Debt vs. Equity?

RECENT FASB STAFF POSITION

FAS 123R-4: Classification of Options and Similar Instruments Issued as Employee Compensation That Allow for Cash Settlement upon the Occurrence of a Contingent Event

Under FASB Statement Number 123R, Share-Based Payment, an employee stock option is classified as a liability only if, under any circumstance, the option can be settled in cash or with a transfer of assets. No liability is recorded in the typical case where the option is settled with a share issue at the exercise price.

On February, 2006, the FASB posted a Staff Position (FSP FAS 123R -4) limiting the liability classification for these options. Previously, employee options were classified as liabilities only if they could be required to be settled in cash under a particular circumstance. The new FSP modifies the requirement by overlaying criteria familiar from FASB Statement Number 5: the liability classification applies only if cash contingent settlement is probable and is outside the control of the employee (the employee’s death, a change in company control, or a financing event could fit the latter.) Otherwise the option is equity.

The FSP states in an appendix that “The majority of the Board supported the probability approach because that approach provides internal consistency between the classification of shares and options or similar instruments when the instruments are issued as employee compensation and embody a conditional obligation to transfer assets.” Complicated fine-tuning in accounting standards often arises from misguided conceptual thinking, to tidy up the muddle. Enforcing consistency with earlier misguided treatments confounds the problem. In the accounting for convertible securities, the FASB is actually producing more inconsistency. While employee stock options, stock warrants and other (contingent) call options on a firm’s stock are classified as equity (and not liabilities), FASB Statement Number 150 requires a liability classification for put options and put warrants.

In formulating FASB Statement Number 150, the FASB recognized the inconsistencies. It understood that the treatment of put obligations under Statement 150 conflicted with the definition of a liability in FASB Concepts Statement Number 6. CON 6 says that a liability exists only if it will be discharged by an asset transfer (usually cash) -- thus the special treatment of an employee option settled contingently settled in cash. The CON 6 definition presumably has creditors in mind, for they are concerned with assets available to meet their claims. Debt holders are not concerned with obligations to be settled with shareholders’ paper. But, certainly, shareholders’ are concerned when management settles obligations with the shareholders’ wealth: issuing shares at less than market price (when options are exercised) is certainly a diminution of shareholder value, as a basic proposition in finance. From the shareholders’ point of view, a claim on their wealth is a liability, not part of their equity, and faithful reporting to shareholders – the owners – requires such treatment.

The FASB has long struggled with the question of the distinction between debt and equity. The International Accounting Standards Board faces the same issue. The resolution is easy if these Boards simply took a shareholder perspective. Conflicts in treatments of instruments that are, in substance, the same would disappear. Structural engineering of instruments to achieve a desired accounting treatment would not be productive. And turning to fine nuisances – as in this recent Staff Position – would not be necessary. Quite simply, one would produce transparent reporting to shareholders. If precedence has to be binding, Concept Statement Number 6 requires amendment. Otherwise the FASB will continue to produce muddled and inconsistent regulations.

CEASA White Paper Number 1, "Debt vs. Equity: Accounting for Claims Contingent on Firms’ Common Stock Performance with Particular Attention to Employee Compensation Options" covers these issues in considerable detail and lays out a unified and consistent accounting treatment for all contingent claims on equity. Access this paper online at: