[Journal of Business & Leadership: Research, Practice, and Teaching (2005-2012)](https://scholars.fhsu.edu/jbl)

Volume 2
Number 1 *Journal of Business & Leadership*

Article 20

1-1-2006

Capstone Approach For Teaching Financial Instruments In Intermediate Financial Accounting

Konrad Gunderson
Missouri Western Stale University

Recommended Citation

Gunderson, Konrad (2006) "Capstone Approach For Teaching Financial Instruments In Intermediate Financial Accounting," *Journal of Business & Leadership: Research, Practice, and Teaching (2005-2012)*: Vol. 2: No. 1, Article 20.
DOI: 10.58809/GSZX4540
Available at: https://scholars.fhsu.edu/jbl/vol2/iss1/20

Journal of Business and Leadership: Research, Practice, and Teaching
2006, Vol. 2, No. 1, 177-185

CAPSTONE APPROACH FOR TEACHING FINANCIAL INSTRUMENTS IN INTERMEDIATE FINANCIAL ACCOUNTING

Konrad Gunderson, Missouri Western State University

Since the release in 2003 of Statement of Financial Accounting Standard 150 (SFAS150), accounting for certain financial instruments with characteristics of both liabilities and equity, intermediate accounting textbooks now include mandatorily redeemable preferred stock (MRPS) as a financial instrument requiring liability classification. MRPS is not legal debt in the traditional sense, but is classified as debt because its characteristics make it essentially equivalent to debt. This paper presents a series of teaching modules which, building on standard coverage of long-term debt and contributed capital, are designed to increase students' understanding of the essential characteristics of financial instruments. Completion of the modules will allow students to understand provisions of SFAS150 and prepare them for further standards developed in the Financial Accounting Standards Board's (FASB) financial instruments project. The approach enhances the skills students need for entry into the accounting profession, such as conceptual thinking, working in groups, written and oral communication, and applied professional research.

INTRODUCTION

Students will need a conceptual foundation in financial instruments to navigate FASB pronouncements such as SFAS150 and further accounting pronouncements dealing with financial instruments. To this end, this paper presents an approach which brings together the study of long-term debt and contributed capital (equity capital) in a series of three capstone modules which provide more depth of understanding than would be attained in a more traditional approach.

Several bodies have discussed educational requirements for entry into the accounting profession (big 8 public accounting firms 'The White Paper', 1989, Accounting Education Change Commission, 1990, American Institute of Certified Public Accountants' core competency framework, 1999, Albrecht and Sack 'Charting a Perilous Future' Monograph, 2000). These bodies all agree that accounting students have been too narrowly focused on technical detail. Accounting students, to enter the profession successfully, need better conceptual foundations in their subject matter, as well as broader exposure allowing them to see connections between accounting and general business, as well as finance, economics, and international issues. In addition, students need improved professional skills to succeed, such as oral and written communication skills, ability to work effectively in groups, and applied professional research skills. The teaching modules themselves broaden the conceptual basis students have when dealing with accounting issues related to financial instruments. Students completing the modules will have the ability to encounter a new financial instrument and make judgments about its essential character and its likely classification as either debt or equity. In addition, the modules can be used to address professional skills of written and oral communication, working in groups, and applied professional research (see below under the section Implementation Guidance and Assignment Suggestions).

The first two modules encourage students to see financial instruments on a continuum, rather than as simply debt or equity, and that when forced to combine instruments into two groups, liability and equity categories on the balance sheet necessarily reflect something less than perfect representational faithfulness. The third module provides three financial instruments adapted from actual companies which students must classify as debt or equity, a task which requires identification of essential characteristics of each security. This exercise allows instructors to introduce students to the next phase of the FASB's financial instruments project, the fundamental components approach, and to contrast SFAS150 with the International Accounting Standards Board (IASB) related standard, *Financial Instruments: Disclosure and Presentation* (IASB, 2003).

Background - SFAS150

With the release of SFAS150 (FASB, 2003), the FASB has completed an initial phase of its ongoing financial instruments project. In the next phase of the project, the FASB will take up the issue of how to account for compound financial instruments such as

convertible debt which combine a host instrument (e.g. a bond) with an embedded option. Prior to undertaking compound instruments, the FASB had to first decide on basic issues regarding classification of hybrid financial instruments, such as redeemable preferred stocks, which inseparably combine features of debt and equity. This is the genesis of SFAS150.

SFAS150 requires debt classification for mandatorily redeemable financial instruments such as mandatorily redeemable preferred stock (MRPS), and financing expense classification of related dividends. This decision can be seen as one of choosing substance over legal form since MRPS lacks a legal characteristic of debt - the ability to force the issuing firm into bankruptcy for lack of payment. The move can be criticized as reducing the representational faithfulness of the debt category on the balance sheet which traditionally has been limited to financial instruments which are legal debt. The American Accounting Association Financial Accounting Standards Committee (2001), for example, has called for additional categories as a way of reducing the heterogeneity of individual categories. The idea of adding a third capital element was one of the possibilities included in the discussion memorandum preceding SFAS150 (FASB, 1990).

SFAS150 makes it clear that the FASB is committed to the traditional dichotomous classification of financial instruments on the balance sheet. While the FASB has stated its willingness to modify the conceptual definition of a liability, there is no indication that a new financial statement element, such as quasi-equity, or temporary equity, will be added. Staying with three basic balance sheet elements: assets, liabilities, and ownership interest, also keeps with FASB on track toward convergence with international accounting standards which also prohibit any mezzanine or middle capital element between liabilities and equity.

The International Accounting Standards Board (IASB) in 2003 issued International Accounting Standard No. 32 (IAS32), *Financial Instruments: Disclosure and Presentation* (IASB, 2003). IAS32 and SFAS150 both require liability classification for mandatorily redeemable preferred stock, but only IAS32 requires liability classification for preferred stock which is redeemable at the discretion of the holder (i.e. puttable stock). Paragraph 19 of IAS32 states that for equity classification, a firm must have an *unconditional* right to avoid repayment, otherwise a liability exists. Thus, puttable stock is a liability under IAS 32, since the firm *may* have to redeem it. On the other hand, SFAS150 requires liability classification only for preferred stock which *must* be redeemed. SFAS150 does not address the accounting for puttable stock. The FASB views puttable stock as a compound financial instrument and has deferred ruling on these until the next phase of its financial instruments where it will provide guidance on the decomposition of financial instruments into components, with each component being classified according to its character as either an asset, liability, or equity item.

Teaching Modules

The teaching modules assume basic background in accounting for long-term debt, stockholders' equity, and contributed capital. To complete the modules presented below students are provided in appendix I with summary statements of essential legal and economic characteristics of debt and equity. These summaries define "pure" debt and "pure" equity, and allow students to evaluate hybrid financial instruments. By referring to the summaries students can identify elements of both debt and equity in a financial instrument and ultimately judge whether, the instrument is more equity-like or debt-like and therefore conjecture as to its appropriate classification.

Module I: Ranking Securities and Drawing the Line Between Debt and Equity. In this part, students are asked to rank a series of financial instruments on a continuum from "most debt-like" (e.g. secured debt) to "most-equity-like" (i.e. common stock). After ranking the securities, students are asked to identify the key characteristic that defines the line separating debt from equity.

Students will know from textbook background which securities are included in debt and which in equity; the purpose of the exercise is to instill a conceptual approach to security classification in which individual securities are seen not as simply debt or equity, but as having a variety of features, some of which draw them closer to equity, some closer to debt.

Module I: Exercise. Consider the following financial instruments, listed in alphabetical order:

Common Stock
Cumulative Preferred Stock
Bonds Payable (debentures)
Income Bonds
Manditorily Redeemable Preferred Stock
Preferred Stock

1. Based on your knowledge of these financial instruments and essential features of debt and equity, rank the securities on a continuum, in descending order, from most debt-like, to most equity-like. Present your ranking like this:

Debt:
dependent
Security judged "most debt-like"
Security judged next "most debt-like"
•
•
•
Name of security judged "most equity-like"

Equity:

For each security, provide a rationale for why you placed it in the continuum where you did.

2. Draw a line separating those securities that should be classified as debt from those classified as equity. What appears to be the single key factor in determining whether a security is classified as debt or equity? To answer this question, it may help to first consider the following: (i) what feature do all the debt securities share (but none of the equity securities have); (ii) what feature do all the equity securities share (but none of the debt securities has)?

Module I: Exercise Solution.

1. The suggested ranking, with the line separating debt and equity, is as follows:

Debt
Debentures
Income Bonds
Mandatorily Redeemable Preferred Stock

Cumulative Preferred Stock
Preferred Stock
Common Stock

EQUITY

Students should be able to identify debentures and common stock as the two "pure" items; all of the others represent hybrid instruments combining features of debt and equity. The two debt items, income bonds and mandatorily redeemable preferred stock, are similar in that their return payments (interest, dividends) are reliant on profitability of the issuing firm. However, income bonds are legal debt, while redeemable preferred stock is not, thus income bonds are ranked higher in the continuum. Students may ask what legal implications exist for firms not making payments on redeemable preferred stock. Kimmel and Warfield (1993) report that the most common legal remedy available to holders of MRPS is the right to place representatives on the board of directors until payments are made.

In the equity category, the preferred stocks are not residual securities due to their fixed liquidation value and annual stated dividend preference. Of the two preferreds, the cumulative shares are more debt-like because with the cumulative feature their annual dividends become more like interest payments than dividends on standard preferred.

2. The second objective of this exercise is to have students identify the key feature that separates debt from equity. The key issue revolves around whether the investment is permanent, i.e. for equity classification there is no obligation on the part of the issuing firm to return the initial investment, whereas for debt classification this obligation is present. By reaching this insight, students gain an appreciation for representational faithfulness. While debt and equity categories exhibit diversity, there is still a fundamental characteristic which unites all the items within each category.

Module II: Representational Faithfulness of Debt and Equity under SFAS150. This exercise asks the student to consider the representational faithfulness of the liability and equity categories of an example company (fictitious) balance sheet. The exercise brings out the fact that, under current accounting practice, debt and equity categories on the balance sheet combine a heterogeneous mix of financial instruments. Specifically, the liability category combines securities which are legal debt in the traditional sense (secured debt, debentures), and securities which are not (mandatorily redeemable instruments), and equity combines the true residual ownership interest in the firm (common stock) with the non-residual hybrid, preferred stock.

Module II: Exercise. Indira Corporation at December 31, 2006 has $80 million in total assets, and the securities shown below in Table 1. All securities were issued at par or face amount. All preferred stocks have a liquidation preference equal to their par value per share, and an aggregate liquidation preference equal to the total amount outstanding.

Evaluate the representational faithfulness of the liability and equity categories in the context of Indira Corporation's balance sheet. For the purposes of this analysis, representational faithfulness is defined as the extent to which a financial statement category summarizes items which are similar in nature. Stated another way, a financial statement category containing heterogeneous items exhibits something less than perfect representational faithfulness.

1. Consider Indira's liability total of $38 million. Identify and discuss significant ways in which this category combines items which are dissimilar. Specifically address the following: (a) what key characteristic do secured debt and debentures share, but which is not shared by redeemable preferred stock? (b) In what sense can debentures and redeemable preferred stock be seen as homogeneous and secured debt as different? Consider that legal or contractual factors may not entirely determine the essential nature of a financial instrument.

2. Consider the two items comprising Indira's stockholder equity of $42 million, common stock and preferred stock. How do these two securities fundamentally differ? Specifically address the following: (a) is preferred stock residual in sharing of periodic distributions (interest, dividends)? Is it subject to variability in the amount it receives in periodic distributions? (b) Is preferred stock residual in sharing of liquidation proceeds? Is it subject to variability in the amount it receives in liquidation?

Table 1: Indira Corporation Balance Sheet (Partial)

DESCRIPTION	AMOUNT
Secured Debt: carrying an annual interest rate of 5%. Interest and principal payments are guaranteed by a lien on operating assets with a fair value of $25 million. If an interest payment is missed, the property must be immediately sold and the proceeds used to repay the bonds plus interest due.	$15,000,000
Unsecured Bonds: carrying a 6% annual interest rate. Two years ago Indira was exper ncing cash flow problems and informed bondholders that it would be unable to make a scheduled interest payment. Negotiations with bondholders resulted in a settlement whereby Indira was allowed to make up the missed payment at the next scheduled interest payment date, making a double payment at that time.	$20,000,000
Redeemable Preferred Stock: $100 par value with a 6% annual cumulative dividend; 30,000 shares issued and outstanding. Shares must be redeemed by the company at par on January 1, 2009. Any dividends in arrears must be paid at the time of redemption. As of December 31, 2006 there are no dividends in arrears; over the past 3 years Indira has skipped the annual dividend once, making up the arrearage in the following year.	$3,000,000
Total Debt Securities	$38,000,000
Preferred Stock: $100 par value with a 7% annual dividend; 70,000 shares issued and outstanding.	$7,000,000
Common Stock: $10 par, 3 million shares issued and outstanding.	$30,000,000
Retained Earnings	$5,000,000
Total Common Equity	$35,000,000
Total Stockholders' Equity	$42,000,000

Module II: Exercise Solution.

1. (a) Secured debt and debentures are both legal debt with the ability to force the firm into bankruptcy for lack of payment, while redeemable preferred stock is not legal debt. The distinction is important since a firm's solvency is specifically tied to its legal obligations. A firm can only be forced into bankruptcy by its legal obligations, and bankruptcy costs are in turn a key factor in financial theory in determining optimal capital structure. Thus, the liability category under SFAS150 obscures a distinction which is important from the standpoint of financial theory. The American Accounting Association Financial Accounting Standards Committee (1999) argues that solvency risk assessment is a perspective that needs to be considered in classification of financial instruments in the balance sheet.

1. (b) Secured debt has a specific asset pledged to ensure its return payments, while debentures and MRPS must rely on general faith in the issuer's promises. Thus, while debentures are legal debt and MRPS is not, they may be economically equivalent, a point which is reinforced by the fact that both carry the same interest rate. Nair, et al. (1990) argue that MRPS is in substance a liability and provide an example of a company whose debt and MRPS carry the same interest rate. In times of financial distress, debentures and MRPS afford some flexibility to the issuing firm. Firms may be able to negotiate with bondholders over the timing of payments, and dividends on MRPS may be temporarily avoided. The notion that financial instruments' essential nature may depend on contextual factors has underpinnings in empirical research. For example, Linsmeier et al. (2000) find evidence that market participants view unsecured debt as

equivalent to equity for firms in financial distress. In a similar vein, Cheng et al. (2003) find that market participants view preferred stock of financially strong firms as equivalent to debt.

On the other hand, secured debt offers the firm no similar flexibility. Unlike MRPS and unsecured obligations, the firm must make scheduled payments on secured debt, or suffer liquidation of key assets.

2. (a) Preferred shareholders are residual to all legal debts in periodic distributions. Preferred shareholders are subject to variability in annual distributions in that, in any given year, they may or may not receive their annual dividend. However, preferred stock is a fixed income security because, unlike common stock, their annual return is limited to the preferred dividend. This distinction is important because preferred stock financing adds to the degree of financial leverage employed by the firm's ownership interests, common stock. Standard financial analysis suggests that the mean and variability of return to common stock is impacted by the degree of financial leverage employed. Thus, the equity category under current accounting practice obscures a distinction which is important from the standpoint of financial analysis.

2. (b) Preferred shareholders are residual to all legal debts in liquidation. Preferred shareholders may receive a return of some, all, or none of their investment and as such are subject to variability. However, preferred shares are not truly residual because the amount they receive is limited by their fixed liquidation preference, frequently equal to the par value of the shares. Thus, preferred stock is not truly residual as is common stock.

Students may be unfamiliar with the fixed liquidation preference of preferred stock. Instructors can bring this point out by asking students how much common and preferred shareholders would receive under various liquidation scenarios. For example, if Indira Corporation liquidates with $80 million of cash to distribute, common and preferred would both receive their book value of $35 million and $7 million respectively. Variations from $80 million would first impact the amount common receives and leave preferred unchanged.

Module III: Analysis of Specific Financial Instruments. This part focuses on having students apply essential concepts of debt and equity to determine the classification of specific financial instruments. The financial instruments are ones that fall under the guidance of SFAS150 (mandatorily redeemable shares and shares which can be settled by issuing a variable number of shares) or are specifically excluded from the scope of SFAS150 (shares redeemable at the option of the holder). The latter provides an opportunity to contrast SFAS150 and related guidance under international accounting standards (IAS32).

Module III: Exercise. At December 31, 2006, Extua Corporation had one hundred million shares of its class A common stock outstanding. Each share entitles the holder to one vote on ballot items at the company's annual meeting. The shares are transferable without restriction and are actively traded on the New York Stock Exchange. In addition, Extua also had the following securities outstanding at December 31, 2006 (all shares were issued at par value):

$5 million - Class B Common Shares (100,000 shares of $50 par value stock outstanding). The shares are non-voting, do not share in dividends, but have liquidation rights at par with the class A common shares. The shares were issued December 31, 2006 and are subject to mandatory redemption on December 31, 2008 at $57.245 per share, or a total of $5,724,500. The shares will be accreted to their redemption value using the effective interest method.

$25 million - Series A Preferred Stock (250,000 shares of $100 par value stock outstanding). The shares carry an annual dividend of 6% and an aggregate liquidation preference equal to their par value of $25 million. Dividends are cumulative, and the shares are subject to mandatory redemption at par on January 1, 2009. Any dividends in arrears must be paid at the time of redemption. The company may redeem the shares by paying cash, or by issuing $25 million worth of its class A common stock. The number of shares needed will depend on the market value for the common stock at the time of redemption.

$10 million - Series B Preferred Stock (100,000 shares of $100 par value stock outstanding). The shares carry an annual dividend of 6¾% and an aggregate junior liquidation preference equal to their par value of $10 million. Dividends are cumulative, and the shares are subject to cash redemption at par, at the option of the holder. Any dividends in arrears must be paid at the time of redemption.

For each security, decide whether it should be reported as part of liabilities or equity on Extua's

December 31, 2006 balance sheet. Explain your rationale for your decision in each case, basing your conclusions on what you see as the dominant or overall character of each security.

1. Class B common shares. Should the class B common shares be reported as part of debt or equity on Extua Corporation's December 31, 2006 balance sheet? In answering, specifically address the following points: (a) should the fact that these securities are issued in the form of common shares determine their classification? (b) What is meant by the term "accretion"? How should increases in the carrying value of the shares through accretion be reported in the financial statements?

2. Series A preferred stock. In deciding upon the classification of the series A preferred stock, address the following: (a) Can a security which may be settled by issuance of common stock be classified as a liability? If so, by what justification? (b) In what sense does issuance of additional shares of stock to settle the class A preferred stock represent a "sacrifice of economic benefits" by Extua Corporation and its existing shareholders, as required in the conceptual definition of a liability?

3. Series B preferred stock. In deciding upon the classification of the series B preferred stock, address the following: (a) should redeemable preferred stock which may be redeemed at the option of the holder be classified as a liability? (b) Which is a stronger candidate for liability classification: redeemable preferred stock where redemption is mandatory or redeemable preferred stock where redemption is at the option of the holder? Explain your reasoning.

Module III: Exercise Solution.

1. (a) The class B common stock is classified as a liability under FAS150, paragraph 9, which states, "A mandatorily redeemable financial instrument shall be classified as a liability unless redemption is required to occur only upon the liquidation or termination of the reporting entity. A financial instrument issued in the form of shares is mandatorily redeemable if it embodies an unconditional obligation requiring the issuer to redeem the instrument by transferring its assets at a specified or determinable date (or dates) or upon an event certain to occur."

Students may hesitate to classify this instrument as a liability because it is issued in the form of common shares. It may help students overcome this hesitation if they are reminded of the often repeated theme that economic substance should dictate accounting rather than legal form.

1. (b) Perceptive students will recognize the class B shares as equivalent to zero-interest-bearing notes with two years to maturity and an effective yield of 7%. Increases, or accretion, in the carrying value are equivalent to amortization of discount and should be classified as financing expense in the income statement.

2. (a) The series A preferred stock is classified as a liability under SFAS150, paragraph 12 (a), which reads, "A financial instrument that embodies an unconditional obligation, or a financial instrument other than an outstanding share that embodies a conditional obligation, that the issuer must or may settle by issuing a variable number of its equity shares shall be classified as a liability (or an asset in some circumstances) if, at inception, the monetary value of the obligation is based solely or predominantly on any one of the following: (a) A fixed monetary amount known at inception (for example, a payable settleable with a variable number of the issuer's equity shares)."

The preferred stock is debt-like in that it entails a fixed return on investment, and the return of the initial investment at a specific date. The fact that the fixed value may be conveyed by transfer of common shares may cause students to question liability classification. Indeed, the current definition of liabilities in FASB Concepts Statement 6 does not envision an obligation to issue shares as a liability. For this reason, in its preamble, SFAS150 states the expectation that concepts statement 6 will be amended: "This statement requires that certain obligations that could be settled by issuance of an entity's equity but lack other characteristics of equity be reported as liabilities even though the obligation does not meet the definition of liabilities in concepts statement 6. The board expects to amend concepts statement 6 to eliminate that inconsistency in the next phase of this project."

2. (b) The issuance of shares represents an economic sacrifice on the part of the firm and its owners (i.e. existing common shareholders) who will suffer a dilution of their interests upon issuance of the additional shares.

3. (a) The series B preferred stock is classified as a liability under International Accounting Standards Board (IASB) statement number 32 (IASB, 2003). SFAS150 does not address shares redeemable at the option of the holder since these are a compound financial instrument

combining a share with a put option (i.e. puttable stock). The FASB has deferred on the accounting for compound instruments at this time and will address them in the next phase of its financial instruments project. Although the two boards have reached separate conclusions at this point, harmonization will likely be a factor in new standards developed in the FASB's fundamental components phase.

The issue presented by the series B Preferred is an interesting one for students to consider. They will have already seen that preferred shares, which must be redeemed by the company, are classified as liabilities; what about preferred shares which may have to be redeemed? An appeal may be made to the definition of a liability here: "probable future sacrifices arising from present obligations as a result of past transactions or events." The issue would seem then to fall on the probability that the holder will ask for redemption. An evaluation of this probability may be unattainable however because the holder may ask for redemption in many unpredictable circumstances such as changing market conditions or sudden liquidity needs.

3. (b) Mandatorily redeemable shares are certainly more debt-like than shares redeemable at the option of the holder. In this sense, the FASB, in issuing SFAS150, has moved carefully in adding new items to the liability category while the IASB can be seen as more liberal.

The Series B Preferred shares provide instructors an entrée to discuss with students the nature of the next phase of the FASB's financial instruments project, the fundamental components approach. The series B Preferred represents, from Extua Corporation's standpoint, the issuance of a share and a written put option. In a fundamental components approach, the share would be viewed as equity, and the written put option a liability. Other financial instruments such as convertible bonds can in the same vein be seen as an option embedded in a host instrument. The accounting for these instruments will be affected as the FASB financial instruments project yields new pronouncements. Those interested in following these developments can check the FASB website (www.fasb.org) for project updates.

Implementation Guidance and Assignment Suggestions

The teaching modules should always be implemented toward the conclusion of standard coverage of long-term liabilities and stockholder equity/contributed capital in the intermediate accounting course. A survey of leading intermediate accounting textbooks indicates that these two topics are frequently covered in adjacent chapters. Instructors may wish to utilize module I while these topics are being covered and, while moving on to other topics, revisit financial instruments by covering modules II and III later in the course. Such an approach allows more time for students to reflect on the issues presented in the modules and can provide a break from routine classroom activities later in the course.

The teaching modules are flexible and can be done as in-class discussion sessions, individual writing assignments, or in groups. The first module is particularly well suited to instructor-led discussion with the entire class. A suggested approach is to do part 1 with the class as a whole, followed by time for groups to consider part 2, and then sharing group responses with the whole class again.

Module II requires in-depth analysis and is more suited to individual or group writing assignments. If a group writing assignment is used, the free-rider problem can be mitigated by assigning individuals or pairs to question sub-parts. Depending on available class time, responses can be discussed in class or, if class time is short, written assignments can be graded and returned to individuals or groups. If practice with oral communication skills is desired, instructors may choose to have students report their conclusions to the class in verbal presentations.

Module III involves in-depth analysis and will require students to spend time outside of class to complete. Two approaches can be taken with respect to classification of the financial instruments in this exercise. One approach is to have students reach their conclusions using only the **Essential Features** handouts. This approach stresses the use of logic and application of basic principles to a realistic situation. A second approach is to provide students with access to SFAS No. 150 and have them identify specific paragraphs which apply to the financial instruments in module III. Instructors wishing to expose students to applied professional research may wish to pursue this approach.

REFERENCES

Accounting Education Change Commission. 1990. Objectives of education for accountants: Position statement number one. **Issues in Accounting Education**, 5: 307-312.

Albrecht, W., & Sack, R. 2000. **Accounting education: Charting the course through a perilous future**. Sarasota, Florida: American Accounting Association.

American Accounting Association Financial Accounting Standards Committee. 1999. Comment letter to the FASB: Liability and equity. **Accounting Horizons,** 13: 305-307.

American Accounting Association Financial Accounting Standards Committee. 2001. Evaluation of the FASB's proposed accounting for financial instruments with characteristics of liabilities, equity, or both. **Accounting Horizons**, 15: 387-400.

American Institute of Certified Public Accountants. 1999. **AICPA core competency framework for entry into the accounting profession**. New York: AICPA.

Arthur Andersen & Co., Arthur Young, Coopers & Lybrand, Deloitte Haskins & Sells, Ernst & Whinney, Peat Marwick Main & Co., Price Waterhouse, and Touche Ross (The Big 8). 1989. **Perspectives on education: Capabilities for success in the accounting profession (The white paper)**. New York, NY: The Big 8 Public Accounting Firms.

Cheng, , Q., Frischmann, P., & Warfield, T. 2003. The market perception of corporate claims. **Research in Accounting Regulation,** 16: 3-28.

Financial Accounting Standards Board. 1990. **Discussion memorandum: An analysis of issues related to distinguishing between liability and equity instruments and accounting for instruments with characteristics of both.** Stamford, CT: FASB.

Financial Accounting Standards Board. 2003. **Accounting for certain financial instruments with characteristics of both liabilities and equity - statement of financial accounting standards no. 150**. Stamford, CT: FASB.

International Accounting Standards Board. 2003. **Financial instruments: Disclosure and presentation - international accounting standard no. 32**. London: IASB.

Kimmel, P., & Warfield, T. 1993. Variations in attributes of redeemable preferred stock: Implications for accounting standards. **Accounting Horizons,** 7: 30-40.

Linsmeier. T., Shakespeare, C., & Sougainnis, T. 2000. **Liability/Equity classification and shareholder valuation**. Working Paper, Michigan State University.

Nair, R., Rittenberg, L., & Weygandt, J. 1993. Accounting for redeemable preferred stock: Unresolved issues. **Accounting Horizons**, 4: 33-41.

Konrd Gunderson is assistant professor of accounting at Missouri Western State University. He received his Ph.D. in accounting from University of Nebraska - Lincoln. His research interests include accounting for financial instruments and accounting pedagogy. He has published in Journal of Accounting Case Research, Journal of Business and Leadership, and AICPA Cases in on Fraud, Corporate Governance and Ethics.

DOI: 10.58809/GSZX4540

Appendix I: Summary Statements: Essential Features of Debt and Equity

Essential Features of Debt ("Pure Debt")

Debt is characterized by its legal priority over equity, and detailed contractual terms for return of the lender's principal and payment of interest.

Legal Features

Payments to debt must be made before any dividends can legally be paid to equity. Interest and principal payments are scheduled per contract. If any payment is missed, lenders have the legal right to force the firm into bankruptcy to enforce payment.

In liquidation, debt has priority over equity. If the firm is dissolved, debt must be fully paid before equity can receive anything. Debt receives a fixed sum equal to its principal or face amount; any excess liquidation cash, after satisfaction of debt, goes to equity.

Economic Characteristics

In return for their position of priority and legal guarantees, lenders settle for a fixed, limited amount of return on their investment. They do not receive extra cash if the firm does extremely well.

Debt - from the Issuer's Perspective

Debt is a form of financing that does not provide flexibility for the issuer. Return of the lender's initial investment has a fixed date for repayment which the firm cannot avoid. Similarly, payments of return on investment (i.e. interest) are specifically scheduled and must be made on time. The firm must make payments to debt as scheduled, or suffer legal consequences.

Essential Features of Equity ("Pure Equity")

Equity is defined by its residual status with respect to all legal debts. This contractual feature gives equity its dominant economic characteristic: variability in the return payments it receives.

Legal Features

In periodic distributions of cash, equity can legally receive a dividend only after payments due on debt have been made. However, there is no legal limit to the amount of dividends equity can receive. In liquidation, equity is residual to debt; if the firm is dissolved, all amounts due on debt must be paid before equity can receive anything.

Equity is a permanent investment in the firm; the shareholder does not have a legal right to receive her initial investment back, except in liquidation and then only after all debt claims have been satisfied.

Economic Characteristics

Equity is subject to variability - in any given year they may receive zero dividends, or a large amount depending on the success and profitability of the firm. Equity is also subject to variability in liquidation. If liquidation proceeds are significant, equity receives all excess value after debt has been paid; however if proceeds are sufficient only to pay debt, equity receives nothing.

The economic advantage to equity is its upside potential. If the firm does extremely well, dividends and liquidation proceeds can be substantial. It is the potential for significant economic rewards that compensates for the variability (risk) inherent in equity.

Equity - from the Issuer's Perspective

Equity from the firm's standpoint, allows flexibility. Periodic payments (dividends) are paid at the discretion of the firm, and the shareholders' initial investment does not have a due date. Thus, equity is the most flexible form of financing because the firm decides when, and whether, to make payments.