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Financial Accounting Series

PRELIMINARY VIEWS

Financial Instruments with Characteristics of Equity

This Preliminary Views is issued by the Financial Accounting Standards Board for public comment as a step preceding the development of an Exposure Draft of a proposed Statement of Financial Accounting Standards.

Written comments should be addressed to:

Technical Director
File Reference No. 1550-100

Comments are requested by May 30, 2008

Financial Accounting Standards Board
of the Financial Accounting Foundation

Responses from interested parties wishing to comment on the Preliminary Views must be *received* in writing by May 30, 2008. Interested parties should submit their comments by email to director@fasb.org, File Reference 1550-100. Those without email may send their comments to the "Technical Director—File Reference 1550-100" at the address at the bottom of this page. Responses should *not* be sent by fax.

All comments received by the FASB are considered public information. Those comments will be posted to the FASB's website and will be included in the project's public record.

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PRELIMINARY VIEWS

Financial Instruments with Characteristics of Equity

November 30, 2007

Financial Accounting Standards Board
of the Financial Accounting Foundation
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Notice for Recipients of This Preliminary Views

The primary purpose of this Preliminary Views is to solicit comments on the Financial Accounting Standards Board's (FASB) views on distinguishing between equity and liabilities or assets. There are currently more than 60 pieces of literature that address various aspects of accounting for instruments that are within the scope of this Preliminary Views. Most of the literature addresses specific narrow issues and was developed as the issues arose. As a result, the current literature is inconsistent, subject to structuring, or difficult to understand and apply. The complexity has caused many questions and numerous restatements over the past few years.

In the course of its project on liabilities and equity, the Board has considered many approaches for distinguishing between equity and liabilities or assets. Three of those approaches (basic ownership, ownership-settlement, and reassessed expected outcomes [REO]) are described in this Preliminary Views. The Board has reached a preliminary view that the basic ownership approach provides more decision-useful information to investors while significantly simplifying accounting requirements for issuers and their auditors.

Under the basic ownership approach, an instrument would be classified as equity if it (1) is the most subordinated interest in an entity and (2) entitles the holder to a share of the entity's net assets after all higher priority claims have been satisfied. The holders of equity instruments are viewed as the owners of the entity. All other instruments, for example, all forward contracts, options, and convertible debt, would be classified as liabilities or assets. Instruments classified as liabilities or assets that have varying or uncertain settlement amounts would be measured at fair value with changes reported in income. As a result, changes in an issuer's share price would affect income. The underlying principle of the basic ownership approach is that claims against the entity's assets are liabilities (or assets) if they reduce (or enhance) the net assets available to the owners of the entity.

The Board decided on the basic ownership approach because it classifies only the lowest residual interests in the entity as equity. Additionally, the approach is simpler and easier to apply than the other two approaches the Board considered in detail. Also, the basic ownership approach requires a narrow definition of equity, which provides fewer opportunities than the other approaches to structure instruments and arrangements to achieve a desired accounting treatment.

At this point, the Board is seeking comment on whether the basic ownership approach would represent an improvement in financial reporting that would provide useful information to investors and other users of financial statements. Thus, this Preliminary Views does not include all the guidance that would be provided in a fully developed standard. For example, the Board has not yet discussed how changes in an instrument's value should be presented in the income statement. It also does not address the changes to or the interaction with other literature, for example, FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*.

The Board invites comments on all matters addressed in this Preliminary Views; however, respondents need not comment on all issues and are encouraged to comment

on additional issues the Board should consider. The Board is especially interested in comments on (1) the fundamental principles expressed in this Preliminary Views, including potential issues related to the basic ownership approach, and (2) the specific issues identified in this Notice. These comments will help the Board in its redeliberations leading to an Exposure Draft of a proposed Statement of Financial Accounting Standards on distinguishing between equity and liabilities or assets. To the extent that respondents choose to comment on the following issues, it would be helpful if comments are in response to the issues as stated and include the reasons for positions taken.

Summary of Issues

This section provides an overview of the issues on which the Board is soliciting comments. The issues, which are discussed within the Preliminary Views, are organized by approach. The issues and questions also are repeated in this Preliminary Views after each approach.

Questions on the Basic Ownership Approach

1. Do you believe that the basic ownership approach would represent an improvement in financial reporting? Are the underlying principles clear and appropriate? Do you agree that the approach would significantly simplify the accounting for instruments within the scope of this Preliminary Views and provide minimal structuring opportunities?

Perpetual Instruments

2. Under current practice, perpetual instruments are classified as equity. Under the basic ownership approach (and the REO approach, which is described in Appendix B) certain perpetual instruments, such as preferred shares, would be classified as liabilities. What potential operational concerns, if any, does this classification present?

3. The Board has not yet concluded how liability instruments without settlement requirements should be measured. What potential operational concerns, if any, do the potential measurement requirements in paragraph 34 present? The Board is interested in additional suggestions about subsequent measurement requirements for perpetual instruments that are classified as liabilities.

Redeemable Basic Ownership Instruments

4. Basic ownership instruments with redemption requirements may be classified as equity if they meet the criteria in paragraph 20. Are the criteria in paragraph 20 operational? For example, can compliance with criterion (a) be determined?

Separation

5. A basic ownership instrument with a required dividend payment would be separated into liability and equity components. That classification is based on the Board's understanding of two facts. First, the dividend is an obligation that the entity has little or no discretion to avoid. Second, the dividend right does not transfer with the stock after a specified ex-dividend date, so it is not necessarily a transaction with a current owner. Has the Board properly interpreted the facts? Especially, is the dividend an obligation that the entity has little or no discretion to avoid? Does separating the instrument provide useful information?

Substance

6. Paragraph 44 would require an issuer to classify an instrument based on its substance. To do so, an issuer must consider factors that are stated in the contract and other factors that are not stated terms of the instrument. That proposed requirement is important under the ownership-settlement approach, which is described in Appendix A. However, the Board is unaware of any unstated factors that could affect an instrument's classification under the basic ownership approach. Is the substance principle necessary under the basic ownership approach? Are there factors or circumstances other than the stated terms of the instrument that could change an instrument's classification or measurement under the basic ownership approach? Additionally, do you believe that the basic ownership approach generally results in classification that is consistent with the economic substance of the instrument?

Linkage

7. Under what circumstances, if any, would the linkage principle in paragraph 41 not result in classification that reflects the economics of the transaction?

Measurement

8. Under current accounting, many derivatives are measured at fair value with changes in value reported in net income. The basic ownership approach would increase the population of instruments subject to those requirements. Do you agree with that result? If not, why should the change in value of certain derivatives be excluded from current-period income?

Presentation Issues

9. *Statement of financial position*. Basic ownership instruments with redemption requirements would be reported separately from perpetual basic ownership instruments. The purpose of the separate display is to provide users with information about the liquidity requirements of the reporting entity. Are additional separate display requirements necessary for the liability section of the statement of financial position in order to provide more information about an entity's potential cash requirements? For example, should liabilities required to

be settled with equity instruments be reported separately from those required to be settled with cash?

10. *Income statement*. The Board has not reached tentative conclusions about how to display the effects on net income that are related to the change in the instrument's fair value. Should the amount be disaggregated and separately displayed? If so, the Board would be interested in suggestions about how to disaggregate and display the amount. For example, some constituents have suggested that interest expense should be displayed separately from the unrealized gains and losses.

Earnings per Share (EPS)

11. The Board has not discussed the implications of the basic ownership approach for the EPS calculation in detail; however, it acknowledges that the approach will have a significant effect on the computation. How should equity instruments with redemption requirements be treated for EPS purposes? What EPS implications related to this approach, if any, should the Board be aware of or consider?

Questions on the Ownership-Settlement Approach

1. Do you believe the ownership-settlement approach would represent an improvement in financial reporting? Do you prefer this approach over the basic ownership approach? If so, please explain why you believe the benefits of the approach justify its complexity.

2. Are there ways to simplify the approach? Please explain.

Substance

3. Paragraph A40 describes how the substance principle would be applied to indirect ownership instruments. Similar to the basic ownership approach, an issuer must consider factors that are stated in the contract and other factors that are not stated in the terms of the instrument. Is this principle sufficiently clear to be operational?

Presentation Issues

4. *Statement of financial position*. Equity instruments with redemption requirements would be reported separately from perpetual equity instruments. The purpose of the separate display is to provide users with information about the liquidity requirements of the reporting entity. What additional, separate display requirements, if any, are necessary for the liability section of the statement of financial position in order to provide more information about an entity's potential cash requirements? For example, should liabilities required to be settled with equity instruments be reported separately from those required to be settled with cash?

Separation

5. Are the proposed requirements for separation and measurement of separated instruments operational? Does the separation result in decision-useful information?

Earnings per Share

6. The Board has not discussed the implications of the ownership-settlement approach for the EPS calculation in detail. How should equity instruments with redemption requirements be treated for EPS purposes? What EPS implications related to this approach, if any, should the Board be aware of or consider?

Settlement, Conversion, Expiration, or Modification

7. Are the requirements described in paragraphs A35–A38 operational? Do they provide meaningful results for users of financial statements?

Questions on the REO Approach

1. Do you believe that the REO approach would represent an improvement in financial reporting? What would be the conceptual basis for distinguishing between assets, liabilities, and equity? Would the costs incurred to implement this approach exceed the benefits? Please explain.

Separation and Measurement

2. Do the separation and measurement requirements provide meaningful results for the users of financial statements?

Earnings per Share

3. The Board has not discussed the implications of the REO approach for the EPS calculation in detail; however, it acknowledges that the approach will have a significant effect on the calculation. How should equity instruments with redemption requirements be treated for EPS purposes? What EPS implications related to this approach, if any, should the Board be aware of or consider?

Other Alternatives

1. Some other approaches the Board has considered but rejected are described in Appendix E. Is there a variation of any of the approaches described in this Preliminary Views or an alternative approach that the Board should consider? How would the approach classify and measure instruments? Why would the variation or alternative approach be superior to any of the approaches the Board has already developed?

Preliminary Views

Financial Instrument with Characteristics of Equity

November 30, 2007

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Preliminary Views

Financial Instruments with Characteristics of Equity

November 30, 2007

INTRODUCTION AND BACKGROUND

1. The Financial Accounting Standards Board's (FASB) broad project on **financial instruments**[1] began in 1986 and has been conducted in phases. This Preliminary Views is being issued as a part of the phase that involves the distinction between liability and asset instruments and equity instruments (the liabilities and equity project). Appendix E describes the history of the project.

2. This Preliminary Views was developed by the FASB without participation of the International Accounting Standards Board (IASB). It represents the views of the FASB only and describes issues in the context of U.S. generally accepted accounting principles (GAAP), unless explicitly stated otherwise. However, this Preliminary Views also will be considered for publication by the IASB for comment by its constituents. The Boards plan to use the input received on this Preliminary Views as the basis for a joint project to develop a high-quality common standard.

Distinguishing between Liability Instruments and Equity Instruments

3. Distinguishing between liability instruments and equity instruments affects leverage ratios and other similar financial metrics, but it is most critical for determining an entity's net income. Changes in assets and liabilities affect net income, while changes in equity instruments do not.

4. At first glance, distinguishing between liability instruments and equity instruments may not seem difficult. The most obvious debt instruments are those that require delivery of a specified amount of cash or other assets, for example, a trade account payable. An obvious equity instrument is a share of common stock that represents a claim to a specified percentage of the assets that remain after all other claims are settled. However, some instruments displayed in the statement of financial position between the trade account payable in cash and the common share can be difficult to classify.

5. Although classification issues have existed for decades, they are more prevalent than they once were because new financial instruments have been developed (some purely for economic reasons and some for financial reporting reasons). Current accounting requirements and conventions were designed to apply to the relatively simpler set of instruments that existed when those requirements and conventions were

[1]Terms listed and defined in Appendix F are set in **boldface type** the first time they appear.

developed. In some ways, the current standards depend more on legal form than on economic characteristics.

6. As instruments have become more complex, form and substance have diverged. For example, some instruments called **convertible debt** in the marketplace are actually settled in cash equal to the value of the stock that would have been issued under more conventional convertible debt. Current accounting standards do not adequately address some of the settlement options and other features in instruments that exist today. In some cases, an **issuer** can effectively choose how to report an instrument or instruments by altering their form without changing the substance very much, if at all. For example, under current accounting requirements, a **written call option** settled with cash is classified as a liability. However, a written call option is classified as equity if the issuer can choose to settle in cash or shares. The issuer may insert a share-settlement provision to obtain equity classification even if the intent is to settle in cash.

7. Some other reasons why the classification issues have become more prevalent include the following:

a. Stock issuance is often a readily accepted substitute for cash payment because if the markets are deep and liquid the two are interchangeable for many entities.
b. Entities issue instruments that are legally ownership interests but that require redemption or lead investors to expect specified rates of return (dividends).
c. Closely held entities have employed stock buy-back agreements to plan succession or maintain control.
d. There are different motivations for issuing instruments that involve purchases or sales of an entity's own stock.
e. Instruments may be issued separately to achieve the same outcome as if they were one instrument. The separate instruments may require different classification than the combined instrument.

The principal reason for the increase in classification issues is probably the one described in item (a) above. This issue arises because the definition of a liability in FASB Concepts Statement No. 6, *Elements of Financial Statements,* refers to obligations that require an entity to sacrifice economic benefits (deliver assets or provide services). Strict application of that definition would lead to the conclusion that any obligation that requires an entity to issue shares of its own stock is not a liability. Thus, in these cases, classification based on the form of an instrument is essentially a structuring choice.

8. In developing this Preliminary Views, the Board considered the following three approaches to determine which financial instruments should be classified as equity:

a. The basic ownership approach
b. The ownership-settlement approach

c. The reassessed expected outcomes (REO) approach.

The main body of this Preliminary Views describes the Board's preliminary view (the basic ownership approach). Appendixes A and B describe the other two approaches. The Board also has considered and rejected other approaches. They are described in Appendix E, along with a brief history of the liabilities and equity project.

Issues Other Than Classification

9. In addition to the issues of classification, all three approaches deal with the following related issues:

a. Scope: How to clearly identify the instruments to which the principles apply, thereby avoiding requiring entities to evaluate every financial instrument in every reporting period.
b. Measurement: How to measure liability instruments formerly reported as equity.
c. Separation: When to separate complicated instruments and how to measure the components.
d. Linkage: When to report separate instruments as if they were a single combined instrument.
e. Unstated settlement alternatives: When to assume cash settlement of an instrument that contractually requires issuance of equity instruments but, as a practical matter, can be settled with cash.
f. Substance: When to ignore terms that would affect classification of an instrument but that are not substantive (that is, highly unlikely ever to affect the instrument's outcome).
g. Settlement, conversion, expiration, and modification: How to report modifications, expirations, negotiated settlements, and conversions to equity of separated and unseparated instruments and related matters.
h. Reassessment: When to reassess the terms, classification, and separation of an instrument.

10. While the list of issues is relevant to all three approaches, individual issues are more important in some approaches than in others. For example, the ownership-settlement approach requires separation of some convertible debt instruments and accretion (amortization) of discount (premium) on the debt component over the period until the probability-weighted (expected) settlement date. There may be a reasonable possibility that the instrument will be settled on some other date. Therefore, the issue of how to report separated instruments settled in a manner inconsistent with the assumptions used to separate them (part of the issue in paragraph 9(g)) is very important in that approach.

11. In contrast, the basic ownership approach requires classification of convertible debt instruments as liabilities without separation. Therefore, reporting changes in fair value of those instruments in earnings is very important because, otherwise, the issuer would report little or no financing cost.

Interaction with the Board's Financial Statement Presentation Project

12. The FASB and the IASB currently are conducting a joint project that addresses the form and content of the basic financial statements. The Boards have tentatively decided that the statement of financial position should have three sections: the business section, the financing section, and the equity section. Assets and liabilities that (a) represent sources of financing and (b) are independent of the entity's business activities would be presented in the financing section. Assets and liabilities that are integral to an entity's business activities would be presented in the business section. Most instruments within the scope of this Preliminary Views likely would be presented within the financing or equity sections.

13. The Boards also have tentatively decided that the financial statements should be cohesive. For example, if an instrument is presented in the financing section of the statement of financial position, changes in that instrument would be presented in the financing section of the income statement. Therefore, most changes arising from the subsequent measurement of nonequity instruments within the scope of this Preliminary Views would be included in the financing section of the income statement. The Board believes that the proposed improvements to the financial statements will allow users to distinguish between changes that are related to financing activities and those that are integral to an entity's business activities.

14. The Boards expect to issue a Preliminary Views of their decisions on the financial statement presentation project in the second quarter of 2008.

SCOPE

15. The proposed requirements would determine whether the following types of financial instruments issued by business enterprises are classified as equity:

a. **Basic ownership instruments** (whether or not they are ownership instruments in legal form)
b. Other instruments that are ownership interests in legal form
c. Any other contract that is settled with basic ownership instruments or whose fair value is determined by prices of basic ownership instruments.

Not all instruments within the scope of the proposed requirements would be classified as equity. Some would be classified as liabilities or assets. (This scope applies to all three approaches described in this Preliminary Views.)

PRELIMINARY VIEWS

Basic Ownership Approach

16. The Board's preliminary view is that the basic ownership approach is the appropriate method for determining which instruments should be classified as equity instruments. The following are the principles underlying that approach:

a. The most residual claim is classified as equity. The holders of this class of instruments are viewed as the owners of the entity. Claims that reduce (or enhance) the net assets available to the owners of the entity are classified as liabilities (or assets).
b. Instruments for which there are no existing measurement requirements should be measured using the existing framework.

17. Basic ownership instruments would be classified as equity. Instruments with a basic ownership component and a liability or asset component (see paragraphs 25 and 26) would be separated, and only the basic ownership component would be classified as equity. All other instruments and components, including **perpetual instruments** like some preferred stock, would be classified as assets or liabilities, as appropriate.

Basic Ownership Instruments

18. A basic ownership instrument has both of the following characteristics:

a. The holder has a claim to a share of the assets of the entity that would have no priority[2] over any other claims if the issuer were to liquidate on the date the classification decision is being made; and
b. The holder is entitled to a percentage of the assets of the entity that remain after all higher priority claims have been satisfied. The holder's share depends on its share of the total claims with the lowest priority and has no upper or lower limit except for the amount of assets available.

19. A share of stock with the lowest priority claim of all instruments the entity has issued is an example of a basic ownership instrument. If an entity issues two classes of stock that are not equal in priority, only the class with the lowest priority would be a basic ownership instrument even if both issues are labeled common stock.

Redeemable Basic Ownership Instruments

20. Many basic ownership instruments are perpetual, but an instrument that is redeemable (mandatorily or at the option of the holder)[3] is a basic ownership instrument

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[2]Priority refers to subordination, which must be legally determined.

[3]An instrument that is redeemable at the option of the holder is usually referred to as puttable.

if it possesses the two characteristics in paragraph 18. It possesses those characteristics if both of the following criteria are met:

a. The redemption amount is the same as the share of the issuer's net assets to which the holder would be entitled if it were to liquidate on the classification date; and
b. The terms of the instrument prohibit redemption if redemption would impair the claims of any instruments with higher priority than other basic ownership instruments.

21. The fair value of an instrument would be used to approximate the share of the issuer's net assets for purposes of the criterion in paragraph 20(a) unless both of the following conditions exist. If both conditions exist, a redemption amount based on book value would be acceptable.

a. The redemption formula is designed to approximate fair value of the instrument or the share of assets to which the holder would be entitled; and
b. There is no active market for the instrument or the instrument can be exchanged only with the reporting entity.

The Difference between a Basic Ownership Instrument and a Legal Form Ownership Interest

22. The term *legal form ownership interest* refers to a proprietary interest in a business organization. Proprietary interests are defined by law in the United States, for example, as shares of stock issued subject to Chapter 6 of the *Revised Model Business Corporation Act* and partnership interests subject to Article 2 of the *Revised Uniform Partnership Act*.

23. Proprietary interests subject to comparable laws in other jurisdictions also would be legal form ownership interests. Legal form may be important for determining what instruments are within the scope of this Preliminary Views, but legal form does not determine classification. Therefore, it is not critical to determine whether a particular instrument with unclear legal status is a legal form ownership interest. In applying the requirements in this Preliminary Views, an entity would assume an instrument with an unclear legal status is within the scope of this Preliminary Views and would apply the principles to determine its classification.

24. Some legal form ownership interests are basic ownership instruments. For example, a share of common stock is a legal form ownership interest and also is likely to possess the characteristics of a basic ownership instrument in paragraph 18. However, a share of preferred stock is legally an ownership interest, but it normally does not have the lowest priority claim against the entity. Therefore, it would not be a basic ownership instrument.

Basic Ownership Components

25. An instrument composed of a basic ownership component and a liability component would be separated and reported as if it were two separate freestanding financial instruments. An instrument would have two components if (a) it requires a payment that does not meet the criteria in paragraph 18 (the liability component) and (b) after the payment is made, a basic ownership instrument remains outstanding. Examples of instruments that would be separated are basic ownership instruments with **registration rights penalties** and basic ownership instruments with a **net-cash-settled** written put feature. A common share with an embedded net-cash-settled feature requires the issuer to pay the holder cash equal to the difference between the strike price and the current share price. If the share price is lower than the strike price, the holder will receive cash and the share will remain outstanding.

26. An entity may not avoid separation of an instrument with a basic ownership component and a liability or asset component by electing a fair value option for the instrument in its entirety.[4] However, the entity would be permitted to apply a fair value option to a separated nonequity component if a comparable freestanding instrument would be eligible for a fair value option.

Classification of Other Instruments

27. All instruments that are not basic ownership instruments and components that are not basic ownership components would be classified as assets or liabilities. (That includes perpetual instruments that are not basic ownership instruments.) If FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities,* or other GAAP requires separation of an instrument classified as an asset or liability, each component would be classified as an asset or liability.

28. All **forward contracts** and options would be classified as liabilities or assets. This would be true even if the option or forward involves delivery or receipt of basic ownership instruments. (See Table 2 in Appendix C for detailed classification examples.) If the basic ownership approach was applied to share-based-payment awards, those awards would be classified as liabilities. FASB Statement No. 123 (revised 2004), *Share-Based Payment,* requires that liability awards be reported using a fair-value-based measure. The Board will need to consider at a future date whether or not share-based-payment awards should be in the scope of any standard resulting from this Preliminary Views.

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[4]FASB Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities,* permits entities to measure most financial assets and liabilities at fair value. FASB Statement No. 155, *Accounting for Certain Hybrid Financial Instruments,* permits entities to measure certain hybrid instruments at fair value instead of separating them into a host contract and an embedded derivative.

Basic Ownership Instruments Issued by Subsidiaries and Consolidated Variable Interest Entities

29. Basic ownership instruments of a subsidiary or a consolidated **variable interest entity** would be identified at the subsidiary or variable interest entity level. Those instruments would retain their basic ownership nature in the consolidated financial statements unless their characteristics are different in the context of the consolidated financial statements. For example, if a subsidiary issues a redeemable basic ownership instrument (which it is required to redeem at fair value), the parent may decide to induce investors to purchase the security by guaranteeing a minimum redemption amount to those investors. That instrument would be equity in the subsidiary's financial statements because the subsidiary is not involved in the guarantee. Without the parent's guarantee, that instrument would be equity (noncontrolling interest) in the parent's consolidated financial statements. However, because the guarantee places a lower limit on the redemption amount, the instrument does not have characteristic (b) of a basic ownership instrument as described in paragraph 18. Therefore, it would be classified as a liability in the consolidated financial statements.

Measurement and Display of Instruments and Components

Initial Measurement

30. All freestanding instruments within the scope of this Preliminary Views would be initially measured at the transaction price unless initial measurement is specified in other GAAP (for example, share-based payment instruments under Statement 123(R)). For this purpose, the term *transaction price* does not include transaction costs, whether they are included in the price paid by the seller (to the buyer) or billed and paid separately. Transaction costs or fees would be charged or credited to income immediately.

31. If an instrument is separated, the sum of the initial measures of the components must always equal the transaction price of the entire instrument. To achieve this result, the nonequity component of a separated instrument would be measured first at fair value. The difference between the fair value of the nonequity component and the transaction price of the instrument would be the initial measure of the basic ownership component.

Display and Subsequent Measurement—Basic Ownership Instruments and Basic Ownership Components

32. Basic ownership instruments and components with redemption requirements would be reported under a separate heading within equity. Those instruments would be remeasured at each reporting date at the **current redemption value**—the fair value of the consideration that would be paid if the instrument was redeemed at the reporting date. An instrument has a current redemption value even if it is not actually redeemable at the measurement date. The formula for determining the redemption

amount would be applied as if redemption was required at the measurement date. Changes in the redemption value would be reported as a separate equity account.

33. No other basic ownership instruments or basic ownership components would be remeasured unless required under other GAAP.

(The examples provided in this Preliminary Views are simplified and are not intended to serve as a guide for detailed analysis and calculations necessary in applying the proposed requirements.)

Example—Separate Display in Equity

The following example illustrates separate display within the equity section of the statement of financial position for equity instruments that may be settled with cash or other assets. The assumptions in the example are as follows:

Mandatorily redeemable basic ownership interests were issued at the end of period 1 at a transaction price of $200, (which was the market price on that date).

The mandatorily redeemable basic ownership interests are redeemable at fair value on the redemption date. Redemption will not occur until after the end of period 2.

The entity's net income for period 2 was $300.

The fair value of the mandatorily redeemable basic ownership interests (which is the current redemption amount) increased by $50 during period 2.

	Period 1	**Period 2**
Total assets	$ 1,300	$ 1,600
Total liabilities	$ 450	$ 450
Equity		
Mandatorily redeemable basic ownership interests	$ 200	$ 200
Cumulative change in current redemption amount	—	50
Redeemable equity	200	250
Nonredeemable basic ownership interests	500	500
Retained earnings*	150	400
Nonredeemable equity	650	900
Total liabilities and equity	$ 1,300	$ 1,600

*Retained earnings increased by $250, which is $300 in net income less the $50 change in the current redemption amount.

Subsequent Measurement—Perpetual Instruments Not Classified as Equity

34. The Board did not decide whether or how to remeasure a perpetual instrument (such as preferred stock) that is classified as a liability. Some possibilities would be:

a. Do not remeasure, but report dividends as an expense either when declared or at regular intervals (if dividends are normally paid each period).
b. Remeasure at fair value with changes reported in income.
c. Determine an expected retirement date and an expected dividend stream and discount using a market-based rate.

Subsequent Measurement—Other Instruments and Components Classified as Liabilities or Assets

35. Instruments for which there are no existing measurement requirements should be measured using the existing framework. Therefore, other instruments and components within the scope of this Preliminary Views that have varying or uncertain settlement amounts, for example, options and forward contracts on the issuer's basic ownership instruments, would be remeasured at fair value each measurement date unless another standard permits or requires a different measurement attribute. Changes in fair value would be reported in income.

36. This Preliminary Views would not require assets and liabilities with fixed maturity dates and settlement amounts that are fixed or that change only because of variable interest rates to be remeasured at fair value. Those instruments would be accounted for as required by GAAP for the specific type of instrument.

37. The probability-weighted (expected) settlement date would be used for accretion or amortization for an instrument that bears interest or is issued at a discount that represents interest and that is callable or puttable or otherwise has an uncertain settlement date. Current GAAP would require the contractual maturity date or other contractual prepayment date.

38. If an asset or liability instrument is settled earlier than its probability-weighted (expected) settlement date, an entity would recognize a gain or loss in net income for the difference between the settlement amount and the carrying amount. If an instrument remains outstanding after its probability-weighted settlement date, an entity may need to determine a new probability-weighted amortization period and amount and begin a new amortization or accretion pattern.

Example—Subsequent Measurement of Bond Payable with Embedded Put Option (Puttable Bond) Settled with a Variable Number of Basic Ownership Instruments

Note: Interest is ignored to make the example as simple as possible. This example is not a suggested template for making the computations.

Assumptions:

	Date	Proceeds/Price	Probabilities
Issuance:	First day of year 0	$9 million	
Maturity:	Last day of year 10	$10 million	20 percent
Put option:	Last day of year 5	$9.5 million	80 percent

Computations and analysis:

The probability-weighted accretion period is 6 years ((80% × 5 years) + (20% × 10 years)).

The probability-weighted settlement amount is $9.6 million ((80% × 9.5) million + (20% × 10 million)); therefore, the discount to be accreted is $0.6 million.

If the put option is exercised, the issuer would pay $9.5 million and report a loss of $0.003 million because on the last day of year 5 (exercise date of the put option), the accreted value will be $9.497 million (based on annual accretion).

If the put is not exercised, the only remaining possibility is payment at maturity. The new accretion period will be 5 years (from last day of year 5 to the last day of year 10). The new discount to be accreted is $0.503 million.

Reassessment of Classification

39. An entity would reassess the classification of every instrument at each reporting date and reclassify if necessary. For example, if an embedded put option expires, a puttable share of stock may become a basic ownership instrument and be reclassified appropriately.

40. An entity would not report a gain or loss upon reclassifying an instrument even if the reclassification requires a change in the way the instrument is measured. Instead, an entity would report any difference in value upon reclassification in equity. Upon reclassification, the entity would measure the instrument according to the requirements

for the new classification as of the date of the event that caused the reclassification. There would be no limit on the number of times an instrument may be reclassified.

Linkage

41. Two or more freestanding instruments would be linked—that is, classified and measured as if they were a single instrument—if both of the following apply:

a. They are part of the same arrangement (see paragraph 43); and
b. Reporting the instruments individually would result in reporting amounts of net income or equity that are different from the amounts that would result from accounting for a comparable single instrument, that is, a single instrument with the same or similar outcome(s).

42. The purpose of the linkage requirement is to eliminate the opportunity to choose between alternative accounting results by altering the structure of an arrangement. To meet this objective, an entity may be required to link an instrument within the scope of paragraph 15 with a financial instrument outside that scope. The combined instruments would be accounted for under the requirements in this Preliminary Views.

43. Instruments would be deemed part of the same arrangement if at least one of the following conditions exists:

a. The instruments are contractually linked. For example, two instruments are contractually linked if exercise of one depends on exercise of the other or causes the expiration of the other.
b. The instruments were entered into at or near the same time with the same or related counterparty and together achieve an overall economic outcome that could have been achieved as simply or more simply with a single instrument.

Example—Linkage

On December 31, 20X1, a reporting entity has 1,000 Class A common shares outstanding. The Class A common shares meet the definition of a basic ownership instrument. On January 1, 20X2, the reporting entity writes 1,000 put options on Class A common shares with a fixed strike price.

The instruments are part of the same arrangement because they were issued at almost the same time and together achieve an overall economic outcome that could have been achieved by issuing a single instrument.

If the instruments are accounted for separately, the shares would be classified as equity and not subsequently remeasured and the put options would be classified as liabilities and measured at fair value. If combined, the instruments have an outcome similar to stock puttable at a fixed price, which is reported as a liability in its entirety and measured at fair value with changes reported in net income. Because the accounting for the combined instrument results in not reporting an equity component that would have been reported if the instruments were accounted for individually, the instruments should be linked and accounted for as **puttable stock**.

Substance

44. Classification, linkage, and separation of instruments depend on the substance of each instrument or linked group, which may not always be represented by stated terms. An entity would examine the terms and probable outcome(s) of each instrument or linked group to determine whether the instrument's (or linked group's) stated terms reflect its substance. The following two principles would apply:

a. A stated term would not affect classification if the term has only a remote chance of affecting the instrument's outcome in more than a minimal way—the amount, timing, or nature of the instrument's settlement or the holder's rights in liquidation.
b. Factors that have more than a remote chance of affecting the instrument's outcome in more than a minimal way would be considered in classification even if they are not part of the stated terms of the instrument.

45. Two examples of stated terms that would not affect classification, linkage, or separation are (a) a provision that permits the holder of an instrument to require the issuer to redeem it if a specific event occurs and there is only a remote chance that the event will occur and (b) a registration rights penalty feature that provides for a penalty so small that it is insignificant or has a less than remote chance of occurring.

46. At each reporting date, an entity would reassess the terms of an instrument and determine if the classification is still appropriate. See further discussion of reassessment in paragraphs 39 and 40.

Example—Substance

An entity issues a warrant granting the counterparty a right to require the entity to issue a common share for a nominal exercise price (in this example, assume the exercise price is $0.01 and the price of a common share is $100).

The penny exercise price is minimal (nonsubstantive) compared with the share price and should be disregarded. The amount the issuer would require in exchange for issuing the warrant is essentially equal to the price of a share (most likely $99.99), and the minimal exercise price virtually guarantees that the shares will be issued. Consequently, the holder's claim is unlimited and virtually identical to that of a common shareholder. Therefore, the warrant would be considered a basic ownership instrument in substance and reported as equity.

Note that it is not the absolute amount of the exercise price of the warrant that determines whether it is substantive, but rather the relative amount of the exercise price compared with the price of the common share. For example, if the price of a common share was $0.02, then it is likely that an exercise price of $0.01 would be substantive. This is because, at inception, the exercise feature is more than minimal as compared with other features of the instrument, and there is uncertainty about whether the option would be exercised. Therefore, such an instrument would be a liability or asset measured at fair value.

Settlement, Conversion, Expiration, or Modification

47. An instrument or component may cease to exist due to any of the following events:

a. Settlement by delivery or receipt of assets according to its terms or by negotiation between the parties
b. Settlement by issuance or receipt of basic ownership instruments (including conversion) according to its terms or by negotiation between the parties
c. Settlement by issuance or receipt of other liability instruments
d. Expiration according to its terms or forgiveness by the entity or the counterparty.

48. The parties to an instrument also may agree to modify it in a manner that changes its value, classification, or the way in which it is required to be measured. A modification is treated as if the old instrument ceased to exist and was replaced with a new instrument.

49. All of the events that cause an instrument or component to cease to exist would be accounted for as follows:

a. The old instrument or component would be completely derecognized.
b. The new instrument or component (if any) would be recognized at its fair value on the date of the event.
c. If the old instrument or component was classified as an asset or liability, the difference between the carrying amount of the old instrument or component and the fair value of the new instrument or component would be recognized as a gain or loss in net income.
d. If the old instrument or component was classified as equity, the difference between the carrying amount of the old instrument or component and the fair value of the new instrument or component would be recognized as a direct charge to equity.

BASIS FOR THE BOARD'S PRELIMINARY VIEWS

Introduction

50. This section summarizes the considerations that Board members deemed significant in reaching the tentative conclusions described in this Preliminary Views. Individual Board members gave greater weight to some factors than others.

51. Simplicity (reduction of complexity) in financial reporting was an overriding consideration for some Board members in choosing the basic ownership approach. Board members also preferred the basic ownership approach for the following reasons:

a. It classifies all **derivatives** on an issuer's basic ownership instruments as liabilities or assets.
b. An instrument's form of settlement is not considered in determining classification.
c. It provides the users of the financial statements with a clear distinction between the interests of different classes of stakeholders.
d. It classifies only claims that fully participate in the residual as equity, which some Board members believe represent the ownership interests of the entity.

Why Would Only Basic Ownership Instruments Be Classified as Equity?

52. Determining which instruments are equity is most simply described as drawing a line between the different types of claims to an entity's net assets. That line separates claims to a share of the net income of an entity from claims that contribute to the determination of net income.

53. There is no natural line that is obvious to all. Equity has historically been identified as a residual interest in an entity, and this Preliminary Views retains that general idea. A residual interest is one entitled to what is left over, that is, to the residual from the entity's activities. However, there are different levels of residuals. If all claims to an entity's assets were listed in order of seniority, a line could be drawn below any item in that list, and all claims below it would be residual because they are entitled to a share of anything left over after all senior claims are settled. Thus, the search for the appropriate line between equity and other claims is the search for the appropriate level of residual.

54. The basic ownership approach is designed to draw the necessary line in the simplest and most informative way that the Board could devise. Simplicity means making the reported information easy to understand by those who prepare, audit, and use that financial information. In this case, a valuable by-product of simplicity is that it would reduce the opportunities to structure very similar transactions or arrangements differently to achieve a different financial reporting result (structuring opportunities).

55. The simplest distinction that the Board could identify is to classify only basic ownership instruments as equity. Holders of basic ownership instruments bear the ultimate risk and are entitled to the ultimate rewards inherent in an entity and its activities. The basic ownership instruments are the lowest level residual interests in the entity, and, as such, they are the one class of claimants without which the entity could not exist or operate.

56. Without question, basic ownership instruments are ownership interests in the entity. Any amounts that basic ownership instruments receive in dividends, redemption proceeds, or distributions in liquidation are distributions (rather than determinants) of the net income of the entity.

57. Instruments with provisions requiring redemption at fair value do not literally have the characteristic in paragraph 18(a) because the instrument's fair value might not be the same as the portion of net assets the holder would receive if the entity liquidated on that instrument's redemption date. However, the Board decided that instruments redeemable at fair value on a date other than liquidation should be considered basic ownership instruments if they are appropriately subordinated (see paragraph 18(b)) because the fair value of the instruments relates to the holder's proportionate share of the entity's fair value.

58. Other claimants to the entity's assets bear risks and are entitled to rewards, but they are at least partially protected from risk by basic ownership instruments, and their share of the rewards is limited. From the perspective of the holders of basic ownership instruments, any amounts due to other claimants reduce the share of the entity's assets (the residual) attributable to the basic ownership instruments. Said another way, any claim that is senior to the most subordinate ownership interests is potentially dilutive of the residual that would otherwise be attributable to basic ownership interests.

59. The basic ownership approach increases transparency and comparability in the financial statements. Classifying only basic ownership instruments as equity would allow users of the financial statements to easily identify claims that would reduce the residual owner's share of the reporting entity's net assets.

60. Opponents of the basic ownership approach argue that it is based on the proprietary perspective of financial reporting, which states that financial statements of a business should reflect the perspective of its owners. That perspective of financial reporting is different from the entity perspective, which is described in the conceptual framework. In contrast to the proprietary perspective, the entity perspective views the effects of transactions and other events from the perspective of the entity itself. Some people have different opinions about what the difference in perspective means. However, both perspectives determine how information should be reported in the financial statements, not what types of instruments should be included in equity.

61. The opponents of the basic ownership approach argue that stakeholders other than holders of basic ownership interests also are users of financial statements and, therefore, financial reporting also is intended to serve them. However, supporters of the basic ownership approach believe that classifying only basic ownership interests as equity actually better serves all classes of stakeholders.

62. By classifying only the most subordinated instruments as equity, the basic ownership approach more clearly distinguishes between the interests of different stakeholders. Under current GAAP, the interests of several different classes of stakeholders are commingled in equity. Amounts currently reported in retained earnings and accumulated other comprehensive income will eventually accrue to the benefit of common shareholders, preferred shareholders, option holders, and other parties. Classifying only basic ownership instruments as equity results in reporting amounts that will accrue to other stakeholders as components of earnings. If the

components of earnings are identified clearly, stakeholders of any class will be able to determine more easily which amounts are attributable to them and which are not.

Why Would Other Perpetual Instruments and Derivatives on an Issuer's Basic Ownership Instruments Not Be Classified as Equity?

Perpetual Instruments

63. Perpetual instruments other than basic ownership instruments (other perpetual instruments) are currently classified as equity. Liabilities are currently considered to be obligations to sacrifice assets and, in some cases, obligations to issue ownership interests as compensation for something already received.[5] Equity currently includes any item that is not a liability, an asset, or a valuation allowance. Given that view of liabilities, a perpetual instrument must be equity because it is not an asset, a liability, or a valuation allowance.

64. FASB Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity,* closely follows that view. One of the consequences of that view is that no instrument with a settlement requirement is equity. Thus, an entity that issues only redeemable ownership instruments has no equity. The Board believed that classifying all ownership instruments as liabilities did not result in a representationally faithful presentation for such entities. Therefore, it deferred that provision of Statement 150 for certain nonpublic entities and began to question traditional views of equity and liabilities. That process led to this Preliminary Views.[6]

65. The Board tentatively decided earlier in the project that equity should consist of both basic ownership instruments and perpetual instruments. However, for simplicity in concept and application, the Board later decided to define equity as basic ownership instruments only. Classifying other perpetual instruments as liabilities is consistent with the view that claims against the entity's assets are liabilities if they reduce the residual available for distribution to basic ownership instruments. It also simplifies the description and implementation of the basic ownership approach and reduces structuring opportunities.

66. Classifying all perpetual instruments as equity made the basic ownership approach more complex and difficult to describe logically and translate into a concept. It also raised the issue of economic compulsion, which the Board was unable to resolve satisfactorily. For example, some entities have issued perpetual preferred stock with a dividend requirement that increases over time. The dividend rate eventually becomes so high that the entity is effectively forced by the economics of the arrangement to repurchase the instruments. That is not a legal obligation as contemplated in the current

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[5]The definition of a liability in Concepts Statement 6 refers only to obligations to sacrifice assets, but GAAP has not always literally applied that definition.

[6]The approach in this Preliminary Views implies a need to change the conceptual definitions of a liability and equity. See Appendix D.

definition of a liability, but with near certainty, unless the entity goes bankrupt first, it will repurchase the preferred shares.

Derivatives on an Issuer's Basic Ownership Instruments

67. A written option to issue a basic ownership instrument (for example, a written call option on common stock that is a basic ownership instrument) usually is classified as equity under current GAAP. The basic ownership approach would require that option to be classified as a liability because it does not meet the definition of a basic ownership instrument.

68. A written option will be exercised only if its exercise price is less than the fair value of the basic ownership instruments to be received. Issuing a basic ownership instrument for a price lower than its fair value actually increases the total pool of assets available for basic ownership instruments as a group. However, the new basic ownership instrument would entitle the holder to a full share even though it paid less than the value of a full share. Therefore, issuing the new basic ownership instrument would reduce each existing instrument's share of the entity's assets.

69. Current classification requirements for a written call option depend on the instrument's settlement requirements. For example, if the terms of the option require that it be settled with shares, it is generally classified as equity, and if the terms require that it be settled with cash, it is generally a liability. The current classification model does not produce results that are always consistent with the economics of the instrument. Settling an instrument with basic ownership instruments that can be readily traded in the public market (readily convertible to cash) seems to be substantively the same as settling the instrument in cash. The basic ownership approach would eliminate this inconsistent accounting by classifying a written call option as a liability regardless of how it is settled (cash versus shares). Supporters of the basic ownership approach also view this as an advantage because it may prevent issuers from inserting certain settlement features to obtain a desired accounting treatment.

Why Would Some Instruments Be Separated?

70. Separation introduces complexity, which is undesirable. One of the reasons some Board members preferred the basic ownership approach is that it minimizes separation. The only instruments that are required to be separated are those that combine a contractual payment requirement and a basic ownership instrument that will remain outstanding after the contractual requirement is satisfied. The examples cited are the lowest priority common shares with either registration rights penalties (if substantive) or guarantees of a minimum price on a certain date. In both cases, the issuer must pay cash if certain conditions exist, and the holders continue to retain the basic ownership instruments. At all times, the instrument meets the definition of a basic ownership instrument, and at certain times, it also meets the definition of a liability.

71. Board members acknowledge that basic ownership approach could be simplified slightly by eliminating the separation requirement. However, the Board rejected that

idea because it would permit entities to combine other types of payment requirements with basic ownership instruments and report the entire instrument as equity.

Why Would Linkage and Substance Requirements Be Necessary?

72. Linkage and substance requirements make the approach more complicated and for that reason are undesirable. However, they are necessary to reduce structuring opportunities. For example, an entity might issue basic ownership instruments and fixed-price forward contracts on those same instruments on the same day, which is tantamount to issuing debt. Without linkage, the entity would not report the full amount of the obligation as a liability because the forward contract would be reported net (as a derivative) and the basic ownership instrument would be reported as equity. While these requirements create some complexity, they are simpler than requirements in the other approaches.

What Is the Basis for the Measurement Requirements?

73. The measurement requirements in this Preliminary Views are intended to be generally consistent with the measurement requirements that apply to similar instruments not subject to the requirements in this Preliminary Views.

74. For instruments or components that have characteristics of loans or bonds payable, accreted cost measurement would be the basic requirement, but the fair value option in FASB Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities,* may be applied. Instruments that are derivatives or are similar to derivatives would be reported at fair value. As a result, all derivatives on the issuer's basic ownership instruments are reported at fair value with changes in value reported in net income. Instruments with **embedded derivatives** that cause their cash flows to vary more than just for changes in market interest rates would either be separated into a derivative and a host contract or be reported at fair value in accordance with the option in FASB Statement No. 155, *Accounting for Certain Hybrid Financial Instruments*.

75. This Preliminary Views includes a default fair value requirement for variable payment instruments that may not be explicitly covered by other GAAP. For example, an instrument previously reported as equity that would be reported as a liability or an asset under this Preliminary Views might not be subject to any specific current measurement requirement.

76. Basic ownership instruments with redemption requirements would be reported under a separate heading within equity and measured at current redemption value. The objective of the measurement and display requirements is to provide information about the magnitude of a reporting entity's possible cash (or asset) outflows.

QUESTIONS ON THE BASIC OWNERSHIP APPROACH

1. Do you believe that the basic ownership approach would represent an improvement in financial reporting? Are the underlying principles clear and appropriate? Do you agree that the approach would significantly simplify the accounting for instruments within the scope of this Preliminary Views and provide minimal structuring opportunities?

Perpetual Instruments

2. Under current practice, perpetual instruments are classified as equity. Under the basic ownership approach (and the REO approach, which is described in Appendix B) certain perpetual instruments, such as preferred shares, would be classified as liabilities. What potential operational concerns, if any, does this classification present?

3. The Board has not yet concluded how liability instruments without settlement requirements should be measured. What potential operational concerns, if any, do the potential measurement requirements in paragraph 34 present? The Board is interested in additional suggestions about subsequent measurement requirements for perpetual instruments that are classified as liabilities.

Redeemable Basic Ownership Instruments

4. Basic ownership instruments with redemption requirements may be classified as equity if they meet the criteria in paragraph 20. Are the criteria in paragraph 20 operational? For example, can compliance with criterion (a) be determined?

Separation

5. A basic ownership instrument with a required dividend payment would be separated into liability and equity components. That classification is based on the Board's understanding of two facts. First, the dividend is an obligation that the entity has little or no discretion to avoid. Second, the dividend right does not transfer with the stock after a specified ex-dividend date, so it is not necessarily a transaction with a current owner. Has the Board properly interpreted the facts? Especially, is the dividend an obligation that the entity has little or no discretion to avoid? Does separating the instrument provide useful information?

Substance

6. Paragraph 44 would require an issuer to classify an instrument based on its substance. To do so, an issuer must consider factors that are stated in the contract and other factors that are not stated terms of the instrument. That proposed requirement is important under the ownership-settlement approach, which is described in Appendix A. However, the Board is unaware of any unstated factors

that could affect an instrument's classification under the basic ownership approach. Is the substance principle necessary under the basic ownership approach? Are there factors or circumstances other than the stated terms of the instrument that could change an instrument's classification or measurement under the basic ownership approach? Additionally, do you believe that the basic ownership approach generally results in classification that is consistent with the economic substance of the instrument?

Linkage

7. Under what circumstances, if any, would the linkage principle in paragraph 41 not result in classification that reflects the economics of the transaction?

Measurement

8. Under current accounting, many derivatives are measured at fair value with changes in value reported in net income. The basic ownership approach would increase the population of instruments subject to those requirements. Do you agree with that result? If not, why should the change in value of certain derivatives be excluded from current-period income?

Presentation Issues

9. *Statement of financial position*. Basic ownership instruments with redemption requirements would be reported separately from perpetual basic ownership instruments. The purpose of the separate display is to provide users with information about the liquidity requirements of the reporting entity. Are additional separate display requirements necessary for the liability section of the statement of financial position in order to provide more information about an entity's potential cash requirements? For example, should liabilities required to be settled with equity instruments be reported separately from those required to be settled with cash?

10. *Income statement.* The Board has not reached tentative conclusions about how to display the effects on net income that are related to the change in the instrument's fair value. Should the amount be disaggregated and separately displayed? If so, the Board would be interested in suggestions about how to disaggregate and display the amount. For example, some constituents have suggested that interest expense should be displayed separately from the unrealized gains and losses.

Earnings per Share (EPS)

11. The Board has not discussed the implications of the basic ownership approach for the EPS calculation in detail; however, it acknowledges that the approach will have a significant effect on the computation. How should equity instruments with redemption requirements be treated for EPS purposes? What EPS implications related to this approach, if any, should the Board be aware of or consider?

Appendix A

THE OWNERSHIP-SETTLEMENT APPROACH

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Questions on the Ownership-Settlement Approach

Appendix A

THE OWNERSHIP-SETTLEMENT APPROACH

A1. The underlying principle of the ownership-settlement approach is that an entity would classify instruments based on the nature of their return and their settlement requirements (or lack thereof). Instruments that lack settlement requirements are classified as equity. Instruments that represent (or upon settlement will represent) the most residual claim are ownership interests. The following three types of instruments would be classified as equity:

a. Basic ownership instruments (see paragraphs 18–21 for definition and further discussion)
b. Other perpetual instruments
c. **Indirect ownership instruments** settled by issuing related basic ownership instruments.

A2. Because there are more types of equity instruments than under the basic ownership approach, more instruments would be separated. Separation of more instruments leads to more detailed requirements for accounting for settlements, modifications, expirations (including expirations of embedded options), and conversions.

Other Perpetual Instruments

A3. Perpetual instruments do not require settlement as long as the entity is a going concern. They entitle the holder to a fixed or variable portion of the issuer's net assets in liquidation or through dividends and other distributions. Many common stocks and some preferred stocks are perpetual instruments. For this purpose, **callable common or preferred stock** is considered perpetual if it is not (a) mandatorily redeemable or (b) redeemable at the holder's option. That is because the issuer may settle a callable instrument but is not required to do so. A perpetual instrument would be classified as equity under the ownership-settlement approach whether or not it is a basic ownership instrument.

Indirect Ownership Instruments

A4. An indirect ownership instrument has the following three characteristics:

a. It is not perpetual.
b. Its terms link its value to the price of a basic ownership instrument and cause its fair value to change in the same direction as the fair value of that basic ownership instrument.
c. It does not include a contingent exercise provision based on either of the following factors:

(1) A market price for anything other than the reporting entity's basic ownership instruments; or
(2) A price index other than an index calculated or measured solely by reference to the reporting entity's own operations (for example, revenue of the reporting entity).

A5. In other words, an indirect ownership instrument is a derivative instrument or a **hybrid instrument**[7] with a basic ownership instrument as its predominant underlying.

Classification

A6. An indirect ownership instrument would be classified as equity by the issuer of the related basic ownership instrument if it is settled in either of the following ways:

a. By issuing or delivering the basic ownership instrument from which its return is derived; or
b. By delivering another indirect ownership instrument that is part of a chain of indirect ownership instruments, all of which have returns derived from the same basic ownership instrument and the last of which will be settled by delivering that same basic ownership instrument. (See paragraphs A23 and A24 for further explanation.)

A7. An indirect ownership instrument that may be settled in ways other than those in paragraph A6 would be classified as an asset or a liability by the issuer of the underlying basic ownership instrument.

A8. For example, if an entity issues a call option on its own basic ownership instruments, that option is an indirect ownership instrument. If the option is "in-the-money" (has an **intrinsic value** greater than zero), the return to the holder has the same profile as the return to a holder of the related basic ownership instrument. (That means a graph of the return on the two instruments would have the same slope and direction.) The issuer would classify that instrument as equity if it is required to be settled by issuing the basic ownership instruments either in a **net-share settlement** or a physical settlement. Net-share settlement occurs if the instrument is settled by issuing shares for the excess of the market price of the basic ownership instrument over the option's exercise price. Physical settlement occurs if the instrument is settled by an exchange of cash for basic ownership instruments. If the option was required (or permitted by either party's choice) to be net settled for cash or other assets, the issuer would classify the instrument as a liability.

A9. In contrast, if an entity issues a **written put option** on its own basic ownership instruments, that instrument would not be an indirect ownership instrument. Although the return to the holder of the instrument is based on the changes in price of a basic

[7]Equity derivatives (and embedded equity derivatives in hybrid instruments) that are classified as equity (or would be freestanding) are excluded from the scope of Statement 133 by paragraphs 11(a) and 12(c).

ownership instrument, the return is in the opposite direction. As the price of the basic ownership instrument decreases, the return to the holder of the put option increases and vice versa. That instrument would be classified as a liability to the issuer even if it is net settled by issuing shares or **physically settled** by paying cash for shares.

A10. Supporters of the ownership-settlement approach view indirect ownership instruments settled with the related basic ownership instruments as nascent equity. The holder has a return similar to the return of a basic ownership instrument and will eventually become a holder of a basic ownership instrument according to the terms of the existing instrument.

Outcomes

A11. Understanding the term *outcome* is important to understanding indirect ownership instruments (as well as the separation requirements of the ownership-settlement approach). *Outcome* generally refers to the contractual or legal result of an instrument, but it is used in a specialized way in the ownership-settlement approach and requires further explanation.

A12. The outcome of an instrument is important to determine classification of indirect ownership instruments and to identify the need to separate an instrument. Outcome refers to the instrument and not the holder. For example, a holder of an instrument may sell it. That is an outcome for the holder, but the instrument has not yet had an outcome. An instrument may have only a single outcome, two or more separate (multiple) outcomes, or two or more alternative outcomes.

Single Outcomes

A13. Cash settlement of a traditional debt instrument is an outcome. For purposes of classification under the ownership-settlement approach, that would be considered a single outcome because there are no contractual alternatives. The parties may negotiate a different outcome or the debtor may default, but those would not be considered multiple or alternative outcomes because they would not change the classification.

A14. A noncallable perpetual basic ownership instrument has only one required outcome—it remains outstanding in perpetuity. If the entity liquidates, the holder will receive a share of the entity's assets after all senior claims are satisfied. However, the entity is not required to liquidate. Remaining perpetually outstanding would be considered a single outcome even though there are different possible results—the holder may receive nothing if the issuer goes bankrupt, the holder may receive partial distributions of net assets (dividends), the holder may receive net assets in liquidation, or other events such as business combinations may occur that change the holder's status.

A15. A redeemable basic ownership instrument also has a single outcome—the holder receives a share of the issuer's assets comparable to what it would be entitled to if all senior claims had been satisfied first.

Multiple Outcomes and Alternative Outcomes

A16. A basic ownership instrument issued with an accompanying promise to pay the investor cash if the instrument is not registered for public trading by a specified date (a registration rights penalty) has two separate outcomes. One is the contingent payment of cash if the instrument is not registered. That outcome occurs on the date specified in the contract; cash is paid or not paid. The other outcome remains outstanding until liquidation. For purposes of these requirements, that outcome is considered to occur when it is the only possibility remaining under the instrument's terms.

A17. Instruments with settlement options have alternative outcomes. For example, an instrument that permits the holder to choose to receive a payment in cash or to receive basic ownership instruments has two alternative outcomes. Similarly, an otherwise perpetual instrument that permits the holder to require the issuer to repurchase it (a put option) has two alternative outcomes.

A18. A basic ownership instrument redeemable for fair value at the option of the issuer has two alternative outcomes—it may be called or it may be perpetual. The perpetual outcome is the same as a noncallable perpetual basic ownership instrument. Because the call provision is at fair value, the call outcome is the same as a redeemable basic ownership instrument.

A19. Another type of alternative outcome that is important under the ownership-settlement approach involves minimum and maximum returns on an instrument. For example, a net-settled option on a basic ownership instrument requires the issuer to pay cash to the holder. If there are no limits, the amount of cash to be paid is the difference between a specified exercise price and the market price of the basic ownership instrument on the exercise date. However, if the issuer sets a maximum payment amount (a cap), there are two contractual alternatives. One alternative is payment of the fixed maximum payment, and the other is the amount determined by the exercise and current market prices of the basic ownership instrument.

A20. An instrument also may have two outcomes, one of which has alternatives. For example, a basic ownership instrument with an embedded put option also could have a registration rights penalty. The basic ownership instrument with the put option is one outcome with two alternatives, and the registration rights penalty is a second, separate outcome.

Equity Outcomes and Liability or Asset Outcomes

A21. An equity outcome provides a return to the holder of an instrument that has the same general profile as the return to the holder of a basic ownership instrument. For example, if the price of a basic ownership instrument changes, the return on investment to the holder of a call option on that basic ownership instrument changes in the same direction and in the same proportion as the return on investment of the holder of the basic ownership instrument.

A22. Any outcome that is not an equity outcome is a nonequity (liability or asset) outcome. In other words, if the outcome of an instrument provides a return to the holder of an instrument that does not have the same profile as the return to the holder of a basic ownership instrument, the outcome is a liability or an asset outcome. (See paragraph A26 for separation requirements.)

Ultimate Outcome of a Chain of Indirect Ownership Instruments

A23. Some indirect ownership instruments are part of a chain of indirect ownership instruments that will eventually result in the holder's receiving basic ownership instruments. All instruments in such a chain would be considered indirect ownership instruments. The classification of every instrument in the chain would be determined by the settlement of the last instrument.

A24. An example would be an option to purchase a forward contract to purchase a basic ownership instrument from the issuer. The return on the option is derived from the value of the forward contract, which is derived from the basic ownership instrument. Because the last indirect ownership instrument in the chain (the forward contract) is required to be settled by delivery of the basic ownership instrument, the option would be classified as equity by the issuer of the basic ownership instrument. The forward contract also would be classified as equity if the option is exercised by the holder. The Board did not discuss how to classify instruments in a chain if one or more instruments in the chain would be separated into an equity component and a nonequity component. An example is an option on debt that is convertible to a basic ownership instrument.

Separation of Components

A25. If an instrument has one or more equity outcomes and one or more nonequity outcomes, it would be separated into an equity component and a nonequity component. An instrument is separated into a maximum of two components, even if there are two or more different nonequity or equity outcomes.

A26. Instruments that are part equity and part asset or liability would be separated into two components: (a) an equity component and (b) an asset component, a liability component, or a net asset or net liability component. That would include the following types of instruments:

a. An instrument that has or may have two or more separate outcomes, one or more of which would require equity classification if it was the only outcome and one or more of which would require asset or liability classification if it was the only outcome
b. An instrument that has two or more alternative outcomes, one or more of which would require equity classification if it was certain to be the only outcome and one or more of which would require asset or liability classification if it was certain to be the only outcome.

A27. An example of an instrument with two separate outcomes is a basic ownership instrument that also requires the issuer to pay a penalty if the instrument is not registered for public trading by a specified date (a registration rights penalty). The registration rights penalty provision has a liability outcome, and the basic ownership component (which will remain outstanding whether or not the penalty is paid) has an equity outcome. (See Table 2 in Appendix C for more classification examples.)

A28. An example of an instrument with two or more alternative outcomes is debt convertible into a fixed number of basic ownership instruments at the option of the holder. That instrument has two possible forms of settlement. The issuer may be required to issue a fixed number of basic ownership instruments. If that was the only possible outcome, the issuer would classify that instrument as equity (as an indirect ownership instrument settled with the related basic ownership instrument). Alternatively, the issuer may be required to pay cash. If that was the only outcome, the issuer would classify the instrument as a liability. (See Table 2 in Appendix C for more classification examples.)

A29. The following table illustrates how outcomes are identified under the ownership-settlement approach.

Table: Analysis of Outcomes

Description of Instrument	Analysis of Outcomes
Basic ownership instrument that is puttable at the option of the holder for a fixed price.	The instrument has two alternative outcomes. The issuer may be required to pay a fixed amount of cash (liability outcome) or the basic instrument could remain outstanding in perpetuity (equity outcome). Only one outcome will occur. The instrument would be separated into liability and equity components.
A written call option on the issuer's basic ownership instruments that also includes a registration rights penalty.	The instrument has two separate outcomes. Both outcomes may occur. The option would be classified as equity (indirect ownership instrument settled with basic ownership instruments). Additionally, the issuer may be required to pay a penalty—a fixed amount—which is reported as a liability.
Debt that converts into a fixed number of basic ownership instruments at the option of the holder. The instrument also is puttable by the holder and callable by the issuer.	The instrument has two alternative outcomes. The issuer may be required to pay a fixed amount of cash (liability outcome) if (a) the instrument is put by the holder, (b) the instrument is called by the issuer when the conversion option is out-of-the-money, or (c) the instrument is repaid at maturity. Alternatively, the issuer may be required to settle in shares (equity outcome) if (a) the conversion option is exercised by the holder or (b) the instrument is called by the issuer when the instrument is in-the-money, which will force the holder to convert to basic ownership instruments.

Initial Measurement of Instruments and Components

A30. With one exception, instruments not separated into components would be initially measured at their transaction prices,[8] and transaction costs or fees would be charged or credited to income immediately. The only exception is a basic ownership instrument issued as a result of exercise, conversion, or settlement of an indirect ownership instrument.

A31. Basic ownership instruments issued upon the exercise, conversion, or settlement of indirect ownership instruments would be reported at fair value at the issuance date. The difference between the fair value of the basic ownership instrument issued and the carrying value of the indirect ownership instrument (plus the exercise price or other

[8]See paragraph 30 for further discussion of transaction price.

consideration, if any) would be displayed in the statement of changes in equity as a transfer between the indirect ownership instrument and the basic ownership instrument issued.

A32. Instruments separated into components would initially be measured in total at their transaction prices. That is, the total of the initial measurement of the components would equal the transaction price. The price is allocated to the components as follows:

a. The liability, asset, or net liability-asset (nonequity) component would initially be measured at the fair value of a comparable freestanding instrument (even if the comparable instrument is hypothetical).
b. The difference between that amount and the total initial measurement would be allocated to the equity component.
c. Optional fair value measurement would not be permitted in lieu of separation.

A33. The following factors should be considered when identifying a comparable nonequity instrument for purposes of measuring a liability, asset, or net liability-asset component.

a. The probability assigned to the nonequity outcome would always be 100 percent. In other words, a nonequity outcome is always assumed to be certain. For example, in valuing the nonequity component of convertible debt, the issuer would assume the debt would be repaid in cash even though it is possible the holder may convert and receive shares.
b. The probability-weighted settlement amount and date (if the amount or settlement date of the nonequity component varies or is uncertain). Factors such as the share price, put, call, and conversion provisions should be considered.

Example—Initial Measurement of a Separated Instrument

A reporting entity issues a share puttable at a fixed price of $820, for proceeds of $742. The instrument is puttable at Year 5.

The instrument is separated into liability and equity components. It has two alternative outcomes: the counterparty could retain the share (equity outcome) or could put the share back for a fixed price (liability outcome).

At inception, the liability component is measured at fair value, which is $607 (the amount due at the settlement date [$820] discounted using the 5-year straight debt rate [assumed to be 6.1 percent]). The difference between the proceeds and the liability component ($135) is reported as equity.

Subsequent Measurement of Instruments and Components

A34. An instrument or component for which there is a specific measurement requirement in current GAAP would be measured according to that requirement. A fair value option may be applied to a freestanding instrument or a nonequity component of a separated instrument if available (but not to avoid separation). The following requirements would be applied to instruments and components that have no other specific measurement requirements:

a. A liability or asset instrument with fixed cash flows or with fixed principal cash flows and interest cash flows that vary only according to an interest rate index would be measured according to requirements for loans or debt securities as appropriate.
b. A liability or an asset instrument with variable cash flows or cash flows that may not occur would be measured according to the requirements for derivative instruments. These instruments are eligible to be used as hedging instruments if they have all the characteristics of a derivative instrument as specified in paragraphs 6–9 of Statement 133.
c. A perpetual equity instrument or component would not be remeasured unless it meets the requirements of paragraph A34(d).
d. A basic ownership instrument that is redeemable for cash or other assets, for example, a basic ownership instrument callable at a fixed price, would be measured at its current redemption amount (the amount that would be paid if the redemption formula was applied at the measurement date). Gains and losses due to changes in the carrying amount would be reported as a decrease or increase to a separate equity account established for this purpose.
e. An indirect ownership instrument or component classified as equity would not be remeasured.

Example—Subsequent Measurement of a Separated Instrument

Using the puttable share example above, the liability component is accreted to the amount of principal to be paid at the expected settlement date ($820) by applying the straight debt rate (6.1 percent). The equity component remains unchanged.

Settlement, Conversion, Expiration, or Modification

A35. The reporting requirements for settlement, conversion, expiration, and modification are the same as described in the basic ownership approach (paragraphs 47–49). However, additional requirements are necessary for separated instruments under the ownership-settlement approach.

A36. Any new or modified instruments are assessed for classification and separation in the same way as an instrument acquired or incurred for cash. If fair value of the new or modified instrument differs from the carrying amount of the liability at the date of

extinguishment, a gain or loss will result for any remaining amount after reallocation to the liability and equity components. In other words, any modification will result in a reallocation of the liability and equity components, and an extinguishment gain or loss would be recognized for the difference between the carrying amount of the liability component immediately before the modification and its fair value immediately after the modification.

A37. An entity would account for settlement, conversion, expiration, or modification of separated instruments in which the liability component is not measured at fair value as follows:

a. Allocate the fair value of the new or modified instrument to liability and equity components. If the component expires or is forgiven, recognize the gain or loss in net income.
b. Determine the fair value of the liability component by using the:
   (1) Settlement period remaining from the original expected period, or, if zero, the new expected settlement period
   (2) Amount due at the end of the remaining or new expected settlement period
   (3) Discount rate for that period.
c. Apply the remaining portion of the fair value to equity.

If the total fair value of the new or modified instrument differs from the current carrying amount of the liability before the settlement, conversion, or modification, the gain or loss will be the remaining amount after reallocating to the liability and equity components.

A38. The detailed reallocation steps above need not be applied if an instrument is settled either:

a. At its expected settlement date and at its contractual amount (in that case, the liability carrying amount would be simply extinguished and there would be no gain or loss to record); or
b. Outside its contractual terms (in that case, the gain or loss would be equal to the difference between the payment and the current liability carrying amount).

Substance and Linkage

A39. Because of the number and variety of instruments classified as equity, the ownership-settlement approach provides opportunities for entities to structure transactions solely to achieve a specific financial reporting result that may not represent the economic substance of a transaction. The substance and linkage principles, which require a significant amount of judgment in their application, are necessary to determine proper classification under the ownership-settlement approach. In applying

those principles, instruments would be classified based on their probable outcomes rather than legal form.

A40. Because the form of settlement determines classification of indirect ownership instruments, unstated cash-settlement alternatives must be identified and included in an instrument's substantive terms for classification purposes if not deemed remote. In assessing unstated cash settlement features for a share-settled instrument, an entity must evaluate whether it will be able to deliver shares upon settlement. This assessment should consider all facts and circumstances that could occur over the life of the instrument. If two substantive settlement features are identified (cash and shares), the issuer should assume cash settlement and classify the instrument as a liability. It is important to note that for indirect ownership instruments that require share settlement, an unstated cash settlement obligation is always present. In other words, there is always a possibility that an entity may be unable to deliver shares as required under the contract, resulting in a cash-settlement outcome. However, the potential cash settlement outcome resulting from a failure to deliver shares at settlement would not preclude equity classification of the indirect ownership instrument if the entity determines that the possibility of such cash settlement outcome is remote.

Example—Substance

A reporting entity issues a **physically settled forward sales contract** that would be classified as equity because the contractual terms require settlement with basic ownership instruments (shares). At the assessment date, the reporting entity does not have sufficient authorized and unissued shares to satisfy settlement with shares.

The reporting entity should perform an analysis to determine whether share settlement (a) has a more than minimal effect on the outcome and (b) is remote over the life of the instrument. In performing the analysis, the issuer should consider its ability to settle in shares. If it is more than remote that the reporting entity will not have the ability to deliver the shares to settle the contract at the settlement date, a substantive net-cash-settlement feature is identified (although unstated in the contract terms) in addition to the share-settlement alternative.

If so determined, the reporting entity would classify the physically settled forward sales contract as a liability because there would be two substantive settlement alternatives. The reporting entity would reassess its ability to deliver shares at each reporting period to determine if cash settlement has become remote, for example, if there is an increase in the number of authorized and unissued shares. If so, the contract would be reclassified to equity.

A41. There are more opportunities under the ownership-settlement approach to issue separate instruments rather than a single instrument to achieve a desired accounting treatment than under the basic ownership approach because of the broader definition of equity and the mixed measurement attributes. For example, a **forward purchase contract** and a written call option on an entity's basic ownership instruments could be issued separately to achieve the same outcome as a freestanding written put option. Under the ownership-settlement approach, the freestanding written put option would be reported as a liability and measured at fair value. Issued separately, the written call option would be classified as equity and not remeasured, and the forward purchase contract would be classified as a liability or asset and measured at fair value. By issuing the instruments separately, the issuer would be able to avoid some volatility in net income, since the written call option would not be remeasured. Under the basic ownership approach, the forward purchase contract, written call option, and written put option would all be classified as liabilities or assets and reported at fair value.

Why the Board Rejected the Ownership-Settlement Approach

A42. Complexity is a primary reason the Board rejected the ownership-settlement approach. Although this approach is similar in some ways to current accounting requirements, it is more complex in other ways because it requires more separation. The increased separation, in turn, requires complex measurement requirements for nonequity components and rules-based reporting requirements upon settlement, conversion, expiration, and modification of separated instruments. Additionally, because this approach (a) allows for a broader definition of equity compared with the basic ownership approach and (b) focuses on an instrument's form of settlement in determining classification, there are more opportunities to structure instruments to obtain a desired classification than under the basic ownership approach. Some Board members objected to instruments with identical economic profiles (payoffs) having different classifications based solely on the form of settlement.

A43. Some Board members also objected to classifying certain indirect ownership instruments as equity. They believe indirect ownership instruments, such as stock options, do not represent ownership instruments until the option is exercised and the holder receives basic ownership instruments. Those Board members believe that instruments that dilute currently outstanding shareholders should be classified as liabilities.

QUESTIONS ON THE OWNERSHIP-SETTLEMENT APPROACH

1. Do you believe the ownership-settlement approach would represent an improvement in financial reporting? Do you prefer this approach over the basic ownership approach? If so, please explain why you believe the benefits of the approach justify its complexity.

2. Are there ways to simplify the approach? Please explain.

Substance

3. Paragraph A40 describes how the substance principle would be applied to indirect ownership instruments. Similar to the basic ownership approach, an issuer must consider factors that are stated in the contract and other factors that are not stated in the terms of the instrument. Is this principle sufficiently clear to be operational?

Presentation Issues

4. *Statement of financial position.* Equity instruments with redemption requirements would be reported separately from perpetual equity instruments. The purpose of the separate display is to provide users with information about the liquidity requirements of the reporting entity. What additional, separate display requirements, if any, are necessary for the liability section of the statement of financial position in order to provide more information about an entity's potential cash requirements? For example, should liabilities required to be settled with equity instruments be reported separately from those required to be settled with cash?

Separation

5. Are the proposed requirements for separation and measurement of separated instruments operational? Does the separation result in decision-useful information?

Earnings per Share

6. The Board has not discussed the implications of the ownership-settlement approach for the EPS calculation in detail. How should equity instruments with redemption requirements be treated for EPS purposes? What EPS implications related to this approach, if any, should the Board be aware of or consider?

Settlement, Conversion, Expiration, or Modification

7. Are the requirements described in paragraphs A35–A38 operational? Do they provide meaningful results for users of financial statements?

Appendix B

THE REASSESSED EXPECTED OUTCOMES (REO) APPROACH

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Questions on the REO Approach

Appendix B

THE REASSESSED EXPECTED OUTCOMES (REO) APPROACH

B1. The REO approach is derived from techniques currently used by some professionals who underwrite, invest in, and trade convertible debt. The REO approach uses an instrument's probability-weighted outcomes to separate and classify that instrument. Similar to the ownership-settlement approach, classification would be determined by the nature of the counterparty's return. Unlike the ownership-settlement approach, outcomes would be reassessed at each reporting date. That would result in constant reassessment of components with changes reported in earnings.

B2. The underlying principle of the REO approach is that instruments and components with fair value changes in the same or opposite direction as the fair value of a basic ownership instrument are considered equity or contra-equity. One advantage of the approach is that it provides the same classification for instruments regardless of whether they are issued singly or combined with other instruments.

Classification

B3. An entity would classify basic ownership instruments that it issues, including redeemable basic ownership instruments, as equity. Other perpetual instruments issued by an entity would be classified as liabilities because their outcomes are not basic ownership outcomes. That is, they do not share equally with basic ownership instruments at liquidation, and they do not convert to basic ownership instruments.

B4. An entity would classify instruments or components other than basic ownership instruments or basic ownership components as equity or contra-equity if the counterparty's payoff (the return on the date the ultimate outcome occurs) is directly or inversely related to the price of the reporting entity's basic ownership instruments. That is, derivative instruments with the price of the entity's own basic ownership instrument as the underlying (**equity derivatives**) would be equity or have an equity component even if their values change in the opposite direction from the price of a basic ownership instrument. Hybrid instruments with similar embedded derivatives (equity hybrids) would have equity components. The method of settlement does not affect classification. That is, settlement in cash would not require an instrument to be classified outside equity.

B5. Additionally, under the REO approach, assessing substantive terms is automatic because the probability of an instrument's outcome is incorporated in its measurement. No special requirements are necessary. (Measurement is further discussed in paragraphs B10–B14.)

Separation

B6. Equity hybrids, which have the potential for either an equity outcome or a nonequity outcome, are separated into an equity component and a liability or an asset component. Some examples are convertible debt, redeemable preferred stock that also is convertible to basic ownership instruments, and similar instruments with different names. The obligation to pay cash if the instrument is not converted would be the liability component (outcome) of a convertible debt instrument. The obligation to issue basic ownership instruments if the instrument is converted would be the equity component (outcome). Each outcome would be measured based on its probability of occurrence, its probability-weighted amount, and its probability-weighted date of occurrence. A prepaid forward contract to issue equity would be separated and measured similarly except that the amount reported as the liability outcome would be the future value of the prepayment amount. (That future value is analogous to the maturity amount of convertible debt, which is the future value of the initial proceeds.)

B7. The form of settlement of equity hybrids does not affect classification or measurement. Equity hybrids are separated and measured in the same way whether the "conversion" or similar feature is physically settled, settled entirely in cash, or settled partly in cash and partly with basic ownership instruments.

B8. Equity derivatives also would be separated into two components regardless of the form of settlement. For example, a physically settled written call option on an entity's basic ownership instruments would have an equity component and an asset component. The basic ownership instruments that would be issued on the exercise date would be the equity component. The cash payment that would be received if exercised would be the asset component. A written call option settled net in cash or basic ownership instruments would be separated into the same two components as the physically settled option, and those components would be measured the same way.

B9. The equity component of some instruments (for example, put options) would have a debit balance and be described as contra-equity. The intrinsic values of those instruments vary inversely with the price of the entity's basic ownership instruments; they go up in value to the counterparty as the basic ownership instruments go down. For example, an entity holding a forward contract to repurchase its own basic ownership instruments would separate that contract into a contra-equity component (for the instruments to be received) and a liability component (for the cash to be paid). Written put options and **purchased call options** would be similarly separated.

Measurement

B10. Basic ownership instruments would be measured at their transaction (issuance) price, and transaction costs or fees would be charged or credited to income immediately. Perpetual basic ownership instruments would not be remeasured, but mandatorily redeemable or puttable basic ownership instruments would be remeasured at their current redemption amount, as described in paragraph 32. Similar to its

discussions on the basic ownership approach, the Board has not decided how to measure nonequity instruments with no settlement requirements, for example, preferred basic ownership instruments.

B11. Measurement of separated instruments would be the same initially and subsequently. In effect, remeasurement also results in the issuer's separating the instrument again because the revised probabilities of each outcome are used.

B12. Each component of a separated derivative or hybrid instrument would be measured using fair value techniques. The measurement would reflect the probability of each outcome and the probability-weighted amounts and dates of each outcome. If the outcomes are alternatives (as in the case of convertible instruments), the total probabilities of occurrence would, of course, always equal 100 percent. Estimates obtained using lattice models or other option-pricing models would reflect those inputs.

B13. In other cases, more than one outcome will occur, and the measurement would be performed accordingly. An example is a written call option on a basic ownership instrument. The separated equity component would be an obligation to issue the basic ownership instrument; it would be measured as a call option with a zero exercise price. The separated nonequity (asset) component would be a right to receive cash equal to the exercise price of the option; the measurement would be the probability that the option will be exercised multiplied by the exercise price and discounted from the expected exercise date. The two components would not necessarily equal the option's market value at the date it was written.

B14. Gains and losses from remeasurement would be reported in income in the period in which they arise. This includes changes in fair value of both the equity and nonequity components. The sum of the equity and nonequity components will equal the fair value of the instrument.

Settlement, Conversion, Expiration, or Modification

B15. Because all instruments and components subject to the REO approach (except basic ownership instruments and components) would be measured at fair value with changes in income, no special requirements would be needed for settlement, conversion, expiration, or modification. The fair value of an option or other instrument or component with an expiration date approaches zero as the expiration date approaches and is zero after the expiration date. Similarly, a conversion outcome becomes highly probable when the conversion date nears if it is in-the-money (and the component's fair value increases accordingly). Alternatively, it becomes highly improbable (and the component's fair value decreases) if the conversion option is out-of-the-money.

B16. If an instrument is modified in a way that changes its fair value, that event is reflected immediately in the instrument's fair value, regardless of whether that event is considered a modification or a replacement with a new instrument. If an instrument is settled through negotiation for an amount other than its fair value, a gain or loss is recognized.

An Alternative Measurement

B17. In developing the REO approach, the Board considered an alternative measurement of separated components that involved reallocating the transaction price to the two components instead of measuring each component at fair value. The total of the carrying amounts of the two components would always equal the transaction price. This alternative was considered because the liability component was accreted like debt instruments outside the scope of this Preliminary Views.

B18. The nonequity component would be remeasured based on the current probability of the nonequity outcome, including the timing if it varies. (That measurement is not fair value.) The carrying value of the nonequity component would be calculated using the current basic equity instrument and remaining maturity period of the instrument. Some factors such as changes in interest rates are held constant.

B19. Interest would be reported on all liability (asset) instruments and components based on the average balance during the reporting period of the liability (asset) component and the reporting entity's average borrowing (lending) rate for the reporting period. The new carrying value of the equity component would be the difference between (a) the original transaction price less any cash received or paid (for interest, principal installments, and analogous cash flows) and (b) the amount assigned to the liability or asset component. The total carrying value of two components would change because of accrual of interest, amortization of premiums, or accretion of discounts like ordinary debt instruments, but not because of changes in interest rates or other market factors.

B20. This alternative measurement results in accounting for the nonequity component at amortized cost, which is consistent with current accounting requirements for debt. However, the Board rejected this subsequent measurement approach because the fundamental theory behind the REO approach is to provide information about the current probability of an equity or nonequity (or both) outcome. The Board concluded that the only way to obtain that information is to measure both components at fair value.

Why the Board Rejected the REO Approach

B21. Initially, some Board members were attracted to the REO approach for two reasons: (a) the form of settlement does not influence classification or measurement of instruments and (b) the approach presents the economic effects of certain instruments in a way that is superior to the other two approaches. However, the formulas used to separate and measure instruments are complex and difficult to explain. Although the REO approach is clearly relevant and appropriate as a pricing technique, the Board was unable to envision how the approach would comply with the distinctions between assets, liabilities, and equity. Additionally, the REO approach requires more instruments to be separated and measured at fair value than under current accounting requirements. The Board concluded that the complexity and costs associated with implementing the REO approach outweighed the perceived benefits.

QUESTIONS ON THE REO APPROACH

1. Do you believe that the REO approach would represent an improvement in financial reporting? What would be the conceptual basis for distinguishing between assets, liabilities, and equity? Would the costs incurred to implement this approach exceed the benefits? Please explain.

Separation and Measurement

2. Do the separation and measurement requirements provide meaningful results for the users of financial statements?

Earnings per Share (EPS)

3. The Board has not discussed the implications of the REO approach for the EPS calculation in detail; however, it acknowledges that the approach will have a significant effect on the calculation. How should equity instruments with redemption requirements be treated for EPS purposes? What EPS implications related to this approach, if any, should the Board be aware of or consider?

Appendix C

COMPARISONS OF THE CLASSIFICATION, SEPARATION, AND SUBSEQUENT MEASUREMENT OF CERTAIN INSTRUMENTS UNDER THE THREE APPROACHES

C1. The following section includes tables that focus on the differences between the three approaches described in this Preliminary Views. Table 1 provides qualitative comparisons of the approaches. Table 2 compares the classification of certain instruments under current Generally Accepted Accounting Principle (GAAP) to the three proposed approaches. (**Note:** Most instruments are initially measured at transaction price under all three proposed approaches unless specific contrary requirements exist in other GAAP.)

Table 1: Qualitative Comparison

	Basic Ownership	Ownership-Settlement	REO
Relative number of instruments in equity	More whole instruments than REO but less than ownership-settlement. Fewest separated instruments.	Most whole instruments. More separated instruments than basic ownership, but less than REO.	Fewest whole instruments. Most separated instruments.
Potential for changes in reported earnings	More instruments would be reported at fair value with changes in value reported in income than under current GAAP.	Smallest effect on earnings of the three approaches.	More instruments would be reported at fair value with changes in value reported in income than under current GAAP.
Relative number of types of instruments separated	Fewest	Middle—significantly more than basic ownership, but significantly less than REO.	Most
Ability to assess solvency on the face of the financial statements	Disclosure would be necessary to distinguish between cash and share settlement. Redeemable equity is specially displayed.	100 percent maximum obligation (worst case) is reported for all potential liability outcomes. Disclosure would be necessary to distinguish between cash- and share-settled liabilities. Redeemable equity is specially displayed.	Probability of asset or liability outcome is reported and form of settlement is disregarded. Additional disclosure would be necessary. Redeemable equity is specially displayed.

Table 2: Classification Examples

	Instrument	Current GAAP[9]	Basic Ownership	Ownership-Settlement	REO
Legal Ownership Instruments					
1	Common share[10]	**Equity**	**Equity** (Basic ownership instrument) Not subsequently remeasured.	**Equity** (Basic ownership instrument) Not subsequently remeasured.	**Equity** (Basic ownership instrument) Not subsequently remeasured.
2	Perpetual preferred share	**Equity**	**Liability** Subsequent measurement to be determined.	**Equity** (Perpetual instrument) Not subsequently remeasured.	**Liability** Subsequent measurement to be determined.
3	General partnership interest	**Equity**	**Equity** (Basic ownership instrument) Not subsequently remeasured.	**Equity** (Basic ownership instrument) Not subsequently remeasured.	**Equity** (Basic ownership instrument) Not subsequently remeasured.

[9]Current GAAP includes the requirements of Statement 150 before the deferral under FSP FAS 150-3, *Effective Date, Disclosures, and Transition for Mandatorily Redeemable Financial Instruments of Certain Nonpublic Entities and Certain Mandatorily Redeemable Noncontrolling Interests under FASB Statement No. 150*. Instruments denoted by an * indicate those that might have been subject to an indefinite deferral for certain nonpublic entities.

[10]This table was prepared under the assumption that common stock fits the definition of a basic ownership interest. That would not necessarily be the case in all situations. For example, an entity might issue two classes of stock, both of which are called common, but one could have a higher priority in liquidation. If so, only the lowest priority class would be a basic ownership interest.

Table 2: Classification Examples (continued)

	Instrument	**Current GAAP**[9]	**Basic Ownership**	**Ownership-Settlement**	**REO**
			Mandatorily Redeemable Instruments		
4	Common share mandatorily redeemable or puttable at fair value or a formulaic amount designed to approximate fair value	**If mandatorily redeemable—liability*** **If puttable—equity (temporary equity for public companies)**	**Equity** (Basic ownership instrument) Subsequently measured at current redemption value.	**Equity** (Basic ownership instrument) Subsequently measured at current redemption value.	**Equity** (Basic ownership instrument) Subsequently measured at current redemption value.
5	Share mandatorily redeemable at a fixed price	**Liability**	**Liability** Subsequently measured at accreted transaction price.	**Liability** Subsequently measured at accreted transaction price.	**Liability** Subsequently measured at accreted transaction price.
6	Preferred share mandatorily redeemable or puttable regardless of the way the amount is determined and form of settlement (cash or shares)	**If mandatorily redeemable—liability*** **If puttable—equity(temporary equity for public companies)**	**Liability** Subsequently measured at accreted transaction price if redeemed or put at a fixed amount. Subsequently measured at fair value with changes in value reported in income if redeemed or put at a variable amount.	**Liability** Subsequently measured at accreted transaction price if redeemed or put at a fixed amount. Subsequently measured at fair value with changes in value reported in income if redeemed or put at a variable amount.	**Liability** Subsequently measured at accreted transaction price if redeemed or put at a fixed amount. Subsequently measured at fair value with changes in value reported in income if redeemed or put at a variable amount.

Table 2: Classification Examples (continued)

	Instrument	Current GAAP[9]	Basic Ownership	Ownership-Settlement	REO
7	Instrument that "converts" mandatorily into a variable number of basic ownership instruments with a fixed monetary amount (for example, share-settled debt).	**Liability**	**Liability** Subsequently measured at accreted transaction price.	**Liability** Subsequently measured at accreted transaction price.	**Liability** Subsequently measured at accreted transaction price.
Freestanding Options and Forward Contracts					
8	Written call option, warrant, share-settled stock appreciation right (SAR), and employee stock option settled with shares	**Equity**	**Liability** Subsequently measured at fair value with changes in value reported in income.	**Equity** (Indirect ownership instrument) Not subsequently remeasured.	**Equity and asset** Both components subsequently measured at fair value with changes in value reported in income.

Table 2: Classification Examples (continued)

	Instrument	Current GAAP[9]	Basic Ownership	Ownership-Settlement	REO
9	Net-cash-settled written call option and cash SAR	**Liability**	**Liability** Subsequently measured at fair value with changes in value reported in income.	**Liability** Subsequently measured at fair value with changes in value reported in income.	**Liability and asset** Both components subsequently measured at fair value with changes in value reported in income.
10	Warrant to purchase a basic ownership instrument for one cent when assuming the fair value of the basic ownership instrument is substantially higher then one cent.	**Equity**	**Equity** (Basic ownership instrument in substance) Not subsequently remeasured.	**Equity** (Basic ownership instrument in substance) Not subsequently remeasured.	**Equity** (Basic ownership instrument in substance) Not subsequently remeasured.

Table 2: Classification Examples (continued)

	Instrument	Current GAAP[9]	Basic Ownership	Ownership-Settlement	REO
11	Written call option with a substantive registration rights penalty	**Equity and a contingent liability (recognized and measured under FASB Statement No. 5, *Accounting for Contingencies*)**	**Liability** Subsequently measured at fair value with changes in value reported in income.	**Equity and liability** Liability component is subsequently remeasured at fair value with changes in value reported in income. Equity component is not subsequently remeasured.	**Equity and asset** (A liability component [representing the registration rights penalty] is netted against the asset component in the written call option.) Both components subsequently measured at fair value with changes in value reported in income.
12	Physically, net-cash- or net-share-settled forward purchase contract at a fixed price	**Liability or asset**	**Liability or asset** Subsequently measured at fair value with changes in value reported in income.	**Liability or asset** Subsequently measured at fair value with changes in value reported in income.	**Contra-equity and liability** Both components subsequently measured at fair value with changes in value reported in income.

Table 2: Classification Examples (continued)

	Instrument	Current GAAP[9]	Basic Ownership	Ownership-Settlement	REO
13	Prepaid forward purchase contract for a fixed number of shares (or a note receivable for a fixed number of shares)	**Generally, contra-equity**	**Asset** Subsequently measured at fair value with changes in value reported in income.	**Asset** Subsequently measured at fair value with changes in value reported in income.	**Contra-equity** Subsequently measured at fair value with changes in value reported in income.
14	Physically, net-cash- or net-share-settled written put option	**Liability**	**Liability** Subsequently measured at fair value with changes in value reported in income.	**Liability** Subsequently measured at fair value with changes in value reported in income.	**Contra-equity and liability** Both components subsequently measured at fair value with changes in value reported in income.
15	Prepaid written put option	**Generally, contra-equity**	**Asset** Subsequently measured at fair value with changes in value reported in income.	**Asset** Subsequently measured at fair value with changes in value reported in income.	**Contra-equity and asset** Both components subsequently measured at fair value with changes in value reported in income.

Table 2: Classification Examples (continued)

	Instrument	Current GAAP[9]	Basic Ownership	Ownership-Settlement	REO
Instruments with Embedded Options					
16	Share puttable at a fixed price	**Equity**	**Liability** Subsequently measured at fair value with changes in value reported in income.	**Equity and liability** Liability component is subsequently accreted. Equity component is not subsequently remeasured.	**Equity and liability** Both components subsequently measured at fair value with changes in value reported in income.
17	Share puttable at fair value	**Equity**	**Equity** Subsequently measured at current redemption value.	**Equity** Subsequently measured at current redemption value.	**Equity** Subsequently measured at current redemption value
18	Convertible debt for fixed number of shares	**Liability**	**Liability** Subsequently measured at fair value with changes in value reported in income.	**Equity and liability** Liability component is subsequently accreted. Equity component is not subsequently remeasured.	**Equity and liability** Both components subsequently measured at fair value with changes in value reported in income.

Table 2: Classification Examples (continued)

	Instrument	Current GAAP[9]	Basic Ownership	Ownership-Settlement	REO
19	Callable common share (fixed price)	**Equity**	**Equity** (Basic ownership instrument) Subsequently measured at current redemption value.	**Equity** (Perpetual instrument) Subsequently measured at current redemption value.	**Equity and liability** Both components subsequently measured at fair value with changes in value reported in income.
20	Callable preferred share (fixed price)	**Equity**	**Liability** Subsequently measured at fair value with changes in value reported in income.	**Equity** (Perpetual instrument) Subsequently measured at current redemption value.	**Equity and liability** Both components subsequently measured at fair value with changes in value reported in income.
21	Preferred share convertible into a fixed number of basic ownership instruments	**Equity**	**Liability** Subsequently measured at fair value with changes in value reported in income. (This instrument would be measured at fair value because it has a settlement requirement.)	**Equity** (Instruments with two equity components, such as this example, which has both a perpetual and a basic ownership instrument component, are not separated.) Not subsequently remeasured.	**Equity and liability** Both components subsequently measured at fair value with changes in value reported in income.

Table 2: Classification Examples (continued)

	Instrument	Current GAAP[9]	Basic Ownership	Ownership-Settlement	REO
22	Preferred share puttable, callable, and convertible	**Equity**	**Liability** Subsequently measured at fair value with changes in value reported in income.	**Equity and liability** Liability component is subsequently accreted. Equity component is not subsequently remeasured.	**Equity and liability** Both components subsequently measured at fair value with changes in value reported in income.
Other Instruments with Settlement Amounts Determined by Share Prices					
23	Note receivable settled with cash or a variable number of shares.[11]	**Asset (if cash settled)** **Contra-equity (if share settled)**	**Asset** Subsequently measured at amortized transaction price.	**Asset** Subsequently measured at amortized transaction price.	**Asset** Subsequently measured at amortized transaction price.
24	Debt indexed to shares (for example, convertible debt for which the entire conversion value is settled in cash)	**Liability (with a separated embedded derivative)**	**Liability** Subsequently measured at fair value with changes in value reported in income.	**Liability** Subsequently measured at fair value with changes in value reported in income.	**Equity** Subsequently measured at current redemption value.

[11]The example assumes the counterparty can choose the form of settlement. This fact is relevant to the current GAAP classification only.

Table 2: Classification Examples (continued)

	Instrument	Current GAAP[9]	Basic Ownership	Ownership-Settlement	REO
25	Variable share forward sales contract issued in conjunction (separately) with common share that is puttable at a fixed price[12]	**Equity**	**Liability** Subsequently measured at fair value with changes in value reported in income.	**Equity and liability** Liability component is subsequently accreted. Equity component is not subsequently remeasured.	**Equity and liability (or asset)** Both components subsequently measured at fair value with changes in value reported in income.

[12]This example assumes the instruments meet the linkage criteria and are combined and accounted for as one freestanding instrument.

Appendix D

RELATIONSHIP OF THE THREE APPROACHES TO THE CONCEPTUAL FRAMEWORK AND THE CONCEPTUAL FRAMEWORK PROJECT

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Appendix D

RELATIONSHIP OF THE THREE APPROACHES TO THE CONCEPTUAL FRAMEWORK AND THE CONCEPTUAL FRAMEWORK PROJECT

D1. All three approaches described in this Preliminary Views are inconsistent to varying degrees with the definitions of liabilities and equity in Concepts Statement 6. Current GAAP also is inconsistent with those definitions, which is one of the reasons the Board undertook this project. The Board is currently engaged in a joint project with the IASB to reconsider all aspects of the conceptual framework, including the definitions of liabilities and equity, but the Boards have not yet reached any conclusions.

D2. This appendix describes how current reporting requirements and each of the three approaches described in this Preliminary Views relate to the existing definitions of liabilities and equity. It also explains how the concept of a basic ownership instrument, which is fundamental to each of the approaches, relates to the exiting definitions. Finally, it offers suggestions for possible definitions of liabilities and equity that would be consistent with each approach. (**Note:** The Board has not debated the merits of the suggested definitions. They are presented to illustrate possibilities only.)

The Existing Definition of Liabilities Compared with Current Reporting Requirements

D3. The definition of a liability in paragraph 35 of Concepts Statement 6 is as follows:

> Liabilities are probable future sacrifices of *economic benefits* arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events. [Footnote references omitted; emphasis added.]

D4. The term *assets* can be substituted for the phrase *economic benefits* in that definition without changing the meaning. (Some liabilities require an entity to use its assets to provide services [for example, the use of cash to pay employees for providing the services]. Even if that is the case, however, assets are being sacrificed.)

D5. That substitution can be supported by two other paragraphs in Concepts Statement 6. First, paragraph 25 states that "assets are probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events" (footnote reference omitted). Second, paragraph 36 states that one essential characteristic of a liability is that "…it embodies a present duty or responsibility to one or more other entities that entails settlement by probable future transfer or use of assets…."

D6. In short, liabilities are present obligations that require future sacrifice of assets. Under that definition, obligations that require future sacrifices of equity instruments (issuance for compensation less than the market price at the date of issuance) are not liabilities, and mandatorily redeemable equity instruments are liabilities. Current GAAP and practices are inconsistent with that definition. For example, Statement 150 and EITF Issue No. 00-19, "Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock," require that some instruments that will be settled by delivery of an entity's own equity instruments be reported as liabilities, while mandatorily redeemable stock is usually reported in the mezzanine section of the balance sheet between liabilities and equity.

D7. The Board considered establishing new guidance that would be consistent with the current definition of liabilities but quickly rejected that alternative because of some obvious problems. For example, an entity with publicly traded stock could arrange to use its own stock as a currency to pay almost any debt and, thereby, avoid reporting a liability. Also, some entities (especially smaller nonpublic entities) would have no equity under a strict interpretation of the current definition because all of their stock is redeemable upon death or retirement of the holder.

Basic Ownership Instruments Are Fundamental to All Three Approaches

D8. All three of the approaches described in this Preliminary Views start with the concept of a basic ownership instrument—the class (or classes) of claims to assets of an entity that have the lowest priority in the event of bankruptcy or liquidation. The concept of a basic ownership instrument is consistent with (a subset of) the current definition of equity in paragraph 49 of Concepts Statement 6:

> Equity or net assets is the residual interest in the assets of an entity that remains after deducting its liabilities.

D9. A basic ownership instrument clearly is a residual because it is the lowest priority claim and thus does not depend on the definition of a liability. The definition of a basic ownership instrument can stand alone as a reasonable starting point for the definitions of liabilities and equity. In contrast, the current definition of equity cannot stand alone because it depends entirely on the definitions of assets and liabilities.

D10. The three approaches use the concept of a basic ownership instrument as follows:

a. *Basic ownership approach*—A liability is a claim against the entity that reduces the residual net assets available for distribution to the holders of basic ownership instruments. Equity includes only basic ownership instruments and components.
b. *Ownership-settlement approach*—Equity is a basic ownership instrument, a perpetual instrument, or an instrument that is settled by delivery or receipt of a basic ownership instrument and that has a fair value that is derived from the fair value of that same basic ownership instrument. A liability is an instrument that obligates the entity to deliver consideration that is not a

basic ownership instrument or that does not have a fair value derived from a basic ownership instrument.

c. *REO approach*—Equity is an instrument or component that has an ownership return, which means its fair value changes when the fair value of a basic ownership instrument changes (in either the same direction or the opposite direction). A liability is an instrument with a credit balance that does not have an ownership return.

Basic Ownership Approach

D11. The basic ownership approach differs from the current definition of a liability in two ways. First, a claim does not have to create an obligation to be considered a liability (for example, perpetual preferred stock with no dividend requirement). Second, the definition of a liability is not based on sacrifice of assets but on a negative effect on basic ownership instruments. A liability definition consistent with the basic ownership approach would be similar to the following:

> A *liability* is a claim, the probability-weighted outcome of which would reduce the assets available for distribution to basic ownership instruments.

D12. The term *probability-weighted outcome* is included to refer to derivatives, such as forward contracts, and similar instruments that might be assets or liabilities depending on changes in the underlying.

D13. One essential characteristic of a liability under the basic ownership approach is that if an entity's obligation is forgiven, that forgiveness would directly affect (increase) the assets available to holders of basic ownership instruments.

D14. Obligations to sacrifice assets nearly always reduce the assets available to holders of basic ownership instruments. The only exception is the distribution of assets to holders of basic ownership instruments in an amount equal to the value of the basic ownership instruments. (For entities without publicly traded basic ownership instruments, the basic ownership approach allows for distributions in amounts based on book-value-based formulas that are designed to approximate the fair values of the basic ownership instruments. That is a practical exception to the concept.) In that specific circumstance, the entity would have fewer assets after distribution, but the values of the remaining basic ownership instruments would be unaffected.

D15. Perpetual instruments other than basic ownership instruments create claims that reduce the amount of assets available to the basic ownership instruments because they have priority in liquidation.

Ownership-Settlement Approach

D16. The ownership-settlement approach is more similar to current practice than either the basic ownership approach or the REO approach. Thus, it is inconsistent with the current definitions of liabilities and equity for the same reasons as current GAAP. Certain instruments are liabilities even though they require or permit issuance of equity

instruments instead of a sacrifice of assets. Also, certain instruments are equity even though they require a sacrifice of assets.

D17. Basic ownership instruments are equity under the ownership-settlement approach (as they are under the other two approaches). In addition, perpetual instruments are equity. Finally, some instruments with ownership returns are equity, the same as they are under the REO approach. Not all instruments with ownership returns are equity, however. Under the ownership-settlement approach, an instrument with an ownership return would be equity only if its return has the same sign (positive or negative) as basic ownership instruments and, even then, only if it must be settled by issuing or receiving basic ownership instruments.

D18. The following definition of equity can be inferred from the requirements of the approach:

Equity is a claim against an entity that meets **either** of the following conditions:

a. It does not require a settlement before liquidation that would negatively affect the assets available to the entity's basic ownership instruments; or
b. It will be settled by issuing basic ownership instruments, and changes in its fair value are contractually linked to and have the same sign as changes in fair value of the same basic ownership instruments.

D19. The definition of a liability under the ownership-settlement approach might be similar to the following:

> A *liability* is an obligation of an entity that will require the entity to deliver assets or issue equity instruments and that has a fair value that either is not contractually linked to changes in fair values of basic ownership instruments or is contractually linked but has the opposite sign.

REO Approach

D20. Classification of instruments under the REO approach depends entirely on the type of return an instrument provides. An instrument with an ownership return is equity, and an instrument with any other type of return is either an asset or a liability. An instrument has an ownership return if changes in its fair value are contractually linked to changes in the fair value of a basic ownership instrument.

D21. Similar to the basic ownership approach, the REO approach is not based on a present obligation or a sacrifice of assets; therefore, it is inconsistent with the current definitions of liabilities and equity. Those definitions cannot be easily revised to accommodate the REO approach. Completely new definitions based on ownership returns would be needed. The following is one possible set of definitions:

> *Equity* is a claim against an entity (whether obtained from a contract, an ownership interest, or another type of obligation), the fair value of which is contractually linked to the fair value of a basic ownership instrument with

changes occurring in the same direction as or the opposite direction from a basic ownership instrument.

A *liability* is a claim to the assets of an entity, the fair value of which is not contractually linked to the fair value of a basic ownership instrument.

D22. Phase B of the FASB's and IASB's joint conceptual framework project, which will reconsider the definitions of assets, liabilities, and equity, is in its beginning stages. The definitions presented in paragraphs D11, D18, D19, and D21 may or may not be consistent with the Boards' final definitions of elements in that project. However, the Boards have identified several practice problems in current GAAP related to instruments within the scope of this project that need to be resolved at a standards level before the elements definitions are completed in the conceptual framework project. Although one of the Boards' goals is to develop a comprehensive standard on liabilities and equity that is consistent with the current and future conceptual framework, that is not possible in this phase of the liabilities and equity project. The conceptual framework project will address differences created by the standards-level project.

Appendix E

HISTORY OF THE LIABILITIES AND EQUITY PROJECT AND OTHER APPROACHES CONSIDERED

History

E1. The Board added a broad financial instruments project to its agenda in 1986. The dates and titles of key documents issued as part of the liabilities and equity portion of that project are as follows:

a. August 1990—FASB Discussion Memorandum, *Distinguishing between Liability and Equity Instruments and Accounting for Instruments with Characteristics of Both* (1990 Discussion Memorandum)
b. October 2000—FASB Exposure Draft, *Accounting for Financial Instruments with Characteristics of Liabilities, Equity, or Both* (2000 Exposure Draft)
c. October 2000—FASB Exposure Draft, *Proposed Amendments to FASB Concepts Statement No. 6 to Revise the Definition of Liabilities* (Concepts Exposure Draft)
d. May 2003—FASB Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*
e. November 2003—FASB Staff Position (FSP) FAS 150-3, *Effective Date, Disclosures, and Transition for Mandatorily Redeemable Financial Instruments of Certain Nonpublic Entities and Certain Mandatorily Redeemable Noncontrolling Interests under FASB Statement No. 150.*

E2. Some other important standards for distinguishing between liability instruments and equity instruments include:

a. APB Opinion No. 14, *Accounting for Convertible Debt and Debt Issued with Stock Purchase Warrants*
b. EITF Issue No. 00-19, "Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock."

E3. After issuing the 1990 Discussion Memorandum and holding public hearings in 1991, the Board decided to suspend work on the liabilities and equity project to devote its resources to financial instruments projects that it judged to be more urgent at the time. The project was reactivated in December 1996. That effort led to an Exposure Draft in October 2000.

E4. The 2000 Exposure Draft addressed a broad range of liability and equity classification issues. During 2001 and 2002, the Board met with various constituents, held a public roundtable meeting, and redeliberated the issues. At the end of 2002, the Board had affirmed its conclusions in the 2000 Exposure Draft that the following types of instruments should be classified as liabilities: mandatorily redeemable instruments,

instruments that obligate the issuer to repurchase its own equity instruments for cash or other assets, and certain instruments that the issuer must or can settle by issuing a variable number of its own equity shares.

E5. Although the Board had not finished its deliberations on all issues addressed in the 2000 Exposure Draft, it decided to issue a limited-scope Statement to provide necessary and timely guidance for certain troublesome instruments for which the practice problems were clear and resolvable. The Board issued Statement 150 to require classification as liabilities (or assets in some circumstances) for the specific types of instruments about which it had affirmed its conclusions. In that Statement, the Board stated that it planned to continue redeliberating the remaining issues and issue another Statement at a future date. Changes proposed in the Concepts Exposure Draft were delayed because the Board believed that resolution of the remaining issues in the 2000 Exposure Draft could affect any modification to the definition of a liability.

E6. Shortly after the issuance of Statement 150, constituents raised questions about certain types of mandatorily redeemable instruments. To give itself time to resolve those issues, the Board directed the FASB staff to issue FSP FAS 150-3 to defer the effective date for applying the provisions of Statement 150 for:

a. Mandatorily redeemable financial instruments of certain nonpublic entities
b. Certain mandatorily redeemable noncontrolling interests.

Although the Board had stated in Statement 150 that its next step would be to redeliberate the remaining issues discussed in the 2000 Exposure Draft and not resolved by that Statement, the Board changed its plan. The new plan was to start over and attempt to develop a convergent set of classification principles that would avoid the issues raised by Statement 150, as well as resolve the remaining issues.

Other Approaches Briefly Discussed but Not Fully Developed

The Claims Approach—No Distinction between Liabilities and Equity

E7. One possibility discussed in the 1990 Discussion Memorandum is to eliminate the distinction between liabilities and equity. Claims against the entity would be displayed in order of priority. The credit balance accounts on the statement of financial position would add to total claims. There would be no subheading or subtotal for liabilities or equity. The Board concluded that classifying all claims in a single category may avoid the need to deal with difficult classification issues, but it actually changes the nature of the problem. It does not resolve the issue of how to report and measure the claims and distributions related to the claims. Unless all claims are measured the same way, and the changes in their value are reported the same way, the distinction between liabilities and equity is necessary.

E8. More recently, the claims approach was discussed in the Board's conceptual framework project. The discussion was about defining only two elements of the statement of financial position instead of the current three. Instead of balancing assets

with liabilities and equity, the new statement of financial position would balance assets with claims. Some Board members criticized the claims approach as leaving an important conceptual issue to be decided in individual standards. The current definitions attempt to answer two questions: which claims should be recognized and which recognized claims will affect net income? The claims approach would answer only the first of those two questions.

E9. The Board probably will not discuss the claims approach again unless comments on the proposed approaches in this Preliminary Views persuade it otherwise. Respondents who favor eliminating the distinction between liabilities and equity are urged to provide details on how different types of instruments would be measured, whether changes in carrying value would affect net income, and how they would be presented in the financial statements.

The Mezzanine Approach—Add an Element between Liabilities and Equity

E10. The 1990 Discussion Memorandum also considered adding a fourth element to the statement of financial position and placing it between liabilities and equity. The Board did not decide what type of instruments would be displayed in this category; however, it identified two possibilities. The third element could include instruments that (a) have characteristics of both liabilities and equity, such as convertible debt, or (b) are currently displayed as temporary equity under Accounting Series Release No. 268, *Presentation in Financial Statements of "Redeemable Preferred Stocks."* The Board rejected that approach because it was concerned that adding a separate element would set a precedent for creating new elements whenever difficult classification issues arose. The Board also concluded that it would still have to address how to measure instruments in the third element and where the changes in value related to those instruments should be reported.

Loss Absorption Approach

E11. A constituent group partially developed and presented the loss absorption approach to the Board. This approach classifies instruments or components of instruments as equity if the instrument's claim on net assets is reduced if the entity incurs a loss. In contrast, if the claim represented by a debt instrument does not change due to an entity's losses, it is classified as a liability. Note that the value of a debt holder's claim may decrease and the probability of receiving any cash flows may change if the issuer incurs the losses, but the legal amount of the claim is unaffected. The approach may be further developed and presented to the Board again at a later date.

QUESTIONS ON OTHER ALTERNATIVES

1. Is there a variation of any of the approaches described in this Preliminary Views or an alternative approach that the Board should consider? How would the approach classify and measure instruments? Why would the variation or alternative approach be superior to any of the approaches the Board has already developed?

Appendix F

GLOSSARY

F1. This appendix defines terms used in this Preliminary Views.

Basic ownership instrument

A basic ownership instrument has both of the following characteristics:

1. The holder has a claim to a share of the assets of the entity that would have no priority over any other claims if the issuer were to liquidate on the date the classification decision is being made; and
2. The holder is entitled to a percentage of the assets of the entity that remain after all higher priority claims have been satisfied. The holder's share depends on its share of the total claims with the lowest priority and has no upper or lower limit except for the amount of assets available.

Callable common or preferred stock

An instrument in which the holder receives participation in profits and losses of an entity in exchange for its contribution, and the issuer of the instrument has the right to redeem the stock.

Convertible debt

A debt security that is convertible into common stock of the issuer or an affiliated company at a specified price at the option of the holder.

Current redemption value

The fair value of the consideration that would be paid if the instrument were redeemed at the measurement date.

Derivative

A financial instrument or other contract with all three of the following characteristics:

1. It has (a) one or more underlyings and (b) one or more notional amounts or payment provisions or both. Those terms determine the amount of the settlement (or settlements), and, in some cases, whether or not a settlement is required.
2. It requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors.

3. Its terms require or permit net settlement, it can readily be settled net by a means outside the contract, or it provides for delivery of an asset that puts the recipient in a position not substantially different from net settlement.

Embedded derivative

A financial instrument with implicit or explicit terms that affect some or all of the cash flows or the value of other exchanges required by the contract in a manner similar to a derivative instrument.

Equity derivative

A financial instrument (freestanding or embedded) with the price of the entity's own basic ownership instrument as the predominant underlying. An equity derivative may or may not have all of the characteristics of a derivative instrument. For example, physically settled forward option contracts on the shares on a nonpublic entity are considered equity derivatives even though they do not require or permit net settlement or provide for the delivery of an asset that puts the recipient in a position not substantially different from net settlement.

Financial instrument

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

1. Imposes on one entity a contractual obligation[16] (a) to deliver cash or another financial instrument[17] to a second entity or (b) to exchange other financial instruments on potentially unfavorable terms with the second entity; and
2. Conveys to that second entity a contractual right (a) to receive cash or another financial instrument from the first entity or (b) to exchange other financial instruments on potentially favorable terms with the first entity.

[16]"*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." [Statement 133, paragraph 540, fn*]

[17]"*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." [Statement 133, paragraph 540, fn‡]

Forward contract

An agreement to exchange assets at a specified future date and at a specified rate.

Forward purchase contract

An agreement to purchase shares at a specified future date and at a specified price.

Hybrid instrument

A contract that embodies both an embedded derivative and a host contract.

Indirect ownership instrument

An indirect ownership instrument has the following three characteristics:

1. It is not perpetual.
2. Its terms link its value to the price of a basic ownership instrument and cause its fair value to change in the same direction as the fair value of that basic ownership instrument.
3. It does not include a contingent exercise provision based on either of the following factors:
   (a) A market price for anything other than the reporting entity's basic ownership instruments; or
   (b) A price index other than an index calculated or measured solely by reference to the reporting entity's own operations (for example, revenue of the reporting entity).

Intrinsic value

The amount by which the fair value of the underlying stock exceeds the exercise price of an option.

Issuer

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

Net-cash settled

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 settled (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.

Perpetual instrument

An instrument that has no settlement requirement and entitles the holder to a portion of the issuer's net assets in liquidation. A perpetual instrument may be callable by the issuer provided that it is not also (1) mandatorily redeemable or (2) redeemable at the option of the holder under any circumstances.

Physically settled

A form of settling a financial instrument under which (1) the party designated in the contract as the buyer delivers the full stated amount of cash or other financial instruments to the seller and (2) the seller delivers the full stated number of shares of stock or other financial instruments or nonfinancial instruments to the buyer.

Physically settled forward sales contract

An agreement to sell shares at a specified future date for a specified price that will be settled by delivering the full stated amount of cash or other financial instruments.

Purchased call option

A contract that gives an entity the right, but not the obligation, to purchase a certain number of its shares from a counterparty at a predetermined price for a specified period of time.

Puttable stock

An instrument in which a counterparty (1) receives participation in profits and losses of an entity in exchange for its contribution and (2) has the right to put the stock back to the issuer at a specified price.

Registration rights penalty

A promise to remit consideration to an investor if an instrument held by that investor is (1) not registered for public trading by a specified date or (2) not listed on a stock exchange by a specified date.

Variable interest entity

An entity subject to the consolidation provisions of FASB Interpretation No. 46 (revised December 2003), *Consolidation of Variable Interest Entities.*

Written call option

A contract that gives a counterparty the right, but not the obligation, to purchase a certain number of an entity's shares from that entity at a predetermined price for a specified period of time.

Written put option

A contract that gives a counterparty the right, but not the obligation, to sell a certain number of an entity's shares to that entity at a predetermined price for a specified period of time.

Appendix G

EFFECT ON RELATED AUTHORITATIVE LITERATURE

G1. Below is a list of authoritative literature that would be significantly affected (and in many cases eliminated) by the Board's tentative decisions. The list is not, and is not meant to be, comprehensive.

a. FASB Statement No. 84, *Induced Conversions of Convertible Debt*
b. FASB Statement No. 123 (revised 2004), *Share-Based Payment*
c. FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*
d. FASB Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*
e. FASB Statement No. 155, *Accounting for Certain Hybrid Financial Instruments*
f. APB Opinion No. 14, *Accounting for Convertible Debt and Debt Issued with Stock Purchase Warrants*
g. APB Opinion No. 21, *Interest on Receivables and Payables*
h. APB Opinion No. 26, Early Extinguishment of Debt
i. AICPA Accounting Interpretation 1, "Debt Tendered to Exercise Warrants," of Opinion 26
j. FSP FAS 150-1, *Issuer's Accounting for Freestanding Financial Instruments Composed of More Than One Option or Forward Contract Embodying Obligations under FASB Statement No. 150*
k. FSP FAS 150-2, *Accounting for Mandatorily Redeemable Shares Requiring Redemption by Payment of an Amount That Differs From the Book Value of Those Shares under FASB Statement No. 150*
l. FSP FAS 150-3, *Effective Date, Disclosures, and Transition for Mandatorily Redeemable Financial Instruments of Certain Nonpublic Entities and Certain Mandatorily Redeemable Noncontrolling Interests under FASB Statement No. 150*
m. FSP FAS 150-4, Issuers' *Accounting for Employee Stock Ownership Plans under FASB Statement No. 150*
n. FSP FAS 150-5, *Issuer's Accounting under FASB Statement No. 150 for Freestanding Warrants and Other Similar Instruments on Shares That Are Redeemable*
o. FSP EITF 00-19-2, *Accounting for Registration Payment Arrangements*
p. EITF Issue No. 90-19, "Convertible Bonds with Issuer Option to Settle for Cash upon Conversion"
q. EITF Issue No. 96-19, "Debtor's Accounting for a Modification or Exchange of Debt Instruments"
r. EITF Issue No. 98-5, "Accounting for Convertible Securities with Beneficial Conversion Features or Contingently Adjustable Conversion Ratios"

s. EITF Issue No. 99-1, “Accounting for Debt Convertible into the Stock of a Consolidated Subsidiary”

t. EITF Issue No. 99-7, “Accounting for an Accelerated Share Repurchase Program”

u. EITF Issue No. 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”

v. EITF Issue No. 00-6, “Accounting for Freestanding Derivative Financial Instruments Indexed to, and Potentially Settled in, the Stock of a Consolidated Subsidiary”

w. EITF Issue No. 00-19, “Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company’s Own Stock”

x. EITF Issue No. 00-27, “Application of Issue No. 98-5 to Certain Convertible Instruments”

y. EITF Issue No. 01-6, “The Meaning of ‘Indexed to a Company's Own Stock’”

z. EITF Issue No. 03-7, “Accounting for the Settlement of the Equity-Settled Portion of a Convertible Debt Instrument That Permits or Requires the Conversion Spread to Be Settled in Stock (Instrument C of Issue No. 90-19)”

aa. EITF Issue No. 05-1, “Accounting for the Conversion of an Instrument That Becomes Convertible upon the Issuer’s Exercise of a Call Option”

bb. EITF Issue No. 05-2, “The Meaning of ‘Conventional Convertible Debt Instrument’ in Issue No. 00-19”

cc. EITF Issue No. 06-6, “Debtor’s Accounting for a Modification (or Exchange) of Convertible Debt Instruments”

dd. EITF Issue No. 06-7, “Issuer’s Accounting for a Previously Bifurcated Conversion Option in a Convertible Debt Instrument When the Conversion Option No Longer Meets the Bifurcation Criteria in FASB Statement No. 133”

ee. ASR No. 268, *Presentation in Financial Statements of “Redeemable Preferred Stocks,”* and EITF Topic No. D-98, “Classification and Measurement of Redeemable Securities.” (The SEC staff would determine if and how ASR 268 and Topic D-98 would be affected.)