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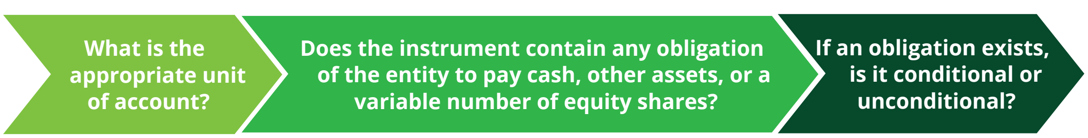
# On the Radar

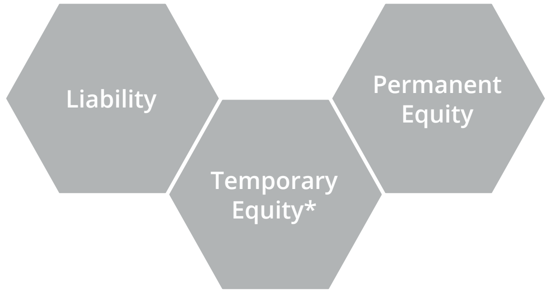
## Distinguishing Liabilities From Equity

Entities raising capital must apply the highly complex, rules-based guidance in U.S. GAAP to determine whether the securities they issue are classified as liabilities, permanent equity, or temporary equity. To reach the proper accounting conclusion, they must consider the following key questions:




All entities are capitalized with debt or equity. The mix of debt and equity securities that comprise an entity's capital structure, and an entity's decision about the type of security to issue when raising capital, may depend on the stage of the entity's life cycle, the cost of capital, the need to comply with regulatory capital requirements or debt covenants (e.g., capital or leverage ratios), and the financial reporting implications. For example, early-stage and smaller growth companies are often financed with preferred stock and warrants with complex and unusual features, whereas larger, more mature entities often have a mix of debt and equity securities with more plain-vanilla common stock capitalization.

Under U.S. GAAP, securities issued as part of an entity's capital structure are classified within one of the following three categories on an entity's balance sheet:




* For SEC registrants and non-SEC registrants that choose to apply the SEC's rules and guidance.

An instrument's classification on the balance sheet will affect how returns on the instrument are reflected in an entity's income statement. Returns on liability-classified instruments are reflected in net income (e.g., interest expense or mark-to-market adjustments), whereas returns on equity-classified instruments are generally reflected in equity, without affecting net income. However, dividends and remeasurement adjustments on equity securities that are classified as temporary equity may reduce an entity's reported earnings per share (EPS).

In addition to the effect on net income and EPS, entities often seek to avoid classifying capital securities as liabilities or within temporary equity for other reasons, including:

- The effect of the classification on the security's credit rating and stock price.
- Regulatory capital requirements.
- Debt covenant requirements (e.g., leverage or capital ratios).

**The SEC staff closely scrutinizes the balance sheet classification of capital securities to determine whether they have been appropriately categorized as liabilities, permanent equity, or temporary equity. This is evident in the staff's comment letters on registrants' filings and the number of restatements arising from inappropriate classification. Accordingly, entities are encouraged to consult with their professional advisers on the appropriate application of GAAP.**

ASC 480 is the starting point for determining whether an instrument must be classified as a liability. SEC registrants and non-SEC registrants that elect to apply the SEC's guidance on redeemable equity securities must also consider the classification within equity. The relevant accounting guidance has existed for a number of years without substantial recent changes. In addition, we are not aware of any plans of the FASB or SEC to significantly change the guidance in the near future.

## Equity Versus Liability Treatment

Securities issued in the legal form of debt must be classified as liabilities. In addition, ASC 480 requires liability classification for three types of freestanding financial instruments that are not debt in legal form:

| | |
|---|---|
| **Mandatorily Redeemable Financial Instruments** | Equity shares that include an unconditional obligation of the issuer to redeem the instrument for cash or other assets. A common example is mandatorily redeemable preferred stock. |
| **Obligations to Repurchase Issuer's Equity** | Instruments other than equity shares that include an obligation of the issuer to repurchase its equity shares. Examples include written put options and warrants to issue redeemable equity securities. |
| **Obligations to Issue a Variable Number of Equity Shares** | Certain types of instruments that obligate the issuer to issue a variable number of equity shares. A common example is preferred stock that must be settled with a variable number of common shares that have a fixed monetary value. |

In evaluating whether an instrument must be classified as a liability under ASC 480, entities must consider three key questions:

**What is the appropriate unit of account?**

ASC 480 applies to each freestanding financial instrument. In some cases, securities are issued on a stand-alone basis and it is readily apparent that there is only one unit of account. In other financing transactions, there are two or more components that individually represent separate units of account (e.g., preferred stock is issued with detachable warrants). When an entity enters into a financing transaction that includes items that can be legally detached and exercised separately, those items are separate freestanding financial instruments and ASC 480 must be applied to them individually.

**Does the instrument contain any obligation that may require the issuer to transfer cash, other assets, or a variable number of equity shares?**

To be a liability under ASC 480, an instrument must contain an obligation that requires the issuer to transfer cash, other assets, or equity shares (e.g., an obligation to redeem an instrument). ASC 480 defines "obligation" broadly to include any "conditional or unconditional duty or responsibility to transfer assets or to issue equity shares."

**If an obligation exists, is it conditional or unconditional?**

Conditional obligations are treated differently than unconditional obligations. To be a liability under ASC 480, an instrument that is a share in legal form must contain an unconditional obligation of the issuer to redeem it in cash, assets, or a variable number of equity shares. However, other obligations that are not outstanding shares may require classification as liabilities under ASC 480 whether the obligation is conditional or unconditional. For example, an obligation to repurchase an issuer's equity shares is a liability whether the obligation is conditional or unconditional.

## Permanent Equity Versus Temporary Equity

SEC registrants are required to apply the SEC's guidance on redeemable equity securities. An entity that has filed a registration statement with the SEC is considered an SEC registrant. Other entities, such as companies that anticipate an IPO in the future, may elect to apply this guidance.

Equity-classified securities that contain any obligation outside the issuer's control (whether conditional or unconditional) that may require the issuer to redeem the security must be classified as temporary equity. Equity securities that are classified as temporary equity are subject to the recognition, measurement, and EPS guidance in ASC 480-10-S99-3A, which is often complex to apply. The remeasurement guidance in ASC 480-10-S99-3A may negatively affect an entity's reported EPS because adjustments to the redemption amount are often treated as dividends that reduce the numerator in EPS calculations.

**An entity must apply the SEC's guidance on the classification of redeemable equity securities in its SEC filings made in contemplation of an IPO or a merger with a SPAC.**

## Earnings per Share

ASC 480 does not comprehensively address how to determine EPS for instruments within its scope. Instead, an entity applies ASC 260 except as specified in ASC 480-10-45-4, which requires the entity to make certain adjustments to the EPS calculation performed under ASC 260 for (1) mandatorily redeemable financial instruments and (2) forward contracts that require physical settlement by repurchase of a fixed number of equity shares of common stock in exchange for cash. For contracts that may be settled in stock or cash, whether at the option of the issuer or the holder, share settlement is presumed; therefore, the calculation of diluted EPS must include the potential shares under such contracts.

Deloitte's Roadmap *Distinguishing Liabilities From Equity* provides a comprehensive discussion of the classification, recognition, measurement, presentation and disclosure, and EPS guidance in ASC 480 and ASC 480-10-S99-3A. Entities should also consider Deloitte's Roadmap *Contracts on an Entity's Own Equity* for guidance on equity-linked instruments that are not outstanding shares as well as Deloitte's Roadmap *Earnings per Share* for guidance on the calculation of basic and diluted EPS.

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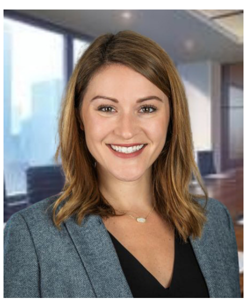

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