

Statement of Financial Accounting Standards No. 150

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Accounting for Certain Financial Instruments
with Characteristics of both
Liabilities and Equity

May 2003



Financial Accounting Standards Board
of the Financial Accounting Foundation
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Statement of Financial Accounting Standards No. 150

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FAS 150: Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity

FAS150 Summary

This Statement establishes standards for how an issuer classifies and measures certain financial instruments with characteristics of both liabilities and equity. It requires that an issuer classify a financial instrument that is within its scope as a liability (or an asset in some circumstances). Many of those instruments were previously classified as equity. Some of the provisions of this Statement are consistent with the current definition of liabilities in FASB Concepts Statement No. 6, *Elements of Financial Statements*. The remaining provisions of this Statement are consistent with the Board's proposal to revise that definition to encompass certain obligations that a reporting entity can or must settle by issuing its own equity shares, depending on the nature of the relationship established between the holder and the issuer. While the Board still plans to revise that definition through an amendment to Concepts Statement 6, the Board decided to defer issuing that amendment until it has concluded its deliberations on the next phase of this project. That next phase will deal with certain compound financial instruments including puttable shares, convertible bonds, and dual-indexed financial instruments.

This Statement concludes the first phase of the Board's redeliberations of the Exposure Draft, *Accounting for Financial Instruments with Characteristics of Liabilities, Equity, or Both*.

Scope and Requirements of This Statement

This Statement requires an issuer to classify the following instruments as liabilities (or assets in some circumstances):

- A financial instrument issued in the form of shares that is mandatorily redeemable—that embodies an unconditional obligation requiring the issuer to redeem it by transferring its assets at a specified or determinable date (or dates) or upon an event that is certain to occur
- A financial instrument, other than an outstanding share, that, at inception, embodies an obligation to repurchase the issuer's equity shares, or is indexed to such an obligation, and that requires or may require the issuer to settle the obligation by transferring assets (for

example, a forward purchase contract or written put option on the issuer's equity shares that is to be physically settled or net cash settled)

- 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, if, at inception, the monetary value of the obligation is based solely or predominantly on any 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
 - b. Variations in something other than the fair value of the issuer's equity shares, for example, a financial instrument indexed to the S&P 500 and settleable with a variable number of the issuer's equity shares
 - c. Variations inversely related to changes in the fair value of the issuer's equity shares, for example, a written put option that could be net share settled.

The requirements of this Statement apply to issuers' classification and measurement of freestanding financial instruments, including those that comprise more than one option or forward contract.

This Statement does not apply to features that are embedded in a financial instrument that is not a derivative in its entirety. For example, it does not change the accounting treatment of conversion features, conditional redemption features, or other features embedded in financial instruments that are not derivatives in their entirety. It also does not affect the classification or measurement of convertible bonds, puttable stock, or other outstanding shares that are conditionally redeemable. This Statement also does not address certain financial instruments indexed partly to the issuer's equity shares and partly, but not predominantly, to something else. Financial instruments with characteristics of both liabilities and equity not addressed in this Statement will be addressed in the next phase of the project. Guidance currently in effect for those instruments continues to apply. In applying the classification provisions of this Statement, nonsubstantive or minimal features are to be disregarded.

Forward contracts to repurchase an issuer's equity shares that require physical settlement in exchange for cash are initially measured at the fair value of the shares at inception, adjusted for any consideration or unstated rights or privileges, which is the same as the amount that would be paid under the conditions specified in the contract if settlement occurred immediately. Those contracts and mandatorily redeemable financial instruments are subsequently measured at the present value of the amount to be paid at settlement (discounted at the rate implicit at inception), if both the amount of cash and the settlement date are fixed, or, otherwise, at the amount that would be paid under the conditions specified in the contract if settlement occurred at the reporting date. Other financial instruments within the scope of this Statement are initially and subsequently measured at fair value, unless required by this Statement or other generally accepted accounting principles to be measured differently. Disclosures are required about the terms of the instruments and settlement alternatives.

Reasons for Issuing This Statement

This Statement was developed in response to concerns expressed by preparers, auditors, regulators, investors, and other users of financial statements about issuers' classification in the statement of financial position of certain financial instruments that have characteristics of both liabilities and equity but that have been presented either entirely as equity or between the liabilities section and the equity section of the statement of financial position. This Statement also addresses questions about the classification of certain financial instruments that embody obligations to issue equity shares. Previously, under Emerging Issues Task Force Issue No. 00-19, "Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock," an issuer of a contract to repurchase its equity shares generally accounted for that contract as equity if the issuer must or could settle it by delivering its equity shares (net share settled). Additionally, certain obligations settleable by delivery of the issuer's equity shares but not indexed to the issuer's shares may have been classified as equity. Under this Statement, those obligations are accounted for as liabilities.

How the Changes in This Statement Improve Financial Reporting and How the Conclusions in This Statement Relate to the Conceptual Framework

FASB Concepts Statement No. 1, *Objectives of Financial Reporting by Business Enterprises*, states that financial reporting should provide information that is useful in making business and economic decisions. The changes in this Statement will result in a more complete depiction of an entity's liabilities and equity and will, thereby, assist investors and creditors in assessing the amount, timing, and likelihood of potential future cash outflows and equity share issuances.

FASB Concepts Statement No. 2, *Qualitative Characteristics of Accounting Information*, identifies the characteristics of financial information that make it useful: relevance and reliability and their components. The changes in this Statement will enhance the relevance of accounting information by providing more information about an entity's obligations to transfer assets or issue shares, thus, improving its predictive value to users. Reliability of accounting information will be improved by providing a portrayal of an entity's capital structure that is unbiased, verifiable, and more representationally faithful than information reported prior to issuance of this Statement. Because restatement on transition is prohibited, the initial and ongoing costs of those changes have been minimized. Overall, in the Board's opinion, the benefits of this Statement in terms of improved decision usefulness, relevance, and reliability justify the costs.

Concepts Statement 6 defines liabilities and equity. This Statement requires that certain obligations that require a transfer of assets and that meet the definition of liabilities in Concepts Statement 6 and other recognition criteria in FASB Concepts Statement No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises*, be reported as liabilities. This

Statement also 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.

The Effective Date of This Statement

This Statement is effective for financial instruments entered into or modified after May 31, 2003, and otherwise is effective at the beginning of the first interim period beginning after June 15, 2003, except for mandatorily redeemable financial instruments of nonpublic entities. It is to be implemented by reporting the cumulative effect of a change in an accounting principle for financial instruments created before the issuance date of the Statement and still existing at the beginning of the interim period of adoption. Restatement is not permitted.

For nonpublic entities, mandatorily redeemable financial instruments are subject to the provisions of this Statement for the first fiscal period beginning after December 15, 2003.

INTRODUCTION

1. This Statement establishes standards for how an **issuer**¹ classifies and measures in its statement of financial position certain financial instruments with characteristics of both liabilities and equity. It requires that an issuer classify a **financial instrument** that is within its scope as a liability (or an asset² in some circumstances) because that financial instrument embodies an **obligation** of the issuer.

2. In August 1990, as part of its financial instruments project, the Board issued an FASB Discussion Memorandum, *Distinguishing between Liability and Equity Instruments and Accounting for Instruments with Characteristics of Both*. In October 2000, the Board issued an FASB Exposure Draft, *Accounting for Financial Instruments with Characteristics of Liabilities, Equity, or Both*. That Exposure Draft proposed classification as a liability or as equity based on the nature of the relationship that an instrument or component of an instrument established between the holder and the issuer. This Statement is the initial result of redeliberations of that Exposure Draft.

Key Terms

3. In this Statement, an *obligation* is a conditional or unconditional duty or responsibility to transfer assets or to issue equity shares. For example, an entity incurs a conditional obligation to transfer assets³ by issuing (writing) a put option that would, if exercised, require an entity to repurchase its equity shares by **physical settlement**. An entity also incurs a conditional

obligation to transfer assets by issuing a similar contract that requires or could require **net cash settlement**. An entity incurs a conditional obligation to issue its equity shares by issuing a similar contract that requires **net share settlement**. In contrast, by issuing shares of stock, an entity generally does not incur an obligation to redeem the shares, and, therefore, that entity does not incur an obligation to transfer assets or issue additional equity shares. However, some issuances of stock (for example, mandatorily redeemable preferred stock) do impose obligations requiring the issuer to transfer assets or issue its equity shares.

4. In this Statement, **monetary value** is what the **fair value** of the cash, shares, or other instruments that a financial instrument obligates the issuer to convey to the holder would be at the settlement date under specified market conditions. For certain financial instruments, this Statement requires consideration of whether monetary value would remain fixed or would vary in response to changes in market conditions. How the monetary value of a financial instrument varies in response to changes in market conditions depends on the nature of the arrangement, including, in part, the form of settlement. For example, for a financial instrument that embodies an obligation that requires:

- a. Settlement either by transfer of \$100,000 in cash or by issuance of \$100,000 worth of equity shares, the monetary value is fixed at \$100,000, even if the share price changes.
- b. Physical settlement by transfer of \$100,000 in cash in exchange for the issuer's equity shares, the monetary value is fixed at \$100,000, even if the fair value of the equity shares changes.
- c. Net share settlement by issuance of a variable number of shares based on the change in the fair value of a fixed number of the issuer's equity shares, the monetary value varies based on the number of shares required to be issued to satisfy the obligation. For example, if the exercise price of a net-share-settled written put option entitling the holder to put back 10,000 of the issuer's equity shares is \$11, and the fair value of the issuing entity's equity shares on the exercise date decreases from \$13 to \$10, that change in fair value of the issuer's shares increases the monetary value of that obligation at settlement from \$0 to \$10,000 (\$110,000 minus \$100,000), and the option would be settled by issuance of 1,000 shares (\$10,000 divided by \$10).
- d. Net cash settlement based on the change in the fair value of a fixed number of the issuer's equity shares, the monetary value varies in the same manner as in the illustration for net share settlement, but the obligation is settled with cash. In a net-cash-settled variation of the previous example, the option would be settled by delivery of \$10,000.
- e. Settlement by issuance of a variable number of shares that is based on variations in something other than the issuer's equity shares, the monetary value varies based on changes in the price of another variable. For example, a net-share-settled obligation to deliver the number of shares equal in value at settlement to the change in fair value of 100 ounces of gold has a monetary value that varies based on the price of gold and not on the price of the issuer's equity shares.

5. For purposes of this Statement, three related terms are used in particular ways. *Shares* includes various forms of ownership that may not take the legal form of securities (for example, partnership interests), ⁴ as well as other interests, including those that are liabilities in substance but not in form. *Equity shares* refers only to shares that are accounted for as equity. For financial instruments issued by members of a consolidated group of entities, *issuer's equity shares* includes the equity shares of any entity whose financial statements are included in the consolidated financial statements.

Proposed Amendment to Concepts Statement 6

6. In October 2000, concurrent with the issuance of the Exposure Draft described in paragraph 2, the Board issued an FASB Exposure Draft, *Proposed Amendment to FASB Concepts Statement No. 6 to Revise the Definition of Liabilities*. That Exposure Draft proposed to revise the definition of liabilities so that, depending on the nature of the relationship established between the holder and the issuer, it would encompass certain obligations that a reporting entity can or must settle by issuing its own equity shares. While the Board still plans to issue such an amendment to FASB Concepts Statement No.6, *Elements of Financial Statements*, the Board decided to defer that amendment until it has concluded its deliberations on the next phase of this project, which will deal with whether and how to separate certain compound financial instruments, including puttable shares, convertible bonds, and dual-indexed financial instruments, into debt and equity components.

Appendixes

7. Appendix A provides implementation guidance and examples of financial instruments that are within the scope of this Statement and are classified as liabilities. That appendix is an integral part of the standards provided in this Statement. Appendix B provides background information and the basis for the Board's conclusions. Appendix C provides amendments to existing accounting pronouncements and discusses the impact of this Statement on EITF Issues and FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, Implementation Issues. Appendix D provides a glossary of certain terms that are used in this Statement.

STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

Scope and Initial Classification

8. The objective of this Statement is to require issuers to classify as liabilities (or assets in some circumstances) three classes of **freestanding financial instruments** that embody obligations for the issuer. In applying this Statement, that objective shall not be circumvented by nonsubstantive or minimal features included in instruments. Any nonsubstantive or minimal features shall be disregarded in applying the classification provisions of this Statement (paragraphs 9–15). Judgment, based on consideration of all the terms of an instrument and other relevant facts and circumstances, is necessary to distinguish substantive, nonminimal features from nonsubstantive or minimal features.

Mandatorily Redeemable Financial Instruments

9. A **mandatorily redeemable financial instrument** shall be classified as a liability unless the 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. ⁵

10. A financial instrument that embodies a conditional obligation to redeem the instrument by transferring assets upon an event not certain to occur becomes mandatorily redeemable—and, therefore, becomes a liability—if that event occurs, the condition is resolved, or the event becomes certain to occur.

Obligations to Repurchase the Issuer's Equity Shares by Transferring Assets

11. A financial instrument, other than an outstanding share, that, at inception, (a) embodies an obligation to repurchase the issuer's equity shares, or is indexed to ⁶ such an obligation, and (b) requires or may require the issuer to settle the obligation by transferring assets shall be classified as a liability (or an asset in some circumstances ⁷). Examples include forward purchase contracts or written put options on the issuer's equity shares that are to be physically settled or net cash settled.

Certain Obligations to Issue a Variable Number of Shares

12. 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)
- b. Variations in something other than the fair value of the issuer's equity shares (for example, a financial instrument indexed to the S&P 500 and settleable with a variable number of the issuer's equity shares)
- c. Variations inversely related to changes in the fair value of the issuer's equity shares (for example, a written put option that could be net share settled).

Freestanding Financial Instruments

13. This Statement applies to freestanding financial instruments, including those that comprise more than one option or forward contract, and paragraphs 9–12 shall be applied to a freestanding financial instrument in its entirety. For example, an instrument that consists of a written put option for an issuer's equity shares and a purchased call option and nothing else is a freestanding financial instrument (paragraphs A15 and A16 provide examples of such instruments). That freestanding financial instrument embodies an obligation to repurchase the issuer's equity shares and is subject to the requirements of this Statement.

14. A freestanding financial instrument that is within the scope of this Statement shall not be combined with another freestanding financial instrument in applying paragraphs 9–12, unless combination is required under the provisions of Statement 133 and related guidance. For example, a freestanding written put option that is classified as a liability under this Statement shall not be combined with an outstanding equity share.

Embedded Features

15. This Statement does not apply to features embedded in a financial instrument that is not a derivative in its entirety. An example is an option on the issuer's equity shares that is embedded in a nonderivative host contract. For purposes of applying paragraph 11(a) of Statement 133 in analyzing an embedded feature as though it were a separate instrument, **8** paragraphs 9–12 of this Statement shall not be applied to the embedded feature. Embedded features shall be analyzed by applying other applicable guidance.

Scope Limitation

16. This Statement does not affect the timing of recognition of financial instruments issued as contingent consideration in a business combination. The accounting for business combinations

is addressed in FASB Statement No. 141, *Business Combinations*.⁹ This Statement also does not alter the measurement guidance for contingent consideration set forth in paragraphs 25–36 of Statement 141. However, when recognized, a financial instrument within the scope of this Statement that is issued as consideration (whether contingent or noncontingent) in a business combination shall be classified pursuant to the requirements of this Statement.

17. This Statement does not apply to obligations under stock-based compensation arrangements if those obligations are accounted for under APB Opinion No. 25, *Accounting for Stock Issued to Employees*, FASB Statement No. 123, *Accounting for Stock-Based Compensation*, AICPA Statement of Position (SOP) 93-6, *Employers' Accounting for Employee Stock Ownership Plans*, or related guidance. However, this Statement does apply to a freestanding financial instrument that was issued under a stock-based compensation arrangement but is no longer subject to Opinion 25, Statement 123, SOP 93-6, or related guidance. For example, this Statement applies to mandatorily redeemable shares issued upon an employee's exercise of an employee stock option.

Presentation

18. Items within the scope of this Statement shall be presented as liabilities (or assets in some circumstances). Those items shall not be presented between the liabilities section and the equity section of the statement of financial position.

19. Entities that have no equity instruments outstanding but have financial instruments issued in the form of shares, all of which are mandatorily redeemable financial instruments required to be classified as liabilities, shall describe those instruments as *shares subject to mandatory redemption* in statements of financial position to distinguish those instruments from other liabilities. Similarly, payments to holders of such instruments and related accruals shall be presented separately from payments to and interest due to other creditors in statements of cash flows and income.

Initial and Subsequent Measurement

20. Mandatorily redeemable financial instruments shall be measured initially at fair value.

21. Forward contracts that require physical settlement by repurchase of a fixed number of the issuer's equity shares in exchange for cash shall be measured initially at the fair value of the shares at inception, adjusted for any consideration or unstated rights or privileges.¹⁰ Equity shall be reduced by an amount equal to the fair value of the shares at inception.

22. Forward contracts that require physical settlement by repurchase of a fixed number of the issuer's equity shares in exchange for cash and mandatorily redeemable financial instruments

shall be measured subsequently in one of two ways. If both the amount to be paid and the settlement date are fixed, those instruments shall be measured subsequently at the present value of the amount to be paid at settlement, accruing interest cost using the rate implicit at inception. If either the amount to be paid or the settlement date varies based on specified conditions, those instruments shall be measured subsequently at the amount of cash that would be paid under the conditions specified in the contract if settlement occurred at the reporting date, recognizing the resulting change in that amount from the previous reporting date as interest cost. Any amounts paid or to be paid to holders of those contracts in excess of the initial measurement amount shall be reflected in interest cost.

23. All other financial instruments within the scope of this Statement shall be measured initially at fair value. If a conditionally redeemable instrument becomes mandatorily redeemable, upon reclassification the issuer shall measure that liability initially at fair value and reduce equity by the amount of that initial measure, recognizing no gain or loss.

24. Financial instruments within the scope of Statement 133 shall be measured subsequently as required by the provisions of that Statement. All remaining financial instruments within the scope of this Statement not covered by the guidance in paragraph 22 shall be measured subsequently at fair value with changes in fair value recognized in earnings, unless either this Statement or other accounting guidance specifies another measurement attribute.

Earnings per Share

25. Entities that have issued mandatorily redeemable shares of common stock or entered into forward contracts that require physical settlement by repurchase of a fixed number of the issuer's equity shares of common stock in exchange for cash shall exclude the common shares that are to be redeemed or repurchased in calculating basic and diluted earnings per share. Any amounts, including contractual (accumulated) dividends and participation rights in undistributed earnings, attributable to shares that are to be redeemed or repurchased that have not been recognized as interest costs in accordance with paragraph 22 shall be deducted in computing income available to common shareholders (the numerator of the earnings per share calculation), consistently with the "two-class" method set forth in paragraph 61 of FASB Statement No. 128, *Earnings per Share*.

Disclosures

26. Issuers of financial instruments within the scope of this Statement shall disclose the nature and terms of the financial instruments and the rights and obligations embodied in those instruments. That disclosure shall include information about settlement alternatives, if any, in the contract and identify the entity that controls the settlement alternatives.

27. Additionally, for all outstanding financial instruments within the scope of this Statement and for each settlement alternative, issuers shall disclose:

- a. The amount that would be paid, or the number of shares that would be issued and their fair value, determined under the conditions specified in the contract if the settlement were to occur at the reporting date
- b. How changes in the fair value of the issuer's equity shares would affect those settlement amounts (for example, "the issuer is obligated to issue an additional x shares or pay an additional y dollars in cash for each \$1 decrease in the fair value of one share")
- c. The maximum amount that the issuer could be required to pay to redeem the instrument by physical settlement, if applicable
- d. The maximum number of shares that could be required to be issued, **11** if applicable
- e. That a contract does not limit the amount that the issuer could be required to pay or the number of shares that the issuer could be required to issue, if applicable
- f. For a forward contract or an option indexed to the issuer's equity shares, the forward price or option strike price, the number of issuer's shares to which the contract is indexed, and the settlement date or dates of the contract, as applicable.

28. Some entities have no equity instruments outstanding but have financial instruments in the form of shares, all of which are mandatorily redeemable financial instruments required to be classified as liabilities. Those entities are required under paragraph 19 of this Statement to describe those instruments as *shares subject to mandatory redemption* in statements of financial position to distinguish those instruments from other liabilities. Those entities shall disclose the components of the liability that would otherwise be related to shareholders' interest and other comprehensive income (if any) subject to the redemption feature (for example, par value and other paid-in amounts of mandatorily redeemable instruments shall be disclosed separately from the amount of retained earnings or accumulated deficit).

Effective Date and Transition

29. This Statement shall be effective for financial instruments entered into or modified after May 31, 2003, and otherwise shall be effective at the beginning of the first interim period beginning after June 15, 2003, except for mandatorily redeemable financial instruments of a **nonpublic entity**. For mandatorily redeemable financial instruments of a nonpublic entity, this Statement shall be effective for existing or new contracts for fiscal periods beginning after December 15, 2003. For financial instruments created before the issuance date of this Statement and still existing at the beginning of the interim period of adoption, transition shall be achieved by reporting the cumulative effect of a change in an accounting principle by initially measuring the financial instruments at fair value or other measurement attribute required by this Statement.

30. For mandatorily redeemable financial instruments and physically settled forward purchase

contracts subject to the measurement requirements in paragraph 22 of this Statement, “dividends” and other amounts paid or accrued prior to reclassification of the instrument as a liability shall not be reclassified as interest cost upon transition. Reclassification to liabilities of preexisting noncontrolling interests that were recognized in business combinations under the purchase method and are mandatorily redeemable shall not result in changes in amounts previously recognized under the purchase method.

31. Restatement of financial statements for earlier years presented is not permitted.

**The provisions of this Statement need
not be applied to immaterial items.**

This Statement was adopted by the affirmative votes of six members of the Financial Accounting Standards Board. Mr. Foster dissented.

Mr. Foster dissents from this Statement because he believes its provisions concerning the accounting for forward purchase contracts on an issuer’s equity securities that require physical settlement in exchange for cash are inappropriate. First, the provisions that govern accounting for a forward purchase contract on an issuer’s equity securities that requires physical settlement conflict with the accounting for almost all other forward purchase contracts and other executory contracts because this Statement requires a forward purchase contract to be recognized as if the future transaction specified in the contract had already occurred. Specifically, stock that is subject to purchase under the forward purchase contract but that is currently outstanding is accounted for as if it had been retired. This is in marked contrast with the accounting for a forward purchase contract on a commodity or other asset for which the asset and liability governed by the contract are not recognized until the transaction subject to the contract is consummated.

Mr. Foster acknowledges that transactions in an entity’s equity securities have different characteristics than other transactions of an entity that sometimes justify different accounting treatment. However, in his view, even if the accounting model permitted other forward contracts and executory contracts to be accounted for on a gross basis (that is, the asset to be acquired under the contract and the liability to settle the contract were both recognized upon execution of the contract), the facts that (1) the equity securities are outstanding until a forward purchase contract on an issuer’s equity securities is settled and (2) the holder of the securities retains all the associated rights until settlement would take precedence. To clarify, even if practice was to account for executory contracts on a gross basis, Mr. Foster would not permit the accounting for any forward purchase contracts on an issuer’s equity securities to ignore the fact that the equity securities are outstanding.

Second, in reaching its conclusion, the Board likened a forward purchase contract that requires physical settlement in exchange for cash to mandatorily redeemable stock because the

terms of the forward purchase contract require that equity securities be purchased. However, there is a significant difference between an instrument that is mandatorily redeemable by its terms and a contract separate from any shares of stock that requires a share (any share) of stock to be purchased. The Board has concluded that mandatorily redeemable financial instruments are liabilities—that is, they are not equity instruments. In contrast, outstanding shares of stock are equity instruments and should be accounted for as such. The Board’s view that the combination of an outstanding share of stock and a forward purchase contract on any outstanding share of stock is tantamount to mandatorily redeemable stock is predicated on the view that two distinct and separate financial instruments should be combined and treated as a single contract. Statement 133 generally prohibits combining a derivative with another financial instrument to achieve a synthetic instrument that would result in different accounting for the combined contracts than if they were accounted for individually. For all the reasons set forth in the basis for conclusions of Statement 133, Mr. Foster agrees with that general prohibition and would apply it in these circumstances.

Finally, forward purchase contracts on an entity’s equity securities as a result of this Statement meet the definition of a derivative in Statement 133. As such, Mr. Foster believes those contracts should be recognized and accounted for, like other derivatives, at fair value. To achieve the accounting for physically settled forward purchase contracts on an issuer’s equity securities that is required by this Statement entails yet another exception to the basic provisions of Statement 133. Mr. Foster believes that an additional exception to the scope of Statement 133 in this circumstance is unwarranted.

Members of the Financial Accounting Standards Board:

Robert H. Herz, *Chairman*

G. Michael Crooch

John M. Foster

Gary S. Schieneman

Katherine Schipper

Edward W. Trott

John K. Wulff

Appendix A

IMPLEMENTATION GUIDANCE

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Appendix A: IMPLEMENTATION GUIDANCE

Introduction

A1. For each class of instrument within this Statement's scope, this appendix provides examples showing classification as a liability (or asset in some circumstances) and, for certain financial instruments, initial and subsequent measurement guidance.

Mandatorily Redeemable Financial Instruments

A2. Various financial instruments issued in the form of shares embody unconditional obligations of the issuer to redeem the instruments by transferring its assets at a specified or determinable date or dates or upon an event that is certain to occur. Paragraph 9 of this Statement requires that those mandatorily redeemable instruments be classified as liabilities. Mandatorily redeemable financial instruments include (among other instruments) certain forms of trust-preferred securities (those that are required to be redeemed at specified or determinable dates) and stock that must be redeemed upon the death or termination of the individual who holds it, which is an event that is certain to occur.

A3. Although some mandatorily redeemable instruments are issued in the form of shares, those instruments are classified as liabilities under this Statement because of the embodied obligation on the part of the issuer to transfer its assets.

Example: Trust-Preferred Securities

A4. Mandatorily redeemable preferred stock and trust-preferred securities may be issued in many forms, including those referred to as monthly-income-preferred securities, trust-preferred securities, and trust-originated-preferred securities. Many trust-preferred securities are issued in the following manner. A financial institution establishes a trust or other entity that the financial institution consolidates. ¹² The trust issues preferred securities to outside investors and uses the proceeds of the issuance of those securities to purchase from the financial institution an equivalent amount of junior subordinated debentures or other loans having stated maturities. The debentures or other loans are the only assets of the trust. When the financial institution makes its payments of interest on the debentures or other loans, the trust distributes the cash to the holders of the trust-preferred securities. The trust-preferred securities must be redeemed upon maturity of the debentures or other loans.

A5. In the above example, because the trust-preferred securities are mandatorily redeemable

and represent obligations to transfer assets to redeem the shares, those instruments are classified as liabilities in the consolidated financial statements of the financial institution, ¹³ and payments or accruals of “dividends” and other amounts to be paid to holders are reported as interest cost.

Example: Stock to Be Redeemed upon Death of the Holder

A6. An entity may issue shares of stock that are required to be redeemed upon the death of the holder for a proportionate share of the book value of the entity. The death of the holder is an event that is certain to occur. Therefore, the stock is classified as a liability. ¹⁴ If the stock represents the only shares in the entity, the entity reports those instruments in the liabilities section of its statement of financial position and describes them as *shares subject to mandatory redemption* so as to distinguish the instruments from other financial statement liabilities. The issuer presents interest cost and payments to holders of such instruments separately, apart from interest and payments to other creditors, in statements of income and cash flows. The entity also discloses that the instruments are mandatorily redeemable upon the death of the holders. The following presentation is an example of the required presentation and disclosure for entities that have no equity instruments outstanding but have shares, all of which are mandatorily redeemable financial instruments classified as liabilities:

Statement of Financial Position:

Total assets	<u>\$1,800,000</u>
Liabilities other than shares	\$1,000,000
Shares subject to mandatory redemption*	<u>800,000</u>
Total liabilities	<u>\$1,800,000</u>

Notes to Financial Statements:

*Shares, all subject to mandatory redemption upon death of the holders, consist of:

Common stock—\$100 par value, 10,000 shares authorized, 5,000 shares issued and outstanding	\$500,000
Retained earnings attributable to those shares	320,000
Accumulated other comprehensive income attributable to those shares	<u>(20,000)</u>
	<u>\$800,000</u>

Example: Reclassification of Stock That Becomes Mandatorily Redeemable

A7. If a financial instrument will be redeemed only upon the occurrence of a conditional event, redemption of that instrument is conditional and, therefore, the instrument does not meet the definition of *mandatorily redeemable financial instrument* in this Statement. However, that financial instrument would be assessed at each reporting period to determine whether circumstances have changed such that the instrument now meets the definition of mandatorily redeemable (that is, the event is no longer conditional). If the event has occurred, the condition is resolved, or the event has become certain to occur, the financial instrument is reclassified as a liability.

A8. For example, an entity may issue equity shares on January 2, 2004, that must be redeemed (not at the option of the holder) six months after a change in control. When issued, the shares are conditionally redeemable and, therefore, do not meet the definition of mandatorily redeemable. On December 30, 2008, there is a change in control, requiring the shares to be redeemed on June 30, 2009. On December 31, 2008, the issuer would treat the shares as mandatorily redeemable and reclassify the shares as liabilities, measured initially at fair value. Additionally, the issuer would reduce equity by the amount of that initial measure, recognizing no gain or loss.

A9. For another example of a conditionally redeemable instrument, an entity may issue preferred shares with a stated redemption date 30 years hence that also are convertible at the option of the holders into a fixed number of common shares during the first 10 years. Those instruments are not mandatorily redeemable for the first 10 years because the redemption is conditional, contingent upon the holder's not exercising its option to convert into common shares. ¹⁵ However, when the conversion option (the condition) expires, the shares would become mandatorily redeemable and would be reclassified as liabilities, measured initially at fair value.

Obligations to Repurchase an Issuer's Equity Shares That Require a Transfer of Assets

Written Put Options That Require Physical or Net Cash Settlement

A10. Freestanding written put options on the option writer's (issuer's) equity shares that require physical settlement were generally classified, before this Statement, as equity under Emerging Issues Task Force (EITF) Issue No. 00-19, "Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock." Under paragraph 11 of this Statement, written put options that require physical settlement are classified as liabilities because those instruments embody obligations to repurchase the issuer's equity shares that require the issuer to settle by transferring its assets. Written put options that require or permit net cash

settlement also are classified as liabilities under paragraph 11 because those instruments are indexed to obligations to repurchase the issuer's equity shares and require the issuer to settle by transferring its assets. Because written put options are classified as liabilities under this Statement, those instruments no longer meet the exception for equity derivatives of the issuer in paragraph 11(a) of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*. Consequently, they either are derivative instruments, if they meet other criteria in Statement 133, or are required to be measured initially and subsequently at fair value under paragraphs 23 and 24 of this Statement.

Forward Purchase Contracts That Require Physical or Net Cash Settlement

A11. Freestanding forward contracts to purchase an issuer's equity shares that require physical settlement were generally classified, before this Statement, as equity under Issue 00-19. Under paragraph 11 of this Statement, those forward purchase contracts are classified as liabilities because those instruments embody obligations that require the issuer to settle by transferring its assets. Unlike physically settled written put options, which are initially and subsequently measured at fair value, liabilities arising from forward contracts to repurchase the issuer's equity shares for cash ¹⁶ that must be physically settled are initially measured under paragraph 21 of this Statement at the fair value of the shares at inception adjusted for any consideration or unstated rights or privileges. Under paragraph 22 of this Statement, if both the amount of cash and the settlement date are fixed, those contracts are subsequently measured at the present value of the amount to be paid at settlement by accruing interest cost at the rate implicit at inception, resulting in a liability at maturity equal to the forward contract amount. If, under the forward purchase contract, either the amount of cash to be paid or the settlement date varies based on specified conditions, those instruments are measured subsequently at the amount of cash that would be paid under the conditions specified in the contract if the shares were redeemed or repurchased at the reporting date, recognizing interest cost for the change from the previous reporting date.

Example: Physically Settled Forward Purchase Contract

A12. An entity may enter into a forward contract to repurchase 1 million shares of its common stock from another party 2 years later. At inception, the forward contract price ¹⁷ per share is \$30, and the current price of the underlying shares is \$25. The contract's terms require that the entity pay cash to repurchase the shares (the entity is obligated to transfer \$30 million in 2 years). Because the instrument embodies an unconditional obligation to transfer assets, it is a liability under paragraph 11 of this Statement. The entity would recognize a liability and reduce equity by \$25 million (which is the present value, at the 9.54 percent rate implicit in the contract, of the \$30 million contract amount, and also, in this example, the fair value of the underlying shares at inception). Interest would be accrued over the 2-year period to the forward contract amount of \$30 million, using the 9.54 percent rate implicit in the contract. If the underlying

shares are expected to pay dividends before the repurchase date and that fact is reflected in the rate implicit in the contract, the present value of the liability and subsequent accrual to the contract amount would reflect that implicit rate. Amounts accrued are recognized as interest cost.

A13. In the example in paragraph A12, no consideration or other rights or privileges changed hands at inception. If the same contract price of \$30 per share had been agreed to even though the current price of the issuer's shares was \$30, because the issuer had simultaneously sold the counterparty a product at a \$5 million discount, that right or privilege unstated in the forward purchase contract would be taken into consideration in arriving at the appropriate implied discount rate—9.54 percent rather than 0 percent—for that contract. That entity would recognize a liability for \$25 million, reduce equity by \$30 million, and increase its revenue for the sale of the product by \$5 million. Alternatively, if the same contract price of \$30 per share had been agreed to even though the current price of the issuer's shares was only \$20, because the issuer received a \$5 million payment at inception of the contract, the issuer would recognize a liability for \$25 million and reduce equity by \$20 million. In both examples, interest would be accrued over the 2-year period using the 9.54 percent implicit rate, increasing the liability to the \$30 million contract price.

A14. In contrast to forward purchase contracts that require physical settlement in exchange for cash, forward purchase contracts that require or permit net cash settlement, require or permit net share settlement, or require physical settlement in exchange for specified quantities of assets other than cash are measured initially and subsequently at fair value, as provided in paragraphs 23 and 24, and classified as assets or liabilities depending on the fair value of the contracts on the reporting date.

Example: Combination of Written Put Option and Purchased Call Option Issued as a Freestanding Instrument

A15. If a freestanding financial instrument consists solely of a written put option to repurchase the issuer's equity shares and another option, that freestanding financial instrument in its entirety is subjected to paragraphs 9–12 of this Statement to determine if it meets the requirements to be classified as a liability. For example, a company may enter into a contract that requires it to purchase 100 shares of its own stock on a specified date for \$20 if the stock price falls below \$20 and entitles the company to purchase 100 shares on that date for \$21 if the stock price is greater than \$21. That contract shall be analyzed as the combination of a written put option and a purchased call option and not as a forward contract. The written put option on 100 shares has a strike price of \$20, and the purchased call option on 100 shares has a strike price of \$21. If at issuance the fair value of the written put option exceeds the fair value of the purchased call option, the issuer receives cash and the contract is a net written option—a liability. If required to be physically settled, that contract is a liability under the provisions in paragraph 11 of this Statement because it embodies an obligation that may require repurchase of the issuer's equity

shares and settlement by a transfer of assets. If the issuer must or can net cash settle the contract, the contract is a liability under the provisions of paragraph 11 of this Statement because it embodies an obligation that is indexed to an obligation to repurchase the issuer's equity shares and may require settlement by a transfer of assets. If the issuer must or can net share settle the contract, that contract is a liability under the provisions in paragraph 12(c) of this Statement, because the monetary value of the obligation varies inversely in relation to changes in the fair value of the issuer's equity shares.

A16. If, in the example in paragraph A15, the fair value of the purchased call option at issuance exceeds the fair value of the written put option, the issuer pays out cash and the contract is a net purchased option, to be initially classified as an asset under either paragraph 11 or paragraph 12(c) of this Statement. If the fair values of the two options are equal and opposite at issuance, the financial instrument has an initial fair value of zero, and is commonly called a zero-cost collar. Thereafter, if the fair value of the instrument changes, the instrument is classified as an asset or a liability and measured subsequently at fair value.

Certain Obligations to Issue a Variable Number of Shares

A17. Paragraph 12 of this Statement requires liability classification if, at inception, the monetary value of an obligation to issue a variable number of shares is based solely or predominantly on (a) a fixed monetary amount known at inception, (b) variations in something other than the fair value of the issuer's equity shares, or (c) variations inversely related to changes in the fair value of the issuer's equity shares. The following examples illustrate the application of this Statement to such share-settled obligations.

Example: Obligation to Issue Shares with Monetary Value Based on a Fixed Monetary Amount Known at Inception

A18. Certain financial instruments embody obligations that require (or permit at the issuer's discretion) settlement by issuance of a variable number of the issuer's equity shares that have a value equal to a fixed monetary amount. For example, an entity may receive \$100,000 in exchange for a promise to issue a sufficient number of its own shares to be worth \$110,000 at a future date. The number of shares required to be issued to settle that unconditional obligation is variable, because that number will be determined by the fair value of the issuer's equity shares on the date of settlement. Regardless of the fair value of the shares on the date of settlement, the holder will receive a fixed monetary value of \$110,000. Therefore, the instrument is classified as a liability under paragraph 12(a) of this Statement.

A19. Some share-settled obligations of this kind require that the variable number of shares to be issued be based on an average market price for the shares over a stated period of time, such as the average over the last 30 days prior to settlement, instead of the fair value of the issuer's equity shares on the date of settlement. Thus, if the average market price differs from the share

price on the date of settlement, the monetary value of the obligation is not entirely fixed at inception and is based, in small part, on variations in the fair value of the issuer's equity shares. Although the monetary amount of the obligation at settlement may differ from the initial monetary value because it is tied to the change in fair value of the issuer's equity shares over the last 30 days prior to settlement, the monetary value of the obligation is predominantly based on a fixed monetary amount known at inception. The obligation is classified as a liability under paragraph 12(a) of this Statement. Upon issuance of the shares to settle the obligation, equity is increased by the amount of the liability and no gain or loss is recognized for the difference between the average and the ending market price.

Example: Obligation to Issue Shares with Monetary Value Based on Something Other Than Changes in the Fair Value of the Issuer's Equity

A20. An entity's guarantee of the value of an asset, liability, or equity security of another entity may require or permit settlement in the entity's equity shares. For example, an entity may guarantee that the value of a counterparty's equity investment in another entity will not fall below a specified level. The guarantee contract requires that the guarantor stand ready to issue a variable number of its shares whose fair value equals the deficiency, if any, on a specified date between the guaranteed value of the investment and its current fair value. Upon issuance, unless the guarantee is accounted for as a derivative, the obligation to stand ready to perform is a liability addressed by FASB Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others*. If, during the period the contract is outstanding, the fair value of the guaranteed investment falls below the specified level, absent an increase in value, the guarantor will be required to issue its equity shares. At that point in time, the liability recognized in accordance with Interpretation 45 would be subject to the requirements of FASB Statement No. 5, *Accounting for Contingencies*. This Statement establishes that, even though the loss contingency is settleable in equity shares, the obligation under Statement 5 is a liability under paragraph 12(b) of this Statement until the guarantor settles the obligation by issuing its shares. That is because the guarantor's conditional obligation to issue shares is based on the value of the counterparty's equity investment in another entity and not on changes in the fair value of the guarantor's equity instruments.

A21. If the example in paragraph A20 of this Statement were altered so that the monetary value of the obligation is based on (a) the deficiency on a specified date between the guaranteed value of the investment in another entity and its current fair value plus (b) .005 times the change in value of 100 of the guarantor's equity shares, the monetary value of the obligation would not be *solely* based on variations in something other than the fair value of the issuer's (guarantor's) equity shares. However, the monetary value of the obligation would be *predominantly* based on variations in something other than the fair value of the issuer's (guarantor's) equity shares and, therefore, the obligation would be classified as a liability under paragraph 12(b) of this Statement. That obligation differs in degree from the obligation under a contract that is indexed in part to the issuer's shares and in part (but not predominantly) to something other than the

issuer's shares (commonly called a dual-indexed obligation). The latter contract is not within the scope of this Statement. Paragraph 12(b) of this Statement applies only if the monetary value of an obligation to issue equity shares is based *solely* or *predominantly* on variations in something other than the fair value of the issuer's equity shares. For example, an instrument meeting the definition of a derivative that requires delivery of a variable number of the issuer's equity shares with a monetary value equaling changes in the price of a fixed number of the issuer's shares multiplied by the Euro/US\$ exchange rate embodies an obligation with a monetary value that is based on variations in both the issuer's share price and the foreign exchange rate and, therefore, is not within the scope of this Statement. (However, that instrument would be a derivative under Statement 133.) **18**

Example: Obligation to Issue Shares with Monetary Value Based on Variations Inversely Related to Changes in the Fair Value of the Issuer's Equity Shares

A22. A freestanding forward purchase contract, a freestanding written put option, or a net written option (otherwise similar to the example in paragraph A15) that must or may be net share settled is a liability under paragraph 12(c) of this Statement, because the monetary value of the obligation to deliver a variable number of shares embodied in the contract varies inversely in relation to changes in the fair value of the issuer's equity shares; when the issuer's share price decreases, the issuer's obligation under those contracts increases. Such a contract is measured initially and subsequently at fair value (with changes in fair value recognized in earnings) and classified as a liability or an asset, depending on the fair value of the contract on the reporting date. A net written or net purchased option or a zero-cost collar similar to the examples in paragraphs A15 and A16 that must or may be net share settled is classified as a liability (or asset) under paragraph 12(c), because the monetary value of the issuer's obligation to deliver a variable number of shares under the written put option varies inversely in relation to changes in the fair value of the issuer's share price. The purchased call option element of that freestanding instrument does not embody an obligation to deliver a variable number of shares and does not affect the classification of the entire instrument when applying paragraph 12(c). In addition, a freestanding purchased call option is not within the scope of this Statement because it does not embody an obligation.

Example: Unconditional Obligation That Must Be either Redeemed for Cash or Settled by Issuing Shares

A23. Some instruments do not require the issuer to transfer assets to settle the obligation but, instead, unconditionally require the issuer to settle the obligation either by transferring assets or by issuing a variable number of its equity shares. Because those instruments do not require the issuer to settle by transfer of assets, those instruments are not within the scope of paragraph 9. However, those instruments may be classified as liabilities under paragraph 12 of this Statement.

A24. For example, an entity may issue 1 million shares of cumulative preferred stock for cash

equal to the stock's liquidation preference of \$25 per share. The entity is required either to redeem the shares on the fifth anniversary of issuance for the issuance price plus any accrued but unpaid dividends in cash or to settle by issuing sufficient shares of its common stock to be worth \$25 per share. Preferred stockholders are entitled to a mandatory dividend, payable quarterly at a rate of 6 percent per annum based on the \$25 per share liquidation preference (\$1.50 per share annually). The dividend is cumulative and is payable in cash or in a sufficient number of additional shares of the preferred stock based on the liquidation preference of \$25 per share. That obligation does not represent an unconditional obligation to transfer assets and, therefore, is not a mandatorily redeemable financial instrument subject to paragraph 9. But it is still a liability, under paragraph 12(a) of this Statement, because the preferred shares embody an unconditional obligation that the issuer may settle by issuing a variable number of its equity shares with a monetary value that is fixed and known at inception. Because the preferred shares are liabilities, payments to holders are reported as interest cost, and accrued but not-yet-paid payments are part of the liability for the shares.

Freestanding Financial Instruments

A25. Paragraph 13 of this Statement requires that the provisions of paragraphs 9–12 be applied to a freestanding instrument in its entirety. Paragraph 14 requires that a freestanding instrument within the scope of this Statement not be combined with other instruments in applying paragraphs 9–12, unless combination is required under Statement 133 and its related guidance. **19** Paragraph 8 requires that any nonsubstantive or minimal features be disregarded in that application. The following examples illustrate how those provisions apply in four circumstances.

Example 1—Three Freestanding Instruments

A26. An issuer has the following three freestanding instruments with the same counterparty, entered into contemporaneously: (a) a written put option on its equity shares, (b) a purchased call option on its equity shares, and (c) outstanding shares of stock. Under this Statement, those three contracts would be separately evaluated. The written put option is reported as a liability under either paragraph 11 or paragraph 12(c) of this Statement (depending on the form of settlement) and is measured at fair value. The purchased call option does not embody an obligation and, therefore, is not within the scope of this Statement. The outstanding shares of stock also are not within the scope of this Statement, because the shares do not embody an obligation for the issuer. Under paragraph 14, neither the purchased call option nor the shares of stock are to be combined with the written put option in applying paragraphs 9–12 unless otherwise required by Statement 133 and its related guidance. **20**

Example 2—Two Freestanding Instruments

A27. An issuer has the following two freestanding instruments with the same counterparty

entered into contemporaneously: (a) a contract that combines a written put option at one strike price and a purchased call option at another strike price on its equity shares and (b) outstanding shares of stock. As required by paragraph 13 of this Statement, paragraphs 9–12 are applied to the entire freestanding instrument that comprises both a put option and a call option. Because the put option element of the contract embodies an obligation to repurchase the issuer’s equity shares, the freestanding instrument that comprises a put option and a call option is reported as a liability (or asset), under either paragraph 11 or paragraph 12(c) of this Statement (depending on the form of settlement) and is measured at fair value. Under paragraph 13, that freestanding financial instrument is within the scope of this Statement regardless of whether at current prices it is a net written, net purchased, or zero-cost collar option and regardless of the form of settlement. The outstanding shares of stock are not within the scope of this Statement ²¹ and, under paragraph 14, are not combined with the freestanding written put and purchased call option.

Example 3—One Freestanding Instrument That Is an Outstanding Share of Stock Containing Multiple Embedded Features

A28. An entity issues a share of stock that is not mandatorily redeemable. However, under its terms the stock is (a) puttable by the holder any time after five years or upon a change in control and is (b) callable by the issuer any time after five years. That instrument is outside the scope of this Statement. The instrument as a whole is not mandatorily redeemable under paragraph 9, because (1) the redemption is optional (conditional) and (2) a written put option and a purchased call option issued together with the same terms differ from a forward purchase contract under this Statement. That combination of embedded features does not render the stock mandatorily redeemable because the options could expire at the money, unexercised, and, thus, the redemption is not unconditional. Because the instrument as a whole is an outstanding share, it is not subject to paragraph 11 of this Statement nor, because the embedded obligation is conditional, is it subject to paragraph 12 of this Statement. As a financial instrument that is not a derivative in its entirety, it is subject to analysis under paragraph 12 of Statement 133 and to related guidance in Issue 00-19 or other applicable literature to determine whether the issuer must account for any embedded feature separately as a derivative. Because of the guidance in paragraph 15 of this Statement, paragraphs 9–12 shall not be applied to any embedded feature for the purposes of that analysis. In applying paragraph 12 of Statement 133, the embedded written put option is evaluated under the previous guidance in Issue 00-19 and would generally be classified in equity. If so, the embedded written put option meets the criterion for exclusion in paragraph 11(a) of Statement 133 and, therefore, is not separated from its host contract. If the written put option was not embedded in the share, but was issued as a freestanding instrument, it would be a liability under this Statement.

Example 4—Option to Redeem Shares Embedded in a Minimal Host

A29. An entity issues one share of preferred stock (with a par amount of \$100), paying a small

dividend, and embeds in it an option allowing the holder to put the preferred share along with 100,000 shares of the issuer's common stock (currently trading at \$50) for a fixed price of \$45 per share in cash. The preferred stock host is judged at inception to be minimal and would be disregarded under paragraph 8 in applying the classification provisions of this Statement. Therefore, under either paragraph 11 or paragraph 12(c) of this Statement (depending on the form of settlement), that instrument would be analyzed as a written put option in its entirety, classified as a liability, and measured at fair value.

Examples of Cumulative-Effect Entries upon Transition

A30. The following table illustrates examples of cumulative-effect entries upon transition under paragraphs 29 and 30 of this Statement. The financial instruments in the table are outstanding on July 1, 2003. The liability and transition adjustment columns illustrate the entry made upon transition, with the balance being a reduction to equity.

<u>Item</u>	<u>Previous Carrying Amount (Equity)</u>	<u>New Carrying Amount (Liability)</u>	<u>Transition Adjustment (Gain) Loss^a</u>	<u>Explanation of Accounting at Transition</u>
Mandatorily Redeemable Shares	\$(5,250)	\$(5,250) ^b	\$0	Recognize liability at present value of redemption amount, using rate implicit in the contract at inception. Do not reclassify prior dividends or accruals.
Physically Settled Forward Purchase Contract	(2,500) ^c	(2,600) ^d	100	Recognize liability at present value of redemption amount, using rate implicit in the contract at inception. Reduce equity by the fair value of the shares at inception (the \$2,500 in this example).

Physically Settled Forward Purchase Contract—Unstated Provision ^e	(3,000) ^c	(2,600) ^d	(400)	Recognize liability at present value of the redemption amount, using rate implicit in the contract at inception adjusted for unstated provision (present value of \$3,000; rate was adjusted for revenue of \$500). Reduce equity by the fair value of the shares at inception (the \$3,000 in this example).
Written Put Option	(10)	(100) ^f	90	Recognize liability at fair value at the date of adoption.
Mandatorily Redeemable Noncontrolling Interests ^g	(5,000)	(5,000) ^h	0	Reclassify carrying amount as a liability if not already recognized as such.

^aThe transition adjustment is before tax considerations.

^bThe liability is measured initially at its present value at the date of adoption, using the rate implicit at inception of the contract. Upon transition, a cumulative adjustment is recognized in the statement of income for any difference between the carrying amount and the present value.

^cThe forward contract had a previous carrying amount of \$0. Equity represents the fair value at inception of the shares underlying the forward purchase contract.

^dThe liability is measured initially at its present value at the date of adoption, using the rate implicit at inception of the contract adjusted for any consideration or unstated provision. Equity is reduced by the fair value of the shares at inception. Upon transition, a cumulative adjustment is recognized in the statement of income for any difference between those amounts.

^eIn this example, the unstated provision is revenue of \$500 attributable to a simultaneous sale to a counterparty at a discount, similar to the example presented in paragraph A13.

^fThe liability (or asset in some circumstances) is measured initially at its fair value at the date of adoption. Upon transition, a cumulative adjustment is recognized in the statement of income for any difference between the carrying amount and the fair value.

^gPrior to adoption of this Statement, some enterprises classified mandatorily redeemable noncontrolling interest as a liability, and others classified it as equity but reported it between the liabilities section and the equity section of the statement of financial position. The cumulative-effect entry illustrated for that financial instrument is applicable only if the mandatorily redeemable noncontrolling interest was classified as equity and presented between the liabilities section and the equity section and if it arose in a business combination under the purchase method.

^hThe liability is reclassified at its current carrying amount, with no cumulative adjustment recognized in the statement of income upon transition.

Appendix B

BACKGROUND INFORMATION AND BASIS FOR CONCLUSIONS

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Appendix B: BACKGROUND INFORMATION AND BASIS FOR CONCLUSIONS

Introduction

B1. This appendix summarizes considerations that Board members deemed significant in reaching the conclusions in this Statement. It includes reasons for accepting certain views and rejecting other views. Individual Board members gave greater weight to some factors than to others.

B2. The Board undertook this project in response to constituents' concerns about classification in the statement of financial position of financial instruments with characteristics of liabilities, equity, or both. Financial instruments with characteristics of liabilities were being presented either entirely as equity or between the liabilities section and the equity section of the statement of financial position. Financial instruments with characteristics of equity also were being presented between the liabilities section and the equity section of the statement of financial position. Additionally, certain financial instruments with characteristics of both liabilities and equity were being classified entirely as liabilities or entirely as equity.

B3. The Board also undertook this project to accelerate international convergence of accounting standards. The Canadian Institute of Chartered Accountants (CICA), the Australian Accounting Standards Board (AASB), and the International Accounting Standards Committee (IASC) have addressed the issue of accounting for financial instruments with characteristics of liabilities, equity, or both. The International Accounting Standards Board (IASB) has proposed significant revisions to existing IASC standards for such instruments. Paragraphs B77–B81 discuss how issuance of this Statement contributes to convergence of accounting standards.

Background Information

B4. This Statement is issued as part of the Board's broad project on financial instruments. That project was added to the Board's agenda in 1986 to address financial reporting issues that were arising, or were given a new sense of urgency, as a result of financial innovation. The project initially focused on disclosures and resulted in the issuance of FASB Statements No. 105, *Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk*, in March 1990, and No. 107, *Disclosures about Fair Value of Financial Instruments*, in December 1991.

B5. In August 1990, the Board issued a Discussion Memorandum, *Distinguishing between Liability and Equity Instruments and Accounting for Instruments with Characteristics of Both*. The issuance of that Discussion Memorandum, combined with the issuance of another Discussion Memorandum in November 1991, *Recognition and Measurement of Financial Instruments*, began the recognition phase of the financial instruments project. That phase of the project has resulted in the issuance of:

- FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan*, May 1993
- FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, May 1993
- FASB Statement No. 118, *Accounting by Creditors for Impairment of a Loan—Income Recognition and Disclosures*, October 1994
- FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, June 1998
- FASB Statement No. 134, *Accounting for Mortgage-Backed Securities Retained after the Securitization of Mortgage Loans Held for Sale by a Mortgage Banking Enterprise*, October 1998
- FASB Statement No. 137, *Accounting for Derivative Instruments and Hedging Activities—Deferral of the Effective Date of FASB Statement No. 133*, June 1999
- FASB Statement No. 138, *Accounting for Certain Derivative Instruments and Certain Hedging Activities*, June 2000
- FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, September 2000.

B6. The 1990 Discussion Memorandum elicited views on 12 issues. Four of those issues related to interpretation and application of the definitions of liabilities and equity in FASB Concepts Statement No. 6, *Elements of Financial Statements*, and whether the distinction between liabilities and equity should be changed. Two issues related to whether particular instruments should be classified as liabilities or as equity. Three issues related to whether the Board should change the distinction between liabilities and equity, including whether equity should be defined independently of liabilities and assets, whether a third “capital” element should be added to include certain instruments with characteristics of both liabilities and equity, and whether the distinction between liabilities and equity should be eliminated. One issue related to measurement at issuance and repurchases of equity instruments. The two remaining issues addressed accounting by issuers for compound instruments with characteristics of both liabilities and equity. The Board received 104 comment letters in response to that Discussion Memorandum.

B7. The Board held 2 days of public hearings on the 1990 Discussion Memorandum in March 1991, at which representatives from 13 organizations testified. Subsequent to the public

hearings, the Board held two public meetings to discuss the conceptual distinctions between liabilities and equity that were pertinent to its project on accounting for stock compensation and whether the conceptual framework should be changed. At those meetings, the Board initially decided not to make fundamental changes to the definitions of liabilities and equity in Concepts Statement 6. After the second of those meetings (held in March 1992), the Board decided to suspend work on the liabilities and equity project to devote its resources to financial instrument issues that were deemed more urgent. The project was inactive until December 1996, at which time it was discussed by the Board's Financial Instruments Task Force. Based on the discussion at that task force meeting, work on the project began again.

B8. After discussing issues related to the liabilities and equity project at 30 Board meetings, as well as 2 additional task force meetings, the Board issued on October 27, 2000, an Exposure Draft of a proposed Statement of Accounting Standards, *Accounting for Financial Instruments with Characteristics of Liabilities, Equity, or Both*. On the same day, the Board issued another Exposure Draft, *Proposed Amendment to FASB Concepts Statement No. 6 to Revise the Definition of Liabilities*.

B9. The Board received 71 letters commenting on those Exposure Drafts. During May, June, and July 2001, Board members and staff met with seven different companies that volunteered to participate in field visits. The objectives of those field visits were to (a) test the understanding of the Exposure Drafts, (b) identify problems related to the implementation of the guidance in the Exposure Drafts, and (c) identify situations that produce results that raise questions about the representational faithfulness of the reporting of instruments or transactions. Board members and staff also met in field visits in November 2001 with various users of financial statements to discuss, from their perspective, the usefulness of the reporting that would result from the proposed change to the definition of liabilities in Concepts Statement 6.

B10. On October 16, 2001, 18 constituents participated in a roundtable discussion focusing on several issues raised in comment letters on the Exposure Drafts. At that roundtable discussion, constituents discussed several aspects of the Exposure Drafts including representational faithfulness, understandability of the proposed reporting, and the appropriateness of classifying certain instruments as liabilities, including mandatorily redeemable stock and certain share-settled obligations.

B11. At 16 public meetings during 2001 and 2002, the Board redeliberated the issues raised in the Exposure Drafts, comment letters, field visits, and the roundtable discussion. At those meetings, the Board affirmed its conclusions that certain freestanding financial instruments should be classified as liabilities: mandatorily redeemable instruments, instruments embodying obligations (or indexed to such obligations) to repurchase an issuer's equity shares by transferring assets, and certain instruments that the issuer must or can choose to settle with equity shares. However, at the end of 2002 the Board had not completed its redeliberations on

several other issues, including separation of instruments with characteristics of both liabilities and equity into components, accounting for noncontrolling interests in consolidated subsidiaries, and inclusion of ownership interest concepts in revised definitions of liabilities and equity. During four further public meetings during 2003, the Board decided that issuance of this limited-scope Statement, even though separation and conceptual issues affecting other instruments are not yet resolved, is needed to provide timely and necessary guidance for certain troublesome instruments for which the practice problems are both clear and resolvable without necessarily addressing separation and conceptual issues. The Board plans to continue redeliberating the remaining issues and to issue another Statement at a future date. Moreover, because the Board believes resolution of those issues may affect any modification to the definition of a liability, the Board decided to delay any changes to that definition until those issues are resolved.

Proposed Amendment to Concepts Statement 6

B12. As part of its deliberations on this Statement, the Board discussed the accounting for financial instruments that embody obligations that require (or permit at the issuer's discretion) settlement by issuance of the issuer's equity shares. Those obligations do not require a transfer of assets and, thus, do not meet the current definition of liabilities in Concepts Statement 6. Therefore, those financial instruments have been classified as equity.

B13. However, not all such obligations establish the type of relationship that exists between an entity and its owners. For example, a financial instrument that requires settlement by issuance of \$100,000 worth of equity shares establishes something more akin to a debtor-creditor relationship than to an ownership relationship, because it requires that the issuer convey a fixed amount of value to the holder that does not vary with the issuer's equity shares. A share-settled put option on the issuer's equity shares establishes the opposite (inverse) of an ownership relationship, because it requires the issuer to convey value to the holder that *increases* as the value of other owners' interests *decreases*.

B14. The Board considered and rejected the alternative of resolving the accounting issues raised by those financial instruments by applying the original definitions of liabilities and equity in Concepts Statement 6. The Board decided that it would be preferable to reconsider the distinction between liabilities and equity. Otherwise, classification by issuers of financial instruments that embody obligations would be based solely on whether the obligation requires settlement by a transfer of assets or by an issuance of equity instruments. As a result, certain instruments would be classified as equity even though those instruments do not establish the type of relationship that exists between an entity and its owners. Instead, the Board decided that the relevance and representational faithfulness of the reporting of those obligations would be improved if classification were based on the type of relationship established between the issuer and the holder of the instrument as well as the form of settlement.

B15. The Board, therefore, proposed an amendment to Concepts Statement 6 to revise its definition of liabilities.

B16. Commentators on the proposed amendment generally objected to the proposed revision to the definition of liabilities. Many said they saw no need to change the current definition. Some pointed out conceptual and practical concerns with the ramifications of incorporating the concept of ownership relationship into the distinction between liabilities and equity. Others, who agreed that an amendment is needed for the reasons cited by the Board, suggested revisions to the definition of liabilities different from the Board's proposal.

B17. After considering those comments and events since the issuance of the Exposure Drafts, the Board did not agree with the majority of commentators and decided that an amendment to Concepts Statement 6 to revise the definition of liabilities is necessary and that the amendment should incorporate the absence of an ownership relationship into the definition of liabilities. The Board affirmed its conclusions that certain financial instruments that embody obligations to issue shares place the holder of the instrument in a position fundamentally different from the position of a holder of the issuer's equity shares, that such obligations do not result in an ownership relationship, and that an instrument that embodies an obligation that does not establish an ownership relationship should be a liability. However, the Board agreed that the proposed amendment to Concepts Statement 6 needs further refinements and that the refinements could not be completed until the Board has considered, in further detail, certain instruments with liability and equity characteristics that are beyond the scope of this limited-scope Statement. The Board plans to deal with those instruments, including compound financial instruments, puttable shares, and dual-indexed financial instruments, in the next phase of this project.

B18. While the Board expects that the requirements of this Statement will be consistent with the revised definition of liabilities in its planned amendment to Concepts Statement 6, it decided to defer completion and issuance of that amendment until it completes its redeliberations of several remaining issues. The Board also notes that its project on revenue recognition may require other amendments to concepts of liabilities and that the Board and international standards-setting bodies have decided to work toward converging their standards and Concepts Statements. That project and those convergence efforts also may affect the timing of the amendment to the definition of liabilities in Concepts Statement 6.

Scope and Initial Classification

B19. This Statement provides guidance for determining the classification of and accounting for certain financial instruments that embody obligations of the issuing entity and fall within its limited scope. The limited scope includes mandatorily redeemable instruments, freestanding instruments that embody obligations to repurchase (or obligations that are indexed to the

repurchase of) an issuer's equity shares by transferring assets, and freestanding instruments that embody certain obligations that the issuer must or can settle by issuing a variable number of its equity shares. The Board plans to provide standards in a later phase of this project for classification of other instruments with characteristics of both liabilities and equity that fall outside the limited scope of this Statement.

Mandatorily Redeemable Financial Instruments

B20. This Statement includes in its scope financial instruments issued in the form of shares that are mandatorily redeemable by transfers of assets because such instruments embody obligations that meet the current definition of liabilities in Concepts Statement 6 and satisfy all other recognition criteria. Mandatorily redeemable instruments, even though they may have the form of shares, (a) embody a present duty that entails settlement by future transfer of assets at a specified or determinable date or on occurrence of a specified event, (b) leave the issuer no discretion to avoid the future sacrifice of assets, and (c) result from a transaction—the issuance of the instrument—that has already happened. Therefore, the obligations under those instruments meet the current definition of liabilities. ²² Liabilities for mandatorily redeemable instruments also satisfy the other recognition criteria set forth in FASB Concepts Statement No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises*. Those liabilities are readily measurable, for example, at fair value by observing market prices for those instruments or by determining the present value of the future cash flows required by the instrument. The measure, and other information about the obligation, is clearly relevant to investors, creditors, and other users of financial statements and has sufficient reliability at issuance for a liability to be recognized.

B21. Commentators on the Exposure Draft generally agreed with that proposal. Those who did not agree did not provide persuasive arguments. Many commentators expressed concern over the effect of transition to that proposed accounting on entities other than public companies (refer to paragraphs B58–B60). One commentator noted that “. . . if the issuing entity must be liquidated and ceases to exist when the mandatory redemption of its shares occurs, then the holders of those shares appear to have an ownership interest similar to the equity owners of the company.” The Board agreed and drafted paragraph 9 of this Statement so that if redemption of an equity instrument is required on liquidation or termination of the reporting entity, the instrument is classified as equity.

B22. Some commentators inquired about certain shares that allow the issuer to extend their term, defer redemption until a specified liquidity level is reached, or have similar provisions that may delay or accelerate the timing of a required redemption. The Board concluded that such shares meet the definition of mandatorily redeemable financial instruments and should be classified as liabilities because those kinds of provisions may affect the timing of but do not remove the unconditional requirement for redemption.

B23. In contrast to mandatorily redeemable shares, shares of nonredeemable common stock do not impose on the issuer an obligation to pay dividends or to reacquire the shares. Declaration of dividends is at the discretion of the issuer, as is a decision to reacquire the shares. Similarly, preferred stock that is not redeemable does not impose on the issuer any obligation either to repurchase the shares or to pay dividends, even though failure to pay dividends may have adverse economic consequences for the issuer. Nonredeemable outstanding shares of both common and preferred stock lack an essential characteristic of a liability.

B24. Some types of preferred stock pay no, or low, dividends during the first few years they are outstanding and then pay dividends at an increasing rate. The Board considered whether an issuer of such “increasing-rate preferred stock” should be deemed to have an obligation to redeem the shares even though it is not legally obligated to do so. The Exposure Draft proposed that to the extent the shares are not mandatorily redeemable and no enforceable obligation to pay dividends exists, increasing-rate preferred stock does not embody an obligation on the part of the issuer and, therefore, should not be classified as a liability. Some commentators proposed that increasing-rate preferred stock be classified as a liability on the grounds that the increasing rate made redemption economically compelling or created an implied mandatory redemption date. The Board reconsidered that issue during its redeliberations but did not resolve it. The Board deferred until the next phase of the project a decision about whether an increasing-rate dividend provision, as well as other forms of economic compulsion, imposes an obligation on the issuer that causes the instrument to be a liability. However, the Board noted that increasing-rate preferred stock that is mandatorily redeemable on (or not later than) a specified date, like other mandatorily redeemable preferred stock, embodies an obligation to transfer assets and, therefore, is classified as a liability under the provisions of this Statement.

B25. Some commentators suggested that shares that the holder can choose to require the issuer to redeem—puttable shares—also should be classified entirely as liabilities. They noted that IAS 32, *Financial Instruments: Disclosure and Presentation*, has such a requirement, based on the characteristic that whether the shares are to be redeemed is outside the issuer’s control. In response, the Board considered whether to include within the scope of this Statement shares that *could* be redeemed—mandatorily, at the option of the holder, or upon some contingent event that is outside the control of the issuer and the holder. However, this Statement limits the meaning of mandatorily redeemable to unconditional obligations to redeem the instrument by transferring assets at a specified or determinable date (or dates) or upon an event certain to occur. The Board decided that puttable and contingently redeemable stock raise issues that should be discussed in the next phase of this project, together with convertible bonds and other compound instruments that raise similar issues.

Obligations to Repurchase the Issuer’s Equity Shares by Transferring Assets

B26. This Statement includes in its scope instruments, other than an outstanding share, that, at

inception, (a) embody an obligation to repurchase the issuer's equity shares (or instruments that are indexed to such an obligation) and (b) require or may require the issuer to settle the obligation by transferring assets because such instruments meet the current definition of liabilities in Concepts Statement 6 and satisfy the other recognition criteria. The Board views such instruments as resulting in liabilities of two types: unconditional and conditional.

B27. Forward purchase contracts that must be physically settled by delivering cash in exchange for shares embody an unconditional obligation to transfer cash to pay the full repurchase price. The Board considers that situation as more akin to a treasury stock purchase using borrowed funds than to participating in a derivative instrument; put another way, such a forward contract effectively converts the shares that the counterparty must deliver into mandatorily redeemable instruments, which this Statement classifies as liabilities. The Board rejected the view that forward purchase contracts that must be physically settled by delivering cash should be reported like other derivative instruments. The Board concluded that the unconditional obligation should result in recognition of a liability that, like many other liabilities that require cash payments, should be subsequently measured at the present value of the full repurchase price, if the amounts to be paid and the settlement date are fixed, or at the (undiscounted) amounts that would be paid under the conditions specified in the contract if the shares were repurchased at the reporting date if the amounts or settlement date can vary.

B28. In contrast, other kinds of contracts to repurchase the issuer's equity shares embody conditional obligations. Forward purchase contracts that must or can be net cash settled embody obligations that are indexed to a repurchase of the equity shares. Such contracts require the issuer of the underlying shares to transfer assets if the fair value of the forward purchase contract at the settlement date places the issuer in a loss position. If prices instead move in the issuer's favor, the issuer will receive assets and will not have to transfer anything. Conditional purchase contracts also embody obligations that are conditional, whether settled by physical exchange or net cash payment. The issuer might have to transfer assets if, for example, the holder of a put option exercises its option, but the issuer will not have to transfer assets if that put option expires unexercised. The Board reasoned that forward purchase contracts that can be cash settled and contingent purchase contracts are liabilities in themselves and that they are generally derivative instruments under Statement 133. However, because the obligation in those contracts is conditional, the Board reasoned that those instruments should be accounted for differently from forward purchase contracts that must be physically settled for cash. Contracts that embody conditional obligations are not akin to a treasury stock purchase using borrowed funds, and they do not effectively convert the shares that the counterparty might or might not deliver into mandatorily redeemable shares, that is, into liabilities. Therefore, those contracts should not be accounted for as if they did.

B29. Forward purchase contracts that must be physically settled by delivering assets other than cash in exchange for shares—barter contracts—also embody an unconditional obligation.

However, the Board did not consider barter contracts akin to a treasury stock purchase using borrowed funds, since no cash is involved. Therefore, it decided that those contracts should be accounted for in the same manner as conditional obligations to purchase the issuer's equity shares.

Obligations to Issue a Variable Number of Shares

B30. Obligations that the issuer can or must settle by issuing its equity shares do not meet the current definition of liabilities in Concepts Statement 6 because, although those instruments embody an obligation that entails settlement, and the obligation arises from a past event, the issuer can avoid having to transfer assets. Because the issuer can or must settle the obligation by issuing its equity shares, under current concepts such instruments have been classified as equity—an ownership interest.

B31. However, certain share-settled obligations establish relationships that, in the Board's view, have little if anything in common with ownership interests. For that reason, the Board proposed to amend Concepts Statement 6 to revise the definition of liabilities to include certain obligations to issue equity shares. However, as discussed in paragraphs B12–B18, the Board decided to defer completion and issuance of that amendment. Instead, the Board decided that this Statement should require certain share-settled obligations to be classified as liabilities rather than as equity, in the expectation that that requirement will be consistent with the revised definition of liabilities in that planned amendment.

B32. This Statement requires that 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 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 (a) a fixed monetary amount known at inception, (b) variations in something other than the fair value of the issuer's equity shares, or (c) variations inversely related to changes in the fair value of the issuer's equity shares. The Board's conclusions about the elements of that requirement are discussed in paragraphs B33–B49.

Obligation

B33. Identifying whether a financial instrument embodies an obligation is the starting point in determining the appropriate classification of that instrument. Both the definition of liabilities in paragraph 35 of Concepts Statement 6 and the essential characteristics of a liability listed in paragraph 36 of that Statement include the notion of an obligation being an essential characteristic. A financial instrument that does not embody an obligation cannot be a liability under the current Concepts Statement 6 definition. The Board concluded in the Exposure Draft that the existence of an obligation should continue to be an essential characteristic of a liability.

B34. In this Statement, an *obligation* is a duty or responsibility on the part of the issuer either to transfer assets or to issue its equity shares. That differs from the usage of that term in Concepts Statement 6 in two respects. This Statement omits the Concepts Statement's phrase *to provide services*, because this Statement applies only to financial instruments. This Statement adds to the notion of an obligation a duty or responsibility to issue equity shares. Although an issuer's equity shares are not assets to the issuer, they become assets to the new holder of the shares. Settling an obligation by issuing shares will adversely affect the interests of the other holders of the issuer's equity shares by diluting their interests in the issuer's assets, just as settling an obligation by transferring assets will adversely affect their interests by reducing the issuer's assets. The duty or responsibility to issue shares leaves an entity little or no discretion to avoid taking an action that it might otherwise wish to avoid. Therefore, the Board concluded that a duty or responsibility to issue shares is an obligation and, potentially, a liability.

B35. Many commentators disagreed with that conclusion. They argued that the current definition of liabilities is appropriate, there are no practice problems related to the current definition, and EITF Issue No. 00-19, "Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock," provides adequate guidance based on the concept that *all* contracts that require or permit the issuer to settle in shares are equity instruments. Other commentators supported the Board's conclusion, citing practice problems and the reasoning presented in the Exposure Draft. The Board observed a number of practice problems, some of which were associated with major business failures that occurred between the comment period and the Board's final deliberations on this Statement. The Board decided that its conclusion in the Exposure Draft was appropriate and reaffirmed it.

Monetary Value

B36. Obligations that require the issuer to issue its equity shares were classified as equity under the original definitions in Concepts Statement 6. As discussed in paragraphs B12–B18, however, the Board concluded in the Exposure Draft that those obligations should not be classified as equity unless they establish an ownership relationship. To be classified as equity, the Board believes that an obligation must expose the holder of the instrument that embodies that obligation to certain risks and benefits that are similar to those to which an owner (that is, a holder of an outstanding share of the entity's equity) is exposed.

B37. The Board concluded in the Exposure Draft that, in determining whether an owner benefits, it is appropriate to consider whether the owner's investment increases in value, not whether the entity is profitable. The value of an owner's investment changes in response to changes in the fair value of the entity's equity shares. Therefore, the Board concluded that exposure to changes in the fair value of the issuer's equity shares is a characteristic of an ownership relationship,

because that fair value reflects the realizable benefits of owners that are within their control. Therefore, for the purpose of classifying an obligation that requires settlement by issuance of the issuer's equity shares, the distinction between obligations that are liabilities and obligations that are equity should be based on the relationship between (a) the value that the holder of the instrument that embodies the obligation is entitled to receive upon settlement of the obligation and (b) the value of the underlying equity shares. In particular, the Board concluded that for an obligation to be classified as equity, any benefits or risks of changes in the obligation must stem directly from changes in the fair value of the issuer's equity shares and be similar to the risks or benefits that would be realized by a holder of an outstanding equity share of the entity.

B38. The Board developed the notion of monetary value to assist in determining whether the risks or benefits from changes in fair value of the issuer's equity shares to which a holder of a financial instrument that embodies an obligation is exposed are similar to those to which a holder of outstanding equity shares is exposed. The Exposure Draft described monetary value as the amount of value measured in units of currency that must be conveyed to the holder upon settlement of an obligation at its maturity, absent a change in current market conditions. Some commentators suggested that the term should be more clearly defined. In response, this Statement further refines the notion of monetary value, defining it as what the fair value of the cash, shares, or other instruments that a financial instrument obligates the issuer to convey to the holder would be at the settlement date under specified market conditions.

B39. The Board concluded that the relationship between changes in the monetary value of an instrument that embodies an obligation and changes in the fair value of the issuer's equity shares during the period the obligation is outstanding would be an effective basic principle to assess whether the holder of the instrument is exposed to risks and benefits that are similar to those to which a holder of a corresponding number of outstanding equity shares (an owner) is exposed.

Variable Number of the Issuer's Equity Shares

B40. In applying that basic principle, the Exposure Draft proposed that a financial instrument that embodies an obligation that requires settlement by issuance of a *fixed* number of the issuer's equity shares should be classified as equity, reasoning that changes in the monetary values of such instruments arise from and are equal to changes in the fair value of that fixed number of shares. Commentators generally supported that view. One possibility that arose in subsequent deliberations is that even the interest of a holder of that sort of obligation differs from the interest of a holder of shares and, therefore, perhaps the obligation should not be classified as equity. While a fixed-price physically settled written call option or warrant would, if exercised, require settlement by a fixed number of shares, such an option might never be exercised and so returns to the option holder would differ from returns to a shareholder. The Board did not decide whether to classify such obligations as liabilities in this limited-scope Statement; the Board

deferred resolution of that issue until it can be discussed together with related issues in the next phase of this project.

B41. Other financial instruments require settlement by issuance of a *variable* number of shares. For some of those kinds of obligations, the monetary values may arise from, and may change equally to and in the same direction as, changes in the fair value of the issuer's equity shares. Those obligations remain outside the scope of this Statement. However, the monetary values of many kinds of obligations to issue a variable number of shares behave differently. Their monetary values may be fixed, may vary in relation to some factor other than the fair value of the issuer's equity shares, or may vary inversely with changes in the fair value of the issuer's equity shares.

Fixed Monetary Amount

B42. Some obligations to issue a variable number of shares have contractually fixed monetary values. For example, if an obligation requires settlement by issuance of shares worth \$100,000 on the settlement date, the number of shares to be issued varies based on the fair value of those shares at settlement. Regardless of changes in the fair value of the shares, however, the holder is to receive \$100,000 of value at settlement—that is, the monetary value of the obligation does not change. The holder of that instrument does not benefit if the fair value of the issuer's equity shares increases and does not bear the risk that the fair value of those shares might decrease. The Board decided that that type of instrument should be classified as a liability because it does not establish an ownership relationship. That is, even though the obligation will be settled by issuance of equity shares, the instrument has more characteristics of a liability than of equity because the holder's return is fixed and, thus, unrelated to changes in the fair value of the issuer's equity shares.

Variations in Something Other Than the Fair Value of the Issuer's Equity Shares

B43. Some obligations to issue a variable number of shares are indexed or otherwise tied to the value of something other than the issuer's equity shares. One example is a guarantee contract that requires that the guarantor issue a variable number of its shares whose fair value equals the deficiency on a specified date between the guaranteed value of the investment and its current market value. Even though the issuer's equity shares will be issued in settlement of the obligation, that type of contract should be classified as a liability because it does not establish an ownership relationship. That is, even though the obligation will be settled by issuance of equity shares, the component has more characteristics of a liability than of equity because the guaranteed party's return is unrelated to changes in the fair value of the issuer's equity shares.

Variations Inversely Related to Changes in the Fair Value of the Issuer's Equity Shares

B44. Some obligations to issue a variable number of shares have monetary values that are indexed or otherwise tied to the fair value of the issuer's equity shares, but those monetary values vary inversely with changes in the fair value of the issuer's shares. Examples include forward purchase contracts, written put options, or net written (or purchased or zero-cost) options or collars that require or permit net share settlement. Because the interests of holders of those instruments are diametrically opposed to those of holders of the issuer's equity shares, the Board concluded that the issuer's obligations under those instruments could not be considered equity interests and, therefore, must be liabilities (or assets in some circumstances).

B45. Some commentators argued that written put options on a company's own stock and forward repurchase agreements are often entered into to manage the risk of price fluctuations during the course of stock repurchase programs and, as a result, should be treated as equity. The Board rejected that argument because (a) efforts to manage the risks of stock repurchase programs would merit accounting recognition only if those efforts met the criteria for hedge accounting, and (b) among its other requirements, Statement 133 permits hedge accounting only if the hedging instrument is a derivative instrument and is classified as a liability or asset, and only if either the hedged item is an asset or liability or the forecasted transaction presents an exposure to variations in cash flows that could affect reported earnings, none of which is the case with stock repurchase programs. Others argued that differentiating between obligations with monetary values that change in the same direction as the fair value of the issuer's shares and those with monetary values that change in the opposite direction would create inconsistency and confusion. The Board rejected that argument because it sees no basis for accounting in the same way for different obligations, one of which comports with the interests of holders of the issuer's equity shares and the other of which is opposed to those interests.

Solely or Predominantly Based

B46. The scope of this Statement is limited because the Board has not completed its redeliberations on several major issues raised in the liabilities and equity Exposure Draft, one of which is the separation of instruments with characteristics of both liabilities and equity into components. Most issues affecting compound instruments, including dual-indexed share-settled instruments (instruments whose value is tied not only to an issuer's equity shares but also to something else), therefore, are beyond the scope of this Statement. Because of that limitation, the Board initially decided that the requirements of paragraph 12 of this Statement should be limited to instruments that embody obligations, the monetary value of which is based *solely* on (a) a fixed monetary amount known at inception, (b) variations in something other than the fair value of the issuer's equity shares, or (c) variations inversely related to changes in the fair value of the issuer's equity shares.

B47. The Board considered that issue further in light of suggestions that requiring the monetary value to be based solely on those factors might result in instruments constructed to avoid this Statement's scope, for example, by embedding a small amount of monetary value variation in response to changes in the fair value of the issuer's equity shares even though the overall variation would predominantly respond to something else. To avoid that, the Board decided to extend the scope to include share-settled instruments whose monetary value is based solely or *predominantly* on one of the three factors in paragraph 12 of this Statement. The Board acknowledged that judgment will be required to distinguish instruments with monetary values predominantly based on one of those three factors from instruments with monetary values that are indexed both to the issuer's equity shares and to one or more other factors and, thus, are excluded from this Statement's scope.

Must or May Settle by Issuing Equity Shares

B48. Certain financial instruments embody obligations that permit the *issuer* to determine whether it will settle the obligation by transferring assets or by issuing equity shares. Because those obligations provide the issuer with discretion to avoid a transfer of assets, the Board concluded that those obligations should be treated like obligations that require settlement by issuance of equity shares. That is, the Board concluded that this Statement should require liability classification of obligations that provide the issuer with the discretion to determine how the obligations will be settled if, and only if, the conditions in paragraph 12 related to changes in monetary value are met.

B49. Other obligations permit the *holder* to determine whether the issuer will be required to transfer assets or issue equity shares to settle the obligation. For that type of obligation, the Exposure Draft proposed that if the monetary values of the two settlement alternatives do not have the potential to differ, the obligation does not establish an ownership relationship, regardless of the settlement provision chosen. Consequently, the Exposure Draft concluded that such an instrument should be classified entirely as a liability. Commentators provided little specific comment on that provision. In its redeliberations, the Board concluded that *all* obligations that permit the holder to require the issuer to transfer assets result in liabilities, regardless of whether the settlement alternatives have the potential to differ. The Board reasoned that such an obligation *could* leave the issuer with no discretion to avoid the future sacrifice of having to transfer assets and, therefore, is a liability under the definition in Concepts Statement 6. That change also makes this Statement more convergent with proposed international accounting standards, although those proposed standards would measure some of those obligations differently (at the full amount that might be paid rather than at the fair value of the option-like conditional obligation).

Freestanding Financial Instruments

B50. The Board decided that, in applying this Statement to freestanding instruments that comprise two or more option or forward contracts, its requirements should be applied to the freestanding instrument in its entirety rather than to separate components in those instruments. The Board also decided that, in applying the classification and measurement provisions of this Statement, freestanding financial instruments that are within the scope of this Statement should not be combined with other freestanding instruments unless combination is required under the requirements of Statement 133 and related guidance. The Board reasoned that those decisions conform to provisions of Statement 133 and related guidance that prohibit separating a compound derivative into risk components or, generally, combining separate freestanding instruments into synthetic instruments for accounting purposes. The Board noted that there are certain circumstances in which Statement 133 and related guidance require separate transactions to be viewed in combination. Those circumstances arise if it is determined that one or more transactions were entered into separately to circumvent the requirements of Statement 133. The Board decided that, in those circumstances, it would be appropriate to retain that guidance.

B51. However, the Board prohibited the combining of instruments within the scope of this Statement to avoid comparability and representational faithfulness problems from inadvertent or planned circumvention of the requirements of this Statement. The Board saw no justification for combining an instrument that in itself is a liability within the scope of this Statement with another freestanding instrument, because that combination might (a) cause a freestanding instrument to be considered to be outside the scope of this Statement, (b) change the reported amount of the liability, or (c) change the required measurement method. For example, combining a freestanding instrument that is a liability under this Statement with a freestanding instrument that is equity under other guidance might have been considered sufficient to change the nature of the instrument such that it would be outside the scope of this Statement and a liability (and any gains or losses resulting from fair value changes of that liability) would not be recognized. Also, permitting freestanding instruments to be combined might have circumvented a requirement to measure those instruments at fair value. For example, combining a written put option and purchased call option might have allowed the combination to be accounted for as a physically settled forward purchase contract. Additionally, the Board noted that allowing or requiring the combining of instruments to create components with differing characteristics might have led to accounting changes that would be reversed in the next phase of this project.

B52. As noted earlier, the scope of this Statement is limited because the Board has not completed its redeliberations on several major issues, one of which is whether and how to separate certain instruments with characteristics of both liabilities and equity into components as proposed in the Exposure Draft. Most issues affecting compound instruments are beyond the scope of this Statement, including how a conversion option or conditional redemption feature embedded in a financial instrument that is not a derivative in its entirety should affect the

classification of the instrument in which it is embedded. Those issues will be addressed in the next phase of this project.

B53. The Board considered the related issue of whether the classification requirements of this Statement should be applied to features embedded in a financial instrument that is not a derivative in its entirety, which would have had the effect of requiring separate accounting—bifurcation—for some embedded features now exempt from that accounting because they are considered not to be derivatives under the existing requirements of Statement 133. Concerns arose about the complexity of those requirements, the measurability of certain embedded features, the possibility of a further required change in accounting in the next phase of this project, and the interaction between that potential requirement and the requirements of the SEC to present redeemable preferred stocks between liabilities and equity in registrants' statements of financial position. In view of those concerns, the Board decided not to apply the classification requirements of this Statement to embedded derivatives. However, the Board noted that other standards and guidance (for example, the embedded derivatives provisions of Statement 133) already require certain compound instruments to be analyzed and separated into components and that current guidance will continue to apply to those embedded derivatives. That decision is effected in paragraph 15 of this Statement and in an amendment to paragraph 12(c) of Statement 133. For similar reasons, paragraph 11 of this Statement excludes outstanding shares from its scope, and paragraph 12 of this Statement excludes outstanding shares embodying conditional obligations that the issuer must or may settle in shares; the Board decided on those scope exclusions so that this Statement does not require outstanding shares in which such derivatives are embedded to be classified entirely as liabilities.

B54. In reaching its conclusion to limit this Statement's classification requirements only to certain freestanding financial instruments, the Board became concerned that a nonsubstantive or minimal feature might be inserted into a financial instrument, which otherwise would be a freestanding financial instrument subject to this Statement, to circumvent the provisions of this Statement. The Board decided to prevent that possibility by providing that any nonsubstantive or minimal features should be disregarded in applying the classification provisions of this Statement. The Board acknowledges that judgment will be required to distinguish nonsubstantive or minimal features from substantive, nonminimal features.

Scope Limitations

B55. The Exposure Draft proposed scope exclusions so as not to affect the timing of recognition of contingent consideration in a business combination and the basic expense recognition criteria for stock compensation arrangements. Commentators did not offer any reasons to change either of those decisions, and the Board excluded both kinds of arrangements from the scope of this Statement. The Board also decided after considering comments on its tentative conclusions in redeliberations to entirely exclude obligations relating to stock compensation from the scope if those obligations are subject to specified guidance for stock compensation arrangements. The

Board noted that it expects to revisit the classification, measurement, and expense recognition for stock compensation arrangements that would be classified as liabilities under this Statement either in the next phase of this project or in its project on stock-based compensation, and, therefore, it saw no need to resolve those issues in this Statement. However, the Board decided that freestanding instruments that are no longer subject to specified guidance for stock compensation arrangements should be within the scope of this Statement, for example, a mandatorily redeemable share that was issued upon exercise of an employee stock option.

Presentation between Liabilities and Equity in Statements of Financial Position

B56. Certain financial instruments were presented between the liabilities section and the equity section of the statement of financial position before the issuance of this Statement. Because Concepts Statement 6 does not accommodate classification of items outside the elements of assets, liabilities, and equity, developing a model that would permit that practice would require the Board to define a new element of financial statements. The Board elected not to pursue that course of action, in part because, among other concerns, adding another element would set an undesirable precedent of adding elements whenever new instruments are created that are difficult to classify.

B57. The Board instead elected to develop an approach that would address the issues related to determining the appropriate classification of financial instruments with characteristics of liabilities, equity, or both. Because the Board believes that the provisions of this Statement sufficiently address those issues for the items within its scope, the Board concluded that presentation of those items between the liabilities section and the equity section of the statement of financial position should be prohibited.

Presentation If All Shares Are Mandatorily Redeemable

B58. The Exposure Draft noted that shares issued by some privately held companies must be sold back to the company, for example, upon the holder's termination of his or her employment and that those financial instruments in the form of shares are liabilities because they are mandatorily redeemable upon an event certain to occur. Accounting for those financial instruments in the form of shares as liabilities would reduce or eliminate the equity of those companies. Some commentators suggested that an exception be made to allow such arrangements to continue to be reported as equity. Others suggested that while those instruments were appropriately classified as liabilities, some sort of special reporting was merited, disclosure about those arrangements was necessary for other investors and creditors, and affected companies needed more time to revise debt covenants or make other changes in response to the change in classification.

B59. The Board concluded that those kinds of arrangements meet the definition of mandatorily

redeemable financial instruments, that the definition should not be changed to classify them differently from other mandatorily redeemable financial instruments, and that there is no adequate basis for any exception. However, the Board acknowledged the need for special reporting in the most often cited circumstance in which no equity would be reported. Therefore, the Board concluded that entities that have no equity instruments outstanding but have financial instruments in the form of shares, all of which are mandatorily redeemable financial instruments required to be classified as liabilities, should describe those instruments as *shares subject to mandatory redemption* to distinguish them from other liabilities and should separately present payments to and interest due to creditors in statements of cash flows and income.

B60. For entities that have financial instruments in the form of shares that are all mandatorily redeemable, the Board decided that, in addition to separate presentation, a related disclosure is needed that displays the nature and composition of the mandatorily redeemable instruments. For example, such an entity would disclose the event triggering the redemption, the number of shares issued and outstanding, the value associated with those financial instruments, and any retained earnings or accumulated other comprehensive income that would be distributed on redemption (the items that those entities have previously displayed in equity). The Board concluded that for those entities that have financial instruments in the form of shares that are all mandatorily redeemable, disclosure will assist financial statement users in assessing the amount and timing of redemptions.

Initial and Subsequent Measurement

B61. This Statement requires that forward contracts that require settlement by delivery of cash in exchange for a fixed number of the issuer's equity shares (forward purchase contracts for the issuer's equity shares that require, physical settlement) be initially measured at the fair value of the shares at inception, adjusted for any consideration or unstated rights or privileges. The Board noted that (a) discounting the settlement amount at the rate implicit in the contract after taking into account any consideration or unstated rights or privileges that may have affected the terms of the transaction and (b) determining the amount of cash that would be paid under the conditions specified in the contract if the shares were repurchased immediately, adjusted for any consideration or unstated rights or privileges, are possible ways to obtain that initial measurement. Those are the common ways of measuring fixed- and floating-rate borrowings, respectively. In the Board's view, such forward contracts are more like a treasury stock purchase using borrowed funds than a derivative instrument. Accounting for this arrangement like a borrowing led the Board to note the need to consider the effect of any unstated rights or privileges, for the same reasons discussed in paragraph 7 of APB Opinion No. 21, *Interest on Receivables and Payables*. The same reasoning also led the Board to decide that those measurement provisions for forward purchase contracts apply only if the issuer will exchange cash for the shares. If the exchange involves barter (for example, specified quantities of gold for shares), the Board saw no reason to reconsider, in this limited-scope project, guidance under

Statement 133 under which that forward purchase contract would be accounted for as a derivative at its fair value.

B62. This Statement requires that those forward contracts, and mandatorily redeemable financial instruments, be subsequently measured in one of two ways. If both the amount of cash and the settlement date are fixed, subsequent measurement is at the present value of the amounts to be paid at settlement, with interest accreted using the rate implicit at inception. If either the amount or the date varies based on specified conditions, subsequent measurement is at the amount of cash that would be paid under the conditions specified in the contract if the shares were redeemed or repurchased at the reporting date. The Board chose those methods because they are generally used to subsequently measure liabilities for funds borrowed at fixed and floating rates. Some Board members prefer those methods to subsequently measuring the obligation at its fair value because they do not accept the recognition of gains and losses on transactions involving the issuer's own stock in circumstances in which cash is exchanged for shares and the obligation is unconditional. The Board also decided that accrued dividends (whether or not declared) on underlying shares and any other amounts paid or to be paid to holders of those contracts be reflected as interest cost because that is consistent with the reporting of those shares as liabilities.

B63. This Statement also requires that all remaining financial instruments within its scope be measured initially and subsequently at fair value unless otherwise required by this Statement or other accounting standards. While many, if not most, of those instruments are classified as derivative instruments under Statement 133, the Board took no inventory of such instruments and did not want to leave constituents without guidance for measuring some newly recognized liabilities. The Board reasoned that subsequent measurement of any such liabilities at fair value would provide more relevant information than measures based on historical proceeds.

B64. The Board decided that when a contingently redeemable instrument becomes mandatorily redeemable, that instrument should be reclassified as a liability and should be initially measured at fair value. The Board decided that the issuer should reduce equity by the amount of that initial measure, so as to recognize no gain or loss. The Board sees that decision as consistent with its other initial measurement decisions in this Statement and believes that recognition of a liability to a former owner on removal of a contingency about redemption is, like other distributions to owners, not an occasion for recognizing gain or loss.

Earnings per Share

B65. In its redeliberations related to financial instruments that could be settled by delivery of an issuer's shares and physically settled forward purchase contracts that are measured at the present value of the contract amount with a corresponding reduction to equity, the Board discussed the implications for calculating diluted and basic earnings per share.

B66. The Board considered, but decided against, amending the guidance in paragraph 29 of FASB Statement No. 128, *Earnings per Share*, so that the dilutive earnings per share calculation and numerator adjustments would no longer be based on the intent to settle in shares or in cash. The Board noted that the issue applies to a broader class of contracts than those included within the scope of this Statement and that this issue is not a result of this Statement. The Board noted that it would reconsider amending those provisions of Statement 128 in the next phase of this project.

B67. The Board also considered, but decided against, amending Statement 128 to treat obligations to repurchase an issuer's equity shares that were previously classified as equity but would now be classified as liabilities differently in calculating dilutive earnings per share under the reverse treasury stock method. The Board decided that including the effect of certain instruments previously classified as equity but now classified as liabilities and measured at fair value in the dilutive earnings per share calculation was appropriate even though those instruments might be "out-of-the-money" from the holder's perspective. The Board noted that being "out-of-the-money" is a calculation issue, not a flaw in the dilutive earnings per share model. Additionally, the Board decided not to change the requirement under Statement 128 that any dilutive effects of those contracts be included in calculating dilutive earnings per share.

B68. The Board decided that the number of outstanding shares associated with physically settled forward purchase contracts measured at the present value of the contract amount should be removed from the denominator in computing basic and diluted earnings per share in the same way as required for mandatorily redeemable shares classified as liabilities. The Board reasoned that, because the accounting for physically settled forward contracts reduces equity, even though the shares are still outstanding, they are effectively accounted for as if retired. Like mandatorily redeemable shares accounted for as liabilities, shares subject to physically settled forward contracts should not be treated as outstanding in earnings per share calculations. The Board noted that amounts paid to holders are interest costs reflected in earnings available to common shareholders, the numerator in calculating earnings per share.

B69. The Board noted that some amounts attributable to shares that are to be redeemed or repurchased, for example, amounts associated with participation rights such as a preferred instrument that entitles the holder to participate in 50 percent of all future declared dividends on common shares, are not recognized as interest costs until the dividend is declared under this Statement or other existing standards. The Board concluded that earnings available to common shareholders (the numerator of the earnings per share calculation) should be reduced by amounts attributable to participation rights as those rights are earned, consistently with the "two-class" method required by Statement 128.

Disclosures

B70. The Board concluded that the existing disclosure requirements for liabilities and for equity instruments, notably the requirements in FASB Statement No. 129, *Disclosure of Information about Capital Structure*, provide users of financial statements with information useful in analyzing an entity's liabilities and equity. The Board decided that additional information would be helpful to users in evaluating an entity's economic exposure to financial instruments that could be settled in an entity's shares. The disclosure requirements for instruments that could be settled with an issuer's shares that were established in Issue 00-19 appear to provide that kind of information, and preparers and users of financial statements are familiar with those requirements. Therefore, the Board decided to require, in addition to the requirements in Statement 129, certain of the disclosures required by Issue 00-19 for all contracts within the scope of this Statement.

Effective Date and Transition

B71. The Board decided to make this Statement effective shortly after issuance for contracts created or modified after it is issued and for existing contracts at the beginning of the first interim period beginning after June 15, 2003. The Board concluded that in view of practice problems that have emerged since the Exposure Draft was issued, it is important that most of the provisions of the Statement be adopted without delay. The Board concluded that that effective date provides entities with adequate time to accumulate and develop the information required by this Statement. The Board also concluded that private companies needed more time to adapt to liability classification, in part because many of them are affected significantly by the requirements on mandatorily redeemable shares, and decided to delay the effective date for mandatorily redeemable instruments of a nonpublic company.

B72. In determining the appropriate transition method, the Board considered prospective application, cumulative-effect transition, and retroactive application. The Board concluded that for contracts created before the issuance date of the Statement and existing at the beginning of that interim period, transition is best achieved by reporting the cumulative effect of a change in accounting principle by initially measuring the contract at fair value or as otherwise required by this Statement. The Board concluded that prospective application (that is, application to financial instruments issued after the adoption of this Statement or some other specified date) would diminish both the comparability of financial statements among entities and consistency within an entity that had entered into similar transactions both before and after adoption of this Statement for quite some time given the long lives of certain financial instruments within the scope of this Statement.

B73. In considering the possibilities of retroactive or cumulative-effect transition, the Board noted that some recent standards issued as part of the comprehensive project on financial

instruments have prohibited retroactive application for two reasons—reliance on intent and transition costs. Statements 115 and 133 do not permit retroactive application partly because both of those standards rely on the reporting entity's intent. However, the reporting entity's intent is not a factor in this Statement and, therefore, is not a factor that would prohibit restatement.

B74. Statement 140 does not permit retroactive application because of the perceived costs of restatement. Transition costs also are a factor in this Statement. However, in the Exposure Draft for this Statement, the Board stated its belief that to determine the effect of adopting that proposed Statement, an entity would be required to determine the fair value of each financial instrument within its scope and its components at the date the financial instrument was issued. That determination would be required regardless of whether the Board required cumulative-effect transition or restatement. In the Exposure Draft, with its significantly broader scope, the Board concluded, therefore, that requiring restatement would not result in significant additional costs to entities above the costs required for cumulative-effect transition. The Exposure Draft for this Statement noted that retroactive application and restatement would maximize consistency and comparability. Given that, and the belief that the costs of restatement would not be materially greater than the costs of cumulative-effect transition, the Exposure Draft proposed that restatement would be the appropriate transition method.

B75. In this limited-scope Statement, the Board again decided to require a single method to improve comparability. However, the Board chose to require cumulative-effect transition instead of restatement. Some commentators suggested that the options in the transition method proposed in the Exposure Draft would confuse some investors and creditors; the Board agreed. Others objected to the costs of restatement, whatever the scope of the restatement. The Board concluded that a full restatement would often cost more than cumulative-effect presentation and that, given the limited scope of this Statement, those incremental costs are not justified by the incremental benefits to investors and creditors from restatement. Some Board members also believe that because the major impact of this Statement would be on the statement of financial position, the need for full restatement is less compelling.

B76. For practical reasons, the Board decided that for mandatorily redeemable instruments and physically settled forward purchase contracts, accumulated prior interest accruals would not be recognized upon transition. The Board also decided that amounts previously recognized in business combinations under the purchase method should not be changed when liabilities for existing noncontrolling interests that are mandatorily redeemable are recognized on adoption of this Statement. The Board plans to address the effects of transition for those mandatorily redeemable noncontrolling interests in the transition guidance in the Board's planned Statement on business combination purchase method procedures.

International Accounting Standards

B77. In June 2002, the IASB issued an Exposure Draft, *Amendments to IAS 32, Financial Instruments: Disclosure and Presentation, and IAS 39, Financial Instruments: Recognition and Measurement*. IAS 32 now does, and the proposed amendments would, provide international guidance for financial instruments within the scope of this Statement. Paragraphs B78–B81 summarize the differences between this Statement and that IASB Exposure Draft.

B78. Paragraph 22 of the current unrevised IAS 32 (which would be consistent with the proposed revisions to IAS 32) states, “When a preferred share provides for mandatory redemption by the issuer for a fixed or determinable amount at a fixed or determinable future date or gives the holder the right to require the issuer to redeem the share at or after a particular date for a fixed or determinable amount, the instrument meets the definition of a financial liability and is classified as such.” Thus, IAS 32 requires that preferred shares be classified as a liability if the holder can choose to require redemption, even if redemption is uncertain. In contrast, under this Statement, only shares (whether common or preferred) that are mandatorily redeemable (upon a specified date, determinable date, or event certain to occur) are classified as a liability.

B79. IAS 32 requires the same accounting for conditionally redeemable instruments as for mandatorily redeemable instruments. This Statement does not go that far. The Board acknowledges that the conditional obligation embedded in such shares may, if accounted for separately, meet the definition of a liability; however, the accounting for such compound instruments is beyond the scope of this Statement.

B80. Paragraph 29F of the proposed revised IAS 32 would require an entity that enters into a derivative contract (such as a forward repurchase contract or written put option) for its equity shares to recognize a liability measured at the present value of the contract’s redemption amount if any of the following is true: (a) the contract requires physical settlement by delivery of cash or other assets, (b) the entity has an unconditional right to require physical settlement, has a past practice of physically settling such contracts, and intends to physically settle the contract, or (c) the counterparty to the contract has the option to require physical settlement of the contract. This Statement requires an entity that enters into a forward purchase contract for its equity shares in exchange for cash to recognize a liability measured at the present value of the redemption amount only if physical settlement is the only settlement method. If physical settlement is not the only settlement method or something other than cash would be exchanged, under this Statement such forward purchase contracts (and *all* written put options) are measured initially at fair value with subsequent changes in fair value recognized in earnings. The difference between IAS 32 as proposed and this Statement is that IAS 32 would define the class of instruments to be measured at the present value of the redemption amount more broadly. The Board views

physically settled forward purchase contracts of an entity's own shares in exchange for cash as being similar to financing a stock purchase or a treasury stock transaction and, therefore, would require the recognition of a liability for the future sacrifice of assets, but that view holds only if the obligation to purchase is unconditional and requires physical settlement in exchange for cash.

B81. Paragraphs 22C and 22D of the proposed revised IAS 32 would require a liability to be recognized if an entity has a fixed monetary obligation or one that fluctuates in part or in full in response to changes in a variable other than the issuer's own shares that can be settled with a number of shares that equals that obligation. Those paragraphs are consistent with this Statement except for instruments with monetary values that fluctuate in part based on something other than changes in the fair value of the issuer's shares and that are settled with a variable number of the issuer's equity shares. This Statement excludes from its scope share-settled "dual-indexed" financial instruments that are indexed (or have fair values that fluctuate) in part based on changes in the fair value of the issuer's shares and in part based on one or more additional underlyings. The Board plans to address those dual-indexed financial instruments in the next phase of the project. The Board notes that the accounting required for dual-indexed financial instruments that are within the scope of Statement 133 is consistent with the accounting under the proposed revised IAS 32.

Benefits and Costs

B82. The mission of the FASB is to establish and improve standards of financial accounting and reporting for the guidance and education of the public, including preparers, auditors, and users of financial information. In fulfilling that mission, the Board endeavors to determine that a proposed standard will fill a significant need and that the costs imposed to meet that standard, as compared with other alternatives, are justified in relation to the overall benefits of the resulting information. Although the costs to implement a new standard may not be borne evenly, investors and creditors—both present and potential—and other users of financial information benefit from improvements in financial reporting, thereby facilitating the functioning of markets for capital and credit and the efficient allocation of resources in the economy.

B83. The Board determined that the requirements in this Statement will result in improved financial reporting. In this Statement, certain obligations that require a transfer of assets and that meet the definition of liabilities in Concepts Statement 6 will be reported as liabilities rather than as equity or between the liability and equity sections of the statement of financial position. Also, certain obligations that can be settled by issuance of an entity's equity shares but lack other characteristics of equity will be reported as liabilities, rather than as equity as previously required under Issue 00-19. Those changes result in financial statements that are more representationally faithful and present a more complete depiction of an entity's liabilities that will assist users in assessing the future cash flows and equity share issuances of an entity.

B84. The Board believes that the incremental costs of implementing this Statement have been minimized principally by (a) requiring cumulative-effect transition instead of restatement of financial statements and (b) providing a delayed effective date for mandatorily redeemable financial instruments of nonpublic companies. Although the one-time costs for changes needed to apply the accounting requirements of this Statement may be significant, the benefits from more representationally faithful information will outweigh those one-time implementation costs and will be ongoing.

Appendix C: AMENDMENTS TO EXISTING PRONOUNCEMENTS AND IMPACT ON EITF ISSUES AND STATEMENT 133 IMPLEMENTATION ISSUES

Amendments to Existing Pronouncements

C1. In the first sentence of paragraph 24 of FASB Statement No. 128, *Earnings per Share*, the phrase *other than forward purchase contracts accounted for under paragraphs 21 and 22 of FASB Statement No. 150, Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*, is added after *forward purchase contracts*.

C2. FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, is amended as follows:

a. In paragraph 11, the following subparagraph is added after subparagraph 11(c):

d. Forward contracts that require settlement by the reporting entity's delivery of cash in exchange for the acquisition of a fixed number of its equity shares (forward purchase contracts for the reporting entity's shares that require physical settlement) that are accounted for under paragraphs 21 and 22 of FASB Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*.

b. The following is added to the end of subparagraph 12(c):

However, this criterion is not met if the separate instrument with the same terms as the embedded derivative instrument would be classified as a liability (or an asset in some circumstances) under the provisions of Statement 150 *but* would be classified in stockholders' equity absent the provisions in Statement 150.*

* For purposes of analyzing the application of paragraph 11(a) of this Statement to an embedded derivative instrument as though it were a separate instrument, paragraphs 9–12 of Statement 150 should be disregarded. Those embedded features are analyzed by applying other applicable guidance.

Impact of This Statement on EITF Issues and Statement 133 Implementation Issues

C3. The remainder of this appendix discusses the impact of the provisions of this Statement on the consensuses reached on EITF Issues and the responses to Statement 133 Implementation Issues through March 31, 2003. This appendix does not address the impact of this Statement on other authoritative accounting literature included in categories (b), (c), and (d) in the GAAP hierarchy discussed in AICPA Statement on Auditing Standards No. 69, *The Meaning of “Present Fairly in Conformity with Generally Accepted Accounting Principles” in the Independent Auditor’s Report*.

C4. The provisions of this Statement nullify or partially nullify the consensuses (or views) in the following EITF Issues and Topics:

- 86-32 “Early Extinguishment of a Subsidiary’s Mandatorily Redeemable Preferred Stock” (partially nullified)
- 88-9 “Put Warrants” (nullified)
- 89-11 “Sponsor’s Balance Sheet Classification of Capital Stock with a Put Option Held by an Employee Stock Ownership Plan” (partially nullified)
- 98-12 “Application of Issue No. 00-19 to Forward Equity Sales Transactions” (nullified)
- 00-4 “Majority Owner’s Accounting for a Transaction in the Shares of a Consolidated Subsidiary and a Derivative Indexed to the Minority Interest in That Subsidiary” (nullified)
- 00-6 “Accounting for Freestanding Derivative Financial Instruments Indexed to, and Potentially Settled in, the Stock of a Consolidated Subsidiary” (partially nullified)
- 00-19 “Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company’s Own Stock” (partially nullified)
- 00-27 “Application of Issue No. 98-5 to Certain Convertible Instruments” (partially nullified)
- D-42 “The Effect on the Calculation of Earnings per Share for the Redemption or Induced Conversion of Preferred Stock” (partially nullified)
- D-72 “Effect of Contracts That May Be Settled in Stock or Cash on the Computation of Diluted Earnings per Share” (partially nullified)

D-98 “Classification and Measurement of Redeemable Securities” (partially nullified)

C5. The provisions of this Statement resolve or partially resolve the following EITF Issues:

84-40 “Long-Term Debt Repayable by a Capital Stock Transaction” (partially resolved)

01-11 “Application of Issue No. 00-19 to a Contemporaneous Forward Purchase Contract and Written Put Option” (resolved)

02-2 “When Separate Contracts That Meet the Definition of Financial Instruments Should Be Combined for Accounting Purposes” (partially resolved)

C6. The effect of the issuance of this Statement will be added to the status section of each affected EITF Issue or Topic in *EITF Abstracts*.

C7. Even though the provisions of this Statement do not nullify or partially nullify the consensuses in the following EITF Issues, the status section of each of those Issues in *EITF Abstracts* will include a reference to the requirements of this Statement:

97-8 “Accounting for Contingent Consideration Issued in a Purchase Business Combination”

97-15 “Accounting for Contingency Arrangements Based on Security Prices in a Purchase Business Combination”

01-6 “The Meaning of ‘Indexed to a Company’s Own Stock’”

C8. Even though the provisions of this Statement do not nullify or partially nullify the responses in the following Statement 133 Implementation Issues, the Implementation Issues will include a reference to the requirements of this Statement:

A18 “Application of Market Mechanism and Readily Convertible to Cash Subsequent to the Inception or Acquisition of a Contract”

C2 “Application of the Exception to Contracts Classified in Temporary Equity”

C9 “Mandatorily Redeemable Preferred Stock Denominated in either a Precious Metal or a Foreign Currency”

G1 “Hedging an SAR Obligation”

- K3 “Determination of Whether Combinations of Options with the Same Terms Must Be Viewed as Separate Option Contracts or as a Single Forward Contract”

Appendix D: GLOSSARY

D1. This appendix defines terms used in this Statement.

Fair value

The amount at which an asset (liability) could be bought (incurred) or sold (settled) in a current transaction between willing parties, that is, other than in a forced or liquidation sale. Additional guidance on determining fair value is provided in other FASB Statements and FASB Concepts Statements.

Financial instrument

Cash, evidence of an ownership interest in an entity, or a contract that both:

- a. Imposes on one entity a contractual obligation^{*} (1) to deliver cash or another financial instrument[†] to a second entity or (2) to exchange other financial instruments on potentially unfavorable terms with the second entity
- b. Conveys to that second entity a contractual right[‡] (1) to receive cash or another financial instrument from the first entity or (2) to exchange other financial instruments on potentially favorable terms with the first entity. [Statement 133, paragraph 540]

^{*} Contractual obligations encompass both those that are conditioned on the occurrence of a specified event and those that are not. All contractual obligations that are financial instruments meet the definition of liability set forth in Concepts Statement 6, although some may not be recognized as liabilities in financial statements—may be "off-balance-sheet"—because they fail to meet some other criterion for recognition. For some financial instruments, the obligation is owed to or by a group of entities rather than a single entity.

[†] The use of the term financial instrument in this definition is recursive (because the term financial instrument is included in it), though it is not circular. The definition requires a chain of contractual obligations that ends with the delivery of cash or an ownership interest in an entity. Any number of obligations to deliver financial instruments can be links in a chain that qualifies a particular contract as a financial instrument.

‡Contractual rights encompass both those that are conditioned on the occurrence of a specified event and those that are not. All contractual rights that are financial instruments meet the definition of asset set forth in Concepts Statement 6, although some may not be recognized as assets in financial statements—may be “off-balance-sheet”—because they fail to meet some other criterion for recognition. For some financial instruments, the right is held by or the obligation is due from a group of entities rather than a single entity.

Freestanding financial instrument

A financial instrument that is entered into separately and apart from any of the entity’s other financial instruments or equity transactions, or that is entered into in conjunction with some other transaction and is legally detachable and separately exercisable.

Issuer

The entity that issued a financial instrument or may be required under the terms of a financial instrument to issue its equity shares.

Mandatorily redeemable financial instrument

Any of various financial instruments issued in the form of shares that embody 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 that is certain to occur.

Monetary value

What the fair value of the cash, shares, or other instruments that a financial instrument obligates the issuer to convey to the holder would be at the settlement date under specified market conditions.

Net cash settlement

A form of settling a financial instrument under which the party with a loss delivers to the party with a gain cash equal to the gain.

Net share settlement

A form of settling a financial instrument under which the party with a loss delivers to the party with a gain shares of stock with a current fair value equal to the gain.

Nonpublic entity

Any entity other than one (a) whose equity securities trade in a public market either on a stock exchange (domestic or foreign) or in the over-the-counter market, including securities quoted only locally or regionally, (b) that makes a filing with a regulatory agency in preparation for the sale of any class of equity securities in a public market, or (c) that is controlled by an entity covered by (a) or (b). [Statement 123, paragraph 395]

Obligation

A conditional or unconditional duty or responsibility to transfer ²³ assets or to issue equity shares. ²⁴

Physical settlement

A form of settling a financial instrument under which (a) the party designated in the contract as the buyer delivers the full stated amount of cash or other financial instruments to the seller and (b) the seller delivers the full stated number of shares of stock or other financial instruments or nonfinancial instruments to the buyer.

Footnotes

FAS150 Footnote 1—Terms defined in Appendix D are set in **bold type** the first time they appear.

FAS150 Footnote 2—This Statement does not address instruments that have only characteristics of assets. However, this Statement does apply to instruments having characteristics of both liabilities and equity that, in some circumstances, also have characteristics of assets, for example, a forward contract to purchase the issuer's equity shares that is to be net cash settled.

FAS150 Footnote 3—An instrument that requires the issuer to settle its obligation by issuing another instrument (for example, a note payable in cash) ultimately requires settlement by a transfer of assets.

FAS150 Footnote 4—Business enterprises have interest holders that are commonly known by specialized names, such as stockholders, partners, and proprietors, and by more general names, such as investors, but all are encompassed by the descriptive term *owners*. Equity of business enterprises is, thus, commonly known by several names, such as owners' equity, stockholders' equity, ownership, equity capital, partners' capital, and proprietorship. Some enterprises (for example, mutual organizations) do not have stockholders, partners, or proprietors in the usual sense of those terms but do have participants whose interests are essentially ownership interests, residual interests, or both.

FAS150 Footnote 5—In determining if an instrument is mandatorily redeemable, all terms within a redeemable instrument shall be considered. A term extension option, a provision that defers redemption until a specified liquidity level is reached, or a similar provision that may delay or accelerate the timing of a mandatory redemption does not affect the classification of a mandatorily redeemable financial instrument as a liability.

FAS150 Footnote 6—In this Statement, *indexed to* is used interchangeably with *based on variations in the fair value of*.

FAS150 Footnote 7—Certain financial instruments that embody obligations that are liabilities within the scope of this Statement also may contain characteristics of assets but be reported as single items. Some examples include net-cash-settled or net-share-settled forward purchase contracts and certain combined options to repurchase the issuer's shares. Those instruments are classified as assets or liabilities initially or subsequently depending on the instrument's fair value on the reporting date.

FAS150 Footnote 8—Paragraph 12 of Statement 133 requires an entity to identify derivative instruments that are embedded in contracts that do not meet the definition of a derivative

instrument in their entirety. That paragraph sets forth criteria for determining whether such embedded derivative instruments are required to be separated from the host contract and accounted for separately as derivative instruments. One of those criteria, in paragraph 12(c) of that Statement, requires an embedded derivative instrument to be analyzed as though it were a separate instrument.

FAS150 Footnote 9—The Board currently is addressing the accounting for contingent consideration issued in a business combination in its project on purchase method procedures.

FAS150 Footnote 10—One way to obtain that amount is by determining the amount of cash that would be paid under the conditions specified in the contract if the shares were repurchased immediately. Another way to obtain the same result is by discounting the settlement amount, at the rate implicit at inception after taking into account any consideration or unstated rights or privileges that may have affected the terms of the transaction.

FAS150 Footnote 11—Paragraph 5 of FASB Statement No. 129, *Disclosure of Information about Capital Structure*, requires additional disclosures for actual issuances and settlements that occurred during the accounting period.

FAS150 Footnote 12—In this example, assume that the trust is required to be consolidated under the provisions of FASB Interpretation No. 46, *Consolidation of Variable Interest Entities*, and related guidance. However, if it were determined that the trust or other variable interest entity is not consolidated by the financial institution, the financial statements would reflect the liability owed to the variable interest entity.

FAS150 Footnote 13—If redemption is required only upon liquidation or termination of the trust, this Statement does not require the securities to be reported as liabilities in the trust's standalone financial statements. However, this Statement does require the obligation to be reported as a liability in the consolidated financial statements of the financial institution because redemption is required to occur before the liquidation or termination of the reporting entity, that is, of the financial institution.

FAS150 Footnote 14—An insurance contract that would cover the cost of the redemption does not affect the classification of the stock as a liability.

FAS150 Footnote 15—If the conversion option were nonsubstantive, for example, because the conversion price is extremely high in relation to the current share price, it would be disregarded as provided in paragraph 8 of this Statement. If that were the case at inception, those preferred shares would be considered mandatorily redeemable and classified as liabilities with no subsequent reassessment of the nonsubstantive feature.

FAS150 Footnote 16—Cash includes foreign currency, so physically settled forward purchase contracts in exchange for foreign currency are to be measured as provided in paragraphs 21 and 22 of this Statement, then remeasured under FASB Statement No. 52, *Foreign Currency Translation*.

FAS150 Footnote 17—Contracts referred to as variable-rate forwards are commonly used to effect equity forward transactions. The contract price on those forward contracts is not fixed at inception but varies based on changes in a specified index (for example, 3-month US LIBOR) during the life of the contract. If such a contract requires physical settlement, a different measurement method is required subsequently, as set forth in paragraph 22 of this Statement.

FAS150 Footnote 18—Paragraph 11(a) of Statement 133 and Statement 133 Implementation Issue No. C8, “Derivatives That Are Indexed to both an Entity’s Own Stock and Currency Exchange Rates,” address derivative instruments that are dual indexed and require an issuer to report those instruments as derivative liabilities or assets.

FAS150 Footnote 19—This Statement precludes combining freestanding instruments only for purposes of applying this Statement’s provisions and only if Statement No. 133 and related guidance do not require combination. For example, Statement 133 Implementation Issue No. K1, “Determining Whether Separate Transactions Should Be Viewed as a Unit,” requires certain separate transactions to be combined.

FAS150 Footnote 20—If Statement 133 and its related guidance required the freestanding written put option and purchased call option to be combined and viewed as a unit, the unit would be accounted for as a combination of options, following the guidance in paragraphs A15 and A16 of this Statement.

FAS150 Footnote 21—Some outstanding shares of stock are within the scope of this Statement, for example, mandatorily redeemable shares or shares subject to a physically settled forward purchase contract in exchange for cash.

FAS150 Footnote 22—This Statement also includes in its scope and requires liability classification for financial instruments issued in the form of shares that are mandatorily redeemable by issuance of a variable number of the issuer’s equity shares, rather than by transfers of assets. The basis for that conclusion is discussed in paragraphs B30–B49.

FAS150 Footnote 23—The term *transfer* is used in this Statement in a broad sense consistent with its use in Concepts Statement 6, rather than in the narrow sense in which it is used in Statement 140.

FAS150 Footnote 24—Because this Statement relates only to financial instruments and not to

contracts to provide services and other types of contracts, but includes duties or responsibilities to issue equity shares, this definition of *obligation* differs from the definition found in Concepts Statement 6 and is applicable only for items in the scope of this Statement.