected payoffs in the up and down states (\$75 and \$50, respectively). Firms would have to estimate the probabilities and expected payoffs, and market data could not be used to verify these estimates. Thus, this approach involves significant computational cost and discretion.

As an alternative, a probability-based components approach could be implemented using risk-neutral probabilities and risk-free rates. In this case, the value of the equity component of the convertible debt would be  $(.55*75)/1.05=39.28$ , and the value of the liability component would be  $(.45*50)/1.05=21.43$ , again for a total of \$60.71. While not yielding exactly the same valuations of the equity and liability components as the previous approach, this approach

similarly mitigates the problem of overstating the value of the liability component.<sup>7</sup> Moreover, a decided advantage of this approach is that firms can use market data to estimate the necessary inputs to calculate the values of the equity and liability components. Specifically, the risk-neutral probabilities can be inferred from estimates of the conversion option value (determined using the with and without method), the strike price (known), the risk free rate (known), and an estimate of the market value of the firm. While inferring the risk-neutral probabilities is complex, the approach is implementable and the reasonableness of estimates can be assessed using market data. This probability-based components approach does involve more estimation than the approach in the Proposed Standard, but the benefit is an allocation to equity that more accurately reflects the likelihood that the instrument pays off as equity.

To further illustrate the limitations of the approach in the Proposed Standard, consider the following permutation on this example. If the face value of the debt were 20 instead of 60 but the option still allowed conversion to half the equity, then the convertible debt would be converted in both the up and down states. In this case, the convertible debt would be equity with certainty but the components approach under the proposed standard would yield a significant value for the liability component for the convertible debt.

### (iii) The presence and joint values of options that interact

The presence of multiple options that interact poses a significant issue for measuring the initial fair value of the components of inseparable compound financial instruments that is not addressed in the Proposed Standard. Barth, Landsman, and Rendleman (2000) provide a precise mathematical treatment of this issue. We discuss this issue intuitively using callable convertible debt as an example.

Compared to the conversion option in convertible debt, the conversion option in callable convertible debt is decreased in value by the presence of the call option, since the exercise of the call option may cause conversion at times this option would not otherwise be exercised. Equivalently, compared to the call option in callable debt, the call option in callable convertible debt is increased in value by the presence of the conversion option, since the call option may be exercised to reduce the value of the conversion option. Because of this interaction between the call and conversion options in callable convertible debt, there is a joint value to the two options that cannot logically be ascribed to either option alone. Barth, Landsman, and Rendleman (2000) emphasize that the relative-fair-value method or any other method that allocates this joint value to the components will obscure the joint value. In the Committee's view, the thorny issue of interactions among options will most likely have to be addressed through supplemental disclosure. Barth, Landsman and Rendleman (2000) provide various possible disclosure formats.

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<sup>7</sup> Specifically, in this example the equity value is 42.03 using the true probabilities and risk-adjusted cost of capital and 39.28 using the risk-neutral probabilities and risk-free rate. In general, the magnitude of the differences in estimates from these two approaches will be a function of factors such as the volatility of firm value and the magnitude of the risk-adjusted cost of capital relative to the risk-free rate. However, the Committee believes that the probability-based components approach using risk-neutral probabilities and the risk-free rate results in valuations for liabilities and equity that are more consistent with accounting definitions of liabilities and equity than does the approach in the Proposed Standard.

### *Articulation of the balance sheet and income statement*

As discussed previously, the Committee takes no issue with the fact that the classification of liabilities and equity on the balance sheet under the Proposed Standard primarily reflects a solvency perspective. At the same time, the Committee believes that the purpose of the income statement is to measure periodic flows available for residual claimants, and that income measurement should reflect primarily, and perhaps even solely, a valuation perspective. However, using two different perspectives for balance sheet and income statement classification purposes is obviously illogical and will result in a useless articulation between the statements that renders commonly used valuation analysis measures, such as return on equity, meaningless. It would be a simpler task to articulate the balance sheet and income statement if the classification of liabilities and equity were based solely on a valuation perspective; some of the members of the Committee favor the primacy of a valuation perspective for this reason.

The Committee favors presenting four categories of expenses or partitions of net income on the income statement that link directly to our proposed categories of financing instruments on the balance sheet. Specifically, four categories should be clearly distinguished on the face of the income statement: 1) the expense associated with liabilities from both solvency and valuation perspectives, 2) the expense associated with liabilities from a solvency perspective but equity from a valuation perspective, 3) the expense associated with liabilities from a valuation perspective but equity from a solvency perspective, and 4) the net income associated with equity from both solvency and valuation perspectives.

It is particularly important that financial statement users be able to calculate net income available to all equityholders from a valuation perspective, even if some of these claims are classified as liabilities on the balance sheet. More generally, users should not be locked into employing single measures of net income and equity, but should be able to calculate consistent measures of net income, equity and thus return on equity from the various conceptually sensible perspectives (i.e., a pure solvency perspective, a pure valuation perspective, and combined perspectives).

Including a noncontrolling interest in the equity section of the balance sheet also compromises the representation of the income statement as a return to equity investors as defined in the balance sheet. However, in the absence of proportional consolidation, the Committee is not opposed to including the noncontrolling interest in the equity section. However, as noted in our response to Issue 7, the Committee strongly concurs with the Proposed Standard that a noncontrolling interest must always be presented and clearly labeled as a separate component of equity.

### *Miscellaneous questions*

In the statement of cash flows, interim payments related to liabilities are currently treated as operating while interim payments on equity are treated as financing. The Committee is uncertain how interim payments on instruments that are liabilities for tax purposes but equity for financial

reporting purposes (or vice versa) will be treated in the statement of cash flows under the Proposed Standard. The tax effect will certainly be operating.

The Committee is uncertain whether the Proposed Standard addresses how financing instruments that are obligations to deliver equity shares will be classified for purposes of calculating shares in basic EPS. Can such a financing instrument that is classified as equity under this proposal – e.g., an obligation to deliver a fixed number of equity shares – not be included in shares for the basic EPS calculation because it does not comprise outstanding shares even though it will surely yield outstanding equity shares? Conversely, can a financing instrument that is classified as a liability under this proposal – e.g., an obligation to deliver a variable number of equity shares with a fixed fair value – be included in shares for the basic EPS calculation because it will surely yield outstanding equity shares?

## Comments on Specific Questions in the Proposed Standard

### *Scope*

*Issue 1: Certain financial instruments that have characteristics of liabilities, equity, or both also contain components that, if freestanding, would be assets. The Board decided not to address separation of asset components in this proposed Statement. Separate recognition of those components might be required by other authoritative pronouncements. Is the Board's decision not to address separation of asset components appropriate? If so, why? If not, why not? Paragraphs 219–221 discuss the basis for the Board's conclusion.*

The Committee found no academic studies that address this issue. However, we believe the netting of asset components of inseparable compound financing instruments is reasonable given that these asset components (presumably call options) effectively reduce the fair value of these financing instruments and are not stand-alone instruments. Issues related to measuring the value of the asset component and allocating its joint value with the other options to the liability and equity components of the inseparable compound financing instrument may be significant, however, as discussed previously and in our response to Issue 2(c) below.

### *Initial Classification*

*Issue 2: This proposed Statement would require that the issuer of a compound financial instrument to separate that instrument into its liability components and its equity components if certain conditions are met. (That requirement would supersede APB Opinion No. 14, Accounting for Convertible Debt and Debt Issued with Stock Purchase Warrants.)*

- a. Is the requirement to separate a compound financial instrument into its liability components and its equity components appropriate? If so, why? If not, why not?*

The Committee generally agrees with the components approach for compound instruments, subject to two caveats. First, the components approach creates measurement problems that can affect the reliability of the reported values of the individual components. This specific issue is addressed in our response to part c below along with suggestions for mitigating the measurement problems. Second, for inseparable compound financing instruments, the components approach leads to the classification of the instrument in part as a liability and in part as equity, even though ultimately the instrument will be settled either as a liability or equity but not both. While we support such partial classification, the Committee believes that the measurement of inseparable compound financing instruments should reflect the probability that the instrument will be settled as a liability or equity, which could have a very significant effect on the amounts classified as a liabilities and equity. For example, convertible debt that is primarily classified as a liability under the Proposed Standard might be classified primarily as equity under an approach that incorporates the probability that the instrument pays off as equity.

The Committee believes that the components approach raises no issues for separable compound financing instruments, and to our knowledge there is no research on such instruments. We summarize below the research investigating the nature of inseparable compound financing instruments, most of which examines convertible debt. The research examines how both *firms* and *investors* view convertible debt relative to straight debt and equity.

Lewis, Rogalski, and Seward (LRS, 1999) address how *firms* view convertible debt. They show that some firms that use convertible debt have high expected costs associated with bondholder/stockholder agency conflicts. They infer that these firms use convertible debt as a substitute for straight debt to mitigate asset substitution problems. Other convertible debt issuers appear to be using the debt as a substitute for equity when adverse selection costs associated with straight equity are high. Their evidence is consistent with the notion that convertible debt is primarily debt or equity depending on the context, and that the determination cannot be made based on the contractual provisions of the instrument.

Several papers (cited by LRS) measure *investors'* perceptions of convertible debt by examining stock market responses to announcements of convertible debt offerings. In general, there is a negative stock market reaction to convertible debt offerings. LRS document that the average announcement date return is between that of announcement date returns for straight debt and equity offerings. Patel, Emery, and Lee (1993) show that, on average, the market views convertible debt and equity as substitutes.

Linsmeier, Shakespeare, and Sougiannis (2000) also raise questions about a classification based on contractual provisions rather than economic substance. They conclude that the association between various hybrid/compound instruments and common shareholder valuations depends on firm characteristics, suggesting that a simple classification based on contractual provisions can produce classifications that do not match economic intuition. Moreover, the firm characteristics that are associated with valuations of these instruments can change over time. Linsmeier et al. measure the association between common shareholder valuations of a firm and the valuations derived from a residual income model where the inputs to the model are calculated under the alternative definitions that include or exclude certain hybrid/compound instruments. They find no difference between models that treat convertible preferred stock as debt and those that treat it as equity, on average. However, the convertible preferred stock of firms more near default is priced more like equity while the convertible preferred stock of other firms is priced more like debt.

Overall, these results do not support use of the components approach for inseparable compound financing instruments as developed in the Proposed Standard. However, the results may support the use of a components approach that incorporates the probabilities that an instrument pays off as a liability or equity and that recognizes the economic substance of an instrument rather than its contractual provisions, as suggested by the Committee. For example, the research shows that both firms and investors view convertible debt as primarily equity in certain circumstances, while the majority of the instrument's value will usually be classified as a liability under the components approach in the Proposed Standard. Whether the instruments are viewed as primarily liabilities or equity depends on firm-specific characteristics (that affect economic substance) that can change through time and that presumably are related to the probability that the instrument pays off as a liability or equity.

- b. Does this proposed Statement provide enough guidance for determining when and how a compound financial instrument should be separated into components? If not, what additional guidance would be helpful?*

The Proposed Standard does not address how legal restrictions on payoffs affect the definition of an instrument's payoffs for purposes of classification. Cheng, Frischmann, and Warfield (2000, p. 7) discuss this issue and use as an example preferred stock (normally a hybrid instrument) that requires regular dividend payments except that the payments are restricted when they threaten the solvency of the issuing firm. As noted in the Proposed Standard, dividends on preferred stock are not typically a legal obligation and thus preferred stock is considered equity. Does the "exception" in this example imply that these dividends are not a requirement and render the instrument equity? Or, does the dividend requirement in the absence of the legal restriction serve to render this instrument debt?

- c. *What implementation issues can be expected to arise as a result of the requirement to separate a compound financial instrument into its components?  
Paragraphs 149–161 discuss the basis for the Board's conclusion.*

In theory, reliable and well-defined models are available to measure fair values of many commonly used financing instruments and components. For example, Brennan and Schwartz (1980), which was cited in Weygandt et al. (1993), provides a model for pricing convertible debt values that allows for realistic (but complicated) assumptions about interest rates and default probabilities. They also show, however, that errors from their model are "slight" when simplified interest rate structures are assumed, increasing the model's usefulness in practice.<sup>8</sup>

While reasonable models exist to measure the fair values of many financing instruments and components, in theory, an important issue is whether these models work in practice. Measuring fair values reliably with existing models requires that the model *inputs* are reliably measured, and determining some of these inputs involves discretion. Moreover, as new instruments are developed, and for new issues of existing instruments, measurement error is likely to be greater than for instruments in developed markets.

Kang and Lee (1996) provide evidence that publicly-traded convertible debt issues are underpriced at the issue date based on significant excess returns associated with the announcement of convertible debt issues. Thus, even for an instrument that is commonly issued, for which liquid markets exist, and for which well-established valuation models are available, prices at the date of issue do not reflect "fair" value. They show that various types of risk inherent in the new issues are useful in explaining cross-sectional variation in the excess returns, although the underpricing is invariant to zero versus nonzero coupon payments, maturity, issue size, and bond ratings.

The empirical results, which indicate that fair value measures are imprecise (although we did not need research to tell us this), support the Committee's view that valuation at the issue date alone, especially for inseparable compound financing instruments, is problematic. However, the

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<sup>8</sup> It is interesting to note that Brennan and Schwartz (1980) motivate development of their model, in part, as a tool for managers to make better decisions regarding new debt issues. This motivation suggests that managers should have a reasonable estimate of the value of an instrument and its components if the firm has entered into a particular transaction.

Proposed Standard does not allow firms to correct for unreliable estimates in subsequent periods. Given that fair value measures may be unreliable, the Committee believes that liability and equity classification should not rest solely on valuations at the issue date.

Barth, Landsman, and Rendleman (1998) is the most applicable research study for assessing implementation issues associated with measurement of fair values of compound instruments. BLR state that their goal is to assess the relevance and reliability of fair value accounting for debt.<sup>9</sup> They indicate that most debt issues are not publicly traded, which means that many instruments will be valued, and classification will be determined, based on estimates from valuation models. To assess reliability, BLR price traded convertible bonds using a binomial pricing model that could be used for non-traded instruments. They compare the pricing estimates from the model to actual bond market prices. They conclude that estimated prices may lack reliability.

To explain the lack of reliability, BLR (2000) highlight two specific measurement difficulties associated with estimating the binomial pricing model in BLR (1998). First, using the model requires estimating various inputs including (1) dividends, (2) the probabilities of up and down stock price movements (“u” and “d”), (3) a term structure of risk free interest rates, (4) historical equity volatility, etc. Second, in general, pricing models ignore the effects of multiple debt issues within a firm (although the BLR model considers the fair value of multiple issues jointly). The Proposed Standard does not address how firms should consider the correlation between valuations of multiple issues when theoretical models are used to determine fair value.

BLR (2000) also specifically address the issue of component measurement for an inseparable compound financing instrument with multiple interrelated components. They show that the calculation of separate values for interrelated components is inherently arbitrary. They discuss the example of a callable convertible bond that can be converted after being called, and show that the sum of the fair values of the components does not equal the fair value of the instrument because of the interdependence of the call and conversion options. Under the Proposed Standard, this difference is allocated to the components based on their relative fair values. BLR (2000) emphasize that this approach implicitly assumes that the source of the difference between the sum of the component values and the value of the instrument is random estimation error, when in fact the difference is specifically due to interdependencies among only the call and conversion option components of the instrument.

BLR’s (2000) analysis implies that liabilities, equity, and net income will be mismeasured under the Proposed Standard. Assume for purposes of illustration that the “estimation error” is positive (i.e., the sum of the fair values of the components exceeds the fair value of the inseparable compound instrument) and that the interrelated options are classified as equity. Under these assumptions, the proposed method of pro rata reducing the instrument’s liability and equity components based on relative fair value will undervalue the liability component of the instrument. Undervaluation of the liability component leads to understated net income over time

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<sup>9</sup> Barth, Landsman and Rendleman (1998) also include an analysis of whether the conversion features of bonds are significant (material) to address the question of relevance. This part of the paper is less salient because convertible debt is only one instrument subject to the Proposed Standard.

as differences between the face and fair value of the debt are amortized to income as a yield adjustment.

BLR (2000) also show how the interrelated component issue can be mitigated (or not) through disclosure. Specifically, Table 1 in BLR (2000) illustrates four disclosure possibilities and highlights how the interdependencies among the instrument's components are obvious in two and obfuscated in two.

*Issue 3: One of the three essential characteristics of a liability discussed in paragraph 36 of FASB Concepts Statement No. 6, Elements of Financial Statements, is that "it embodies a present duty or responsibility to one or more other entities that entails settlement by probable future transfer or use of assets at a specified or determinable date, on occurrence of a specified event, or on demand" (emphasis added). This proposed Statement would require liability classification for certain obligations that require or permit settlement by issuance of a reporting entity's equity shares (and, thus, do not require future transfer or use of the entity's assets).*

*Under the provisions of this proposed Statement, only those financial instrument components that establish an ownership relationship would be classified as equity. A component is deemed to establish an ownership relationship if it (1) is an outstanding equity share not subject to redemption provisions or (2) is an obligation that a reporting entity can or must settle by issuance of the issuer's equity shares and, to the extent the monetary value of the obligation changes, the change is attributable to, equal to, and in the same direction as the change in fair value of the issuer's equity shares.*

- a. Do you agree with the Board's conclusion that certain obligations that permit or require settlement by issuance of the reporting entity's equity shares should be classified as liabilities?*

While the Committee agrees that the mezzanine section of the balance sheet as currently constituted should be eliminated, any classification system with only two categories for a (potentially) limitless number of instruments will result in a heterogenous set of instruments within one or both categories. As discussed previously, in classifying financing instruments, the Proposed Standard adopts a solvency perspective as primary and a valuation perspective in a subordinate and narrow fashion, which locates most of the heterogeneity of financing instruments in liabilities. For example, the Proposed Standard classifies certain obligations that permit or require settlement by issuance of the reporting entity's equity shares as liabilities, even though they do not impair solvency and may have economic substance much like equity from a valuation perspective. By choosing to restrict the instruments that are classified as equity, the Proposed Standard effectively uses the liability category as a default balance sheet classification for instruments that do not fit nicely into either the liability or equity categories. By and large, this approach reverses current accounting practice in which the liability section of the balance sheet is relatively clean and the equity section contains a diverse set of more or less residual claims.

Research suggests that the classification between debt and equity is important and that destroying the clean interpretation of the liability section of the balance sheet may be especially problematic. For example, Hopkins (1996) studies buy side analysts in an experimental setting.

The analysts are asked to estimate stock price immediately after the offering of mandatory redeemable preferred stock (MRPS). The balance sheet classification of the MRPS is manipulated between subjects: debt, equity, and mezzanine. He replicates prior experimental results on the valuation of straight debt versus equity (as a benchmark) and shows that the classification affects the analysts' estimates of stock price. The estimated stock prices are significantly higher when the MRPS is classified as a liability than when it is classified as equity. When the MRPS is classified in the mezzanine, the valuations for the common stock are lower than those when the MRPS is classified as common equity (though the significance of this difference is not reported). One might have expected the valuation of MRPS classified in the mezzanine to be between the common stock valuations that were made when MRPS is classified as either debt or equity.

In additional analysis probing this somewhat unexpected result, Hopkins examines how classification influences the way analysts make their valuations. When the MRPS is classified in the mezzanine, analysts are more likely to make statements about specific attributes of the MRPS (e.g., dividend rate) to justify their valuations. In contrast, when the MRPS is classified as either debt or equity, analysts are more likely to make statements related to its classification, such as that MRPS that is classified as debt increases leverage. His conclusion, based on this additional analysis, is that the analysts more carefully examined the attributes of the MRPS when it was classified in the mezzanine, but the analysts took certain attributes for granted when the MRPS was classified as either debt or equity. This last result suggests that it is extremely important to classify as liabilities (or equity) items with similar characteristics.

Two papers examine how investors perceive hybrid financing instruments in addition to Linsmeier et al. (2000), discussed previously, that examines preferred stock (a hybrid instrument) as well as compound instruments. Cheng, Frischmann, and Warfield (2000) examine the association between systematic risk and stock prices for minority interest and redeemable and non-redeemable preferred stock. The sample period is 1993-1997. Redeemable preferred securities (including trust preferred stock) are not viewed as either debt or equity. Non-redeemable preferred stock is debt-like. Minority interest is equity-like. These results are inconsistent with current treatment in the financial statements. The results are stronger for larger firms. The authors speculate that firm size is correlated with financial health. Thus, for example, they interpret the more debt-like nature of preferred stock for larger firms as evidence that the instrument is more like debt and less like a residual claim for financially healthy firms. The fact that the pricing results vary based on firm size, performance, and bond ratings is another indication that for hybrid instruments, a single classification based on contractual provisions that is done only at the initial issue date will be misleading.

Kimmel and Warfield (1995) conduct a similar analysis for outstanding redeemable preferred stock for the sample period 1979-1989.<sup>10</sup> Instead of a positive relation between redeemable

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<sup>10</sup> There are a few caveats to the studies on firms' and investors' views of compound/hybrid financial instruments. First, with the exception of Lewis, Rogalski, and Seward (1999), the studies do not control for self-selection issues related to a firm's choice of a particular instrument. Second, the papers generally focus on perceptions of stock market participants who are not the only users of financial statements. Third, the papers do not address the classification issue per se. That is, they do not (and cannot) address the question of whether classification of hybrid/compound instruments as liabilities rather than equity (or vice versa) would have affected the valuation. The papers only assess whether investors value a particular hybrid or compound instrument as debt or equity regardless

preferred stock and systematic risk after controlling for operating risk (which would be expected if the redeemable preferred stock is debt like), the relation is actually negative (or zero when controlling for industry and year). A negative relation is predicted if the redeemable preferred stock is viewed like common stock. When there are no conversion features or voting rights, the coefficient on redeemable preferred stock is zero (should be positive if the hybrid instrument is debt like). The authors acknowledge that the lack of results may indicate a lack of power rather than substantial results. Nonetheless, the results suggest that this particular hybrid instrument, which would be classified as a liability under the Proposed Standard, is viewed as equity based on a valuation perspective.

- b. Do you agree with the Board's conclusion that a financial instrument component that does not establish an ownership relationship should not be classified as equity?*

The ownership interest criterion places a significant restriction on the instruments that can be classified as equity. As noted in the response to Issue 3(a), placing a restriction on instruments that can be classified as equity means that many instruments will default into the liability classification. One outcome is that certain instruments are classified as liabilities even though they do not affect the solvency of the firm. As noted by Cheng, Warfield, Frischmann (2000), mandatorily redeemable preferred stock cannot force a delinquent firm into bankruptcy, and “financial theory suggests that a primary characteristic of debt is that creditors have the option to force a delinquent debtor into bankruptcy.” Cheng et. al. cite Myers (1977) and Warner (1977) as examples of financial theory that effectively take a solvency perspective toward defining debt.

A second outcome is that certain instruments are classified as liabilities even though the tax shields on these instruments are significantly different. Carter and Manzon (1995) show that firms with low marginal tax rates rely more heavily on mandatorily redeemable preferred stock than debt relative to firms with high marginal tax rates. Using liabilities as the default classification for many hybrid instruments reduces the ability of the balance sheet to provide information that is useful for forecasting future cash flows. This point reflects the Committee's position that the financial statements should support a valuation perspective for income reporting while still being consistent with a solvency perspective on the balance sheet.

- c. Do you believe that the Board has made an appropriate distinction between equity-settled obligations that should be classified as equity and equity-settled obligations that should be classified as liabilities?*

Our conceptual discussion clearly indicates that our answer to this question is “no”. The Committee believes that the classification criteria represent a mix of the solvency and valuation perspectives for distinguishing liabilities from equity and that the result is a narrow definition of equity and a broad (and meaningless) definition of liabilities.

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of where the instrument is classified. It is interesting to note that these papers, in fact, ignore the classification issue although both Cheng, Frischmann, and Warfield (2000) and Linsmeier, Shakespeare and Sougiannis (2000) offer classification issues as a primary motivation for their studies. Finally, several of the papers are still working papers and have not been subjected to a complete peer review process as yet.

In response to this question, the Committee also wants to bring to the FASB's attention the results of some research that addresses whether managers might "manage" the classification of certain instruments. Engel, Erickson, and Maydew (EEM, 1999) estimate how important managers believe classification to be by showing that firms pay a "premium" to achieve certain classification status. EEM has a sample of 44 firms that issue trust preferred stock and use the proceeds to redeem debt. The firm neither gains nor loses any tax advantages in this transaction since interim payments on both instruments are tax deductible. The firms are merely switching one instrument that is classified as debt on the balance sheet for another that is classified as equity. They estimate the "lower bound of what firms are willing to pay for the label associated with trust preferred stock as the direct issue costs and yield premium incurred..." They measure the upper bound as the forgone tax savings from retiring debt rather than retiring traditional preferred stock (on which the dividend payments are not deductible). The lower bound is \$10 mm (4.14 – 4.31% of issue size) and the upper bound is \$43 mm (15.84 – 28.86% of issue size).

By contrast, Givoly and Palmon (1981) find no evidence of "classification" management. They study the treatment of 683 convertible debt issues between 1951 and 1975 (pre and post APB 15) as a common stock equivalents (CSE) per APB 15. They note that since the classification of convertible debt as a CSE is made only once, the motivation for manipulation is strong. On p. 539, they discuss problems associated with EPS management. In summary, the cost to tweak the terms of the debt just enough to achieve a preferred classification is low. However, they find no direct evidence of manipulation of either the terms of securities (cash yield) or issue timing, both of which are potential manipulations that would change classification.

*Issue 4: Under the approach in this proposed Statement, any financial instrument that is issued in the form of shares that are subject to mandatory redemption provisions (that is, subject to redemption upon a specified date or upon the occurrence of an event that is certain to occur) are classified as liabilities. That would include shares issued by some privately held companies that require that the shares be resold to the issuer upon the holder's termination of its ownership position (whether by selling the shares or by death). That conclusion would reduce (and in some cases eliminate) the equity of some privately held entities. (Alternatively, a privately held entity's shares may be puttable to the issuer at the fair value of the shares at the date the put option is exercised. Paragraph 63 addresses stock that is puttable at its fair value.) Are there other factors that the Board should consider regarding the applicability of its conclusion on shares subject to mandatory redemption provisions to privately held entities that issue that type of security?*

The analysis in this issue highlights an inconsistency in the classification of hybrid instruments and compound instruments within the Proposed Standard. Firms can achieve similar outcomes for payout purposes by structuring a compound rather than complex hybrid instrument. Hybrid instruments would be classified as either liabilities or equity while compound instruments would be classified using the components approach.

#### *Initial Measurement*

*Issue 6: This proposed Statement would require that the issuer of a compound financial instrument allocate the proceeds of issuance of that instrument to its separately classified*

*liability components and equity components using the relative-fair-value method. That requirement would apply in all circumstances except when (a) the instrument contains a component that is a derivative subject to the requirements of FASB Statement No. 133, Accounting for Derivative Instruments and Hedging Activities, or (b) application of the relative-fair-value method is impracticable because the fair value of one or more components cannot be reliably determined. Is the requirement to use the relative-fair-value method appropriate? If not, why not? Are there other circumstances in which that method should not be required?*

*Paragraphs 209–218 discuss the basis for the Board’s conclusion.*

The Committee believes the relative-fair-value method is appropriate for separable compound financing instruments. As discussed previously, applying the relative-fair-value method to inseparable compound financial instruments raises issues regarding interactions between components.

There is limited research evidence that is relevant to the assessment of the relative-fair-value method. Givoly and Palmon (1981), discussed previously, note that the APB rejected the market parity and investment value methods of determining when convertible debt was a CSE “on the grounds that they were too subjective.” The adopted method, however, was also criticized. Under the investment value method (which appears to be similar to the with-and-without method), the market value of the bond is compared to the market value of a comparable bond without the conversion feature. Under the market parity method, one compares the conversion value to the market price...and “if the conversion value is at least 98% of the market value, the security is considered to be residual either at issue time or at a subsequent date.” Given more recent focus on fair value accounting, such a debate as the one that occurred around APB 15 may not occur again, although the fact that the APB rejected these methods as “too subjective” is interesting.

*Classification and Presentation of the Noncontrolling Interest in a Consolidated Subsidiary Issue 7: This proposed Statement would require that an equity instrument that is issued by a consolidated subsidiary of the reporting entity and that represents the noncontrolling interest in that subsidiary be reported in the consolidated financial statements as a separate component of equity. Do you agree with the Board’s conclusion that the noncontrolling interest is part of the equity of the consolidated entity? If not, why not? What implementation issues can be expected to arise as a result of that decision?*

*Paragraphs 226–233 discuss the basis for the Board’s conclusion.*

Clearly, a noncontrolling interest is distinct from other financing instruments that are included in equity. However, in the absence of partial consolidation, the noncontrolling interest must be included somewhere on the balance sheet and the Committee is not opposed to including the noncontrolling interest in the equity section. The Committee strongly concurs with the Proposed Standard that a noncontrolling interest must always be presented and clearly labeled as a separate component of equity.

*Issue 8: In accordance with the Board’s conclusion that shares of a consolidated subsidiary that represent the noncontrolling interest are equity of the consolidated entity, sales of those shares to entities outside the consolidated group would be considered equity transactions. Accordingly,*

*no gain or loss would be recognized on those sales as long as the subsidiary remains consolidated. Do you agree with the Board's conclusion related to recognition of gain or loss on sales of subsidiary shares? If so, why? If not, why not?*

*Paragraphs 234–236 discuss the basis for the Board's conclusion.*

As noted by Credit Suisse First Boston Corporation (2001), the proposed accounting for sales of equity shares of a consolidated entity creates earnings management opportunities through the size and sequencing of share issuances by the subsidiary that cause the parent to lose control and so revert to the equity method. The Committee supports eliminating recognition of gains and losses on sales of shares in a consolidated entity (rejects SAB 51 gains and losses). However, the Committee believes the FASB should consider alternatives that mitigate the potential for accounting abuses. Specifically, we suggest that a sale of shares by a subsidiary that results in the loss of control be divided into two parts – the portion that reduces ownership to 50% and the portion that reduces ownership below 50% – and that firms only recognize gains and losses on the second portion.

#### *Disclosures*

*Issue 11: The disclosure requirements of this proposed Statement are included in paragraph 45. Do you agree with those requirements? If not, what disclosure requirements would you omit or add?*

*Paragraphs 242–247 discuss the basis for the Board's conclusion.*

Forcing financing instruments into two categories will ultimately result in imperfect classifications in the sense that some instruments with dissimilar characteristics will be classified together and some instruments with similar characteristics will be classified separately.

Additional disclosure can mitigate some of the problems associated with such heterogeneity within the balance sheet classifications. The development of appropriate disclosures requires a well-articulated classification methodology based on explicitly stated perspectives as well as an analysis of other possible perspectives that are important for characterizing liabilities and equity. Only when one understands the information that will be discernible from the reported balance sheet amounts and the information that is lost as a result of the selected classification methodology, is it possible to construct disclosures that can provide incrementally relevant information. As an example, under the Proposed Standard, not all instruments that are classified as liabilities create income tax shields, although this is a common “characteristic” of debt. A useful disclosure would be the firm’s tax deductible servicing requirements.

The Committee emphasizes, however, that further disaggregation on the face of the balance sheet is superior to additional disclosure.

#### *Effective Date and Transition*

*Issue 12: This proposed Statement would require that in the initial year of adoption an entity restate all financial statements for earlier years presented for the effects of financial instruments within the scope of this Statement that were outstanding at any time during the initial year of adoption. An entity would be permitted, but not required, to restate all financial statements presented for the effects of financial instruments that were not outstanding at any time during the*

*initial year of adoption. An entity that elects to restate for those financial instruments would be required to restate all financial statements presented for the effects of all financial instruments within the scope of this Statement that were outstanding in any period presented, beginning with the earliest year presented. The cumulative effect of adopting this proposed Statement would be required to be included in the earliest year restated.*

*This proposed Statement also would require that an entity whose consolidated financial statements include one or more less-than-wholly-owned subsidiaries at any time during the initial year of adoption restate all financial statements presented for earlier years that include those subsidiaries to classify the noncontrolling interest as equity. The entity also would be required to restate all financial statements presented for the effects of any gains or losses on any sales of a subsidiary's shares that were not accounted for in accordance with paragraphs 37 and 38 of this Statement. An entity would be permitted but not required to restate all financial statements presented for the classification of the noncontrolling interest and any gains or losses recognized on sales of a subsidiary's shares for the noncontrolling interest that did not exist at any time during the initial year of adoption. An entity that elects to restate for those noncontrolling interests and associated gains and losses would be required to restate all financial statements presented for the effects of all noncontrolling interests that existed and all those gains and losses that were recognized in any period presented, beginning with the earliest year presented. This proposed Statement would not require that an entity recognize a cumulative effect for gains or losses on sales of a subsidiary's shares in periods that are not restated.*

*Would another transition method be more appropriate? If so, what method and why? Paragraphs 248–255 discuss the basis for the Board's conclusion.*

The evidence in Engel, Erickson, and Maydew (1999), discussed previously, suggests that classification rules affect instrument choice. Therefore, firms may have chosen different instruments in the past if the classification methodology in the Proposed Standard had been in place. An alternative transition method is to apply the proposed classification rules to new issues only. However, given the long-term nature of these instruments, such a transition would create balance sheets with mixed classifications for many years into the future.

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